Université de Montréal

Promoting while checking self-interest: A conflict-based governance approach to rebalance corporate power disequilibria in Canada and the United States

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Ce mémoire intitulé:

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ABSTRACT

The delegation of power to corporate directors and officers (Insiders), an essential trait of modern firm management in the context of capitalism, presents desirable efficiency advantages. However, it also confers broad discretion to Insiders . This discretion, when unchecked, may lead to self-interested opportunistic behaviour detrimental to the firm and to the outside shareholders (Outsiders) who supply finance to the firm but do not have management power.

Conflicts between Insiders and Outsiders may emerge from either general governance decisions or from particular transactions (ie. takeovers). In extreme cases, these conflicts can lead to the bankruptcy of the firm or, in more typical cases, to the extraction of private benefits for Insiders, shareholder expropriation and value-reducing actions for the firm. We take the perspective of an outside shareholder to explore corporate governance mechanisms available in the US and Canada.

After reviewing in Part 1 the core theories underlying the study of power in the modern corporation (separation of ownership and control and agency conflicts), we focus in Part 2 on the (1) internal governance, (2) regulatory and (3) market mechanisms through which both Insiders and Outsiders draw power. We examine how Outsiders can harness these mechanisms to check Insiders, as well as to prevent and resolve various types of conflicts. In Part 3, we explore a corporate power equilibrium that helps to minimize Insider opportunism, while reserving sufficient Insider discretion for effective firm management. We make the case for strengthening protections for shareholders and provide an overview of potential legislative reform paths.

Keywords: Corporate governance, Shareholder rights, Elections, Compensation

Promouvoir tout en contrôlant l'intéret personnel :
Une approche de gouvernance d'entreprise centrée sur les conflits pour rebalancer
les déséquilibres de pouvoir corporatif au Canada et aux États-Unis

RÉSUMÉ

La délégation du pouvoir de gestion aux administrateurs et aux gestionnaires, une caractéristique intrinsèque à la gestion efficace de grandes entreprises dans un contexte de capitalisme, confère une grande discrétion à l'équipe de direction. Cette discrétion, si elle n'est pas surveillée, peut mener à des comportements opportunistes envers la corporation, les actionnaires et les autres fournisseurs de capital qui n'ont pas de pouvoir de gestion.

Les conflits entre ces deux classes d'agents peuvent émerger à la fois de décisions de gouvernance générale ou de transactions particulières (ie. offre publique d'achat). Dans les cas extrêmes, ces conflits peuvent mener à la faillite de la firme. Dans les cas plus typiques, ils mènent l'extraction de bénéfices privés pour les administrateurs et gestionnaires, l'expropriation des actionnaires, et des réductions de valeur pour la firme. Nous prenons le point de vue d'un petit actionnaire minoritaire pour explorer les méchanismes de gouvernance disponibles au Canada et aux États-Unis.

Après une synthèse dans la Partie 1 des théories sous-jacentes à l'étude du pouvoir dans la corporation (séparation de la propriété et du contrôle et les conflits d'agence), nous concentrons notre analyse dans la Partie 2 sur les différents types de méchanismes (1) de gouvernance interne, (2) juridiques et (3) marchands, qui confèrent du pouvoir aux deux classes d'agents. Nous examinons comment les intérêts de ces deux classes peuvent être réalignés afin de prévenir et résoudre les conflits au sein de la firme. La Partie 3 explore un équilibre dynamique de pouvoir corporatif qui cherche à minimiser le potentiel d'opportunisme toute en préservant une quantité de discrétion suffisante pour la gestion efficace de la firme. Nous analysons des moyens pour renforcer les protections des actionnaires minoritaires et proposons un survol des pistes de réforme possibles.

Mots clés: Gouvernance d'entreprise, droits des actionnaires, élections, compensation.

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LIST OF ABBREVIATIONS

CBCA	Canadian Business Corporation Act
CCGG	Canadian Coalition for Good Governance
CCQ	Civil Code of Quebec
CEO	Chief Executive Officer
CSA	Canadian Securities Administrators
DGCL	Delaware General Corporate Law
ESB	Effective Staggered Board
FTC	Federal Trade Commission
IIF	Institute of International Finance
IPO	Initial Public Offering
ISS	Institutional Shareholder Services
NLERS	Non-Legally Enforceable Rules and Standards
NPV	Net Present Value
NYSE	New York Stock Exchange
OCA	Ontario Corporations Act
OECD	Organization for Economic Co-Operation and Development
QCA	Quebec Companies Act
RMBCA	Revised Model Business Corporations Act
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act of 2002
SPV	Special Purpose Vehicle

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INTRODUCTION

Over the past decade, the financial markets and the confidence of investors in North America have been severely tested by two important strings of corporate scandals.

The first wave of scandals occurred from 2000 to 2003 and featured mainly corporate giants such as Enron, WorldCom, Adelphia, Global Crossing and Tyco. The second wave of scandals occurred from 2008 to 2009 and featured financial giants such as Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac and AIG.

Both waves had similarly devastating consequences for the North American economy: bankruptcies, restructurings, employee layoffs, shareholder losses and lawsuits, the destruction of billions of dollars of value, and large government bailouts financed with taxpayer money.

At first glance, different mechanisms seemed to have triggered these two waves of massive failures. On the one hand, the corporate giants failed because of financial misstatements, out-of-control personal loans to executives, and dormant auditing practices by accountants. On the other hand, the financial giants failed because of bad loans to homeowners, the collapse of the housing bubble and the implosion of complex structured financial products.

However, in many ways, the underlying roots of these failures may actually be quite similar.

At the most basic level, as frequently portrayed in the business press, both waves were similar in that the scandals were fueled by elements of human nature, such as excess hubris, avarice, and greed or, at the very least, the tendency of some managers and directors to place their own self-interest above the interests of the corporation.

Closer analysis also reveals that failings in both waves related not only to elements of human nature, but to many specific corporate governance mechanisms, such as the oversight of executive compensation, corporate elections and related-party transactions. Exploitable flaws in these corporate mechanisms created a poor governance environment in these corporations, which generally enabled wrongdoing and opportunistic behaviour. In turn, this allowed classic corporate conflicts to flourish, such as management entrenchment, misappropriation and self-dealing.

If corporate governance "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment"[1], we explore how outside shareholders can leverage corporate governance to protect their interests against such insider opportunism.

Furthermore, it seems likely that such massive failures could have been averted with healthier governance environments built on stronger checks and balances in those corporations.

In the recent paper *The Corporate Governance Lessons from the Financial Crisis* prepared by the OECD, the international agency concludes that the second wave of scandals "can be to an extent attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk-taking in a number of financial service companies" and proposes that the "adequacy of corporate governance principles" be re-examined[2].

This paper will examine how key corporate governance mechanisms could be strengthened. The aim is not only to explore how future failures and how destruction of value can be prevented, but indeed how to foster the participation of all corporate agents (managers, directors, shareholders and other stakeholders) in order to create a healthy corporate governance environment that stimulates the creation and preservation of value.

In terms of the methodology of this paper, its aim is to provide the reader with a solid theoretical overview of the key corporate governance concepts pertinent to analyzing conflicts of power within the corporation in Canada and the US. Our analysis follows an approach rooted in the economic analysis of law. Further, breadth is often preferred to depth (except for a few core recurring issues, such as corporate elections and executive compensation) in order to compose a summary of the often extensive scholarship on most of the various relevant corporate governance issues. As best possible, our analysis looks to organize governance mechanisms by whether they generally confer more power to Insiders or to Outsiders. Our analysis also insists slightly more on the US context, while noting relevant differences in Canada (especially given the vastly different ownership landscape) necessary to a fuller theoretical understanding.

1 THE FOUNDATIONS OF POWER

1.1 Self-Interest, Capitalism and the Modern Corporation

1.1.1 Self-Interest

> "It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own self-interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages". – Adam Smith
>
> "All for ourselves, and nothing for other people, seems, in every age of the world, to have been the vile maxim of the masters of mankind" – Adam Smith[3]

In 1776, Adam Smith posits in *The Wealth of Nations* that self-interested competition maximizes the welfare of society. If individuals pursue their own "wants and needs", the invisible hand of the free market should optimally allocate resources among market participants via the forces of supply and demand.

However, in a later passage titled *Of the Different Progress of Opulence in Different Nations* of the same book, Smith also warns us against the danger and evil of this same central notion of self-interest. In his treaty, Smith "criticizes those who act purely out of self-interest and greed"[4].

Self-interest is unmistakably a key ingredient in the fuel of the capitalist engine, as well as a key driver for the creation of wealth, economic progress and the welfare of society. It is difficult to argue that we would enjoy our current standard of living had it not been for return-seeking entrepreneurs willing to tackle ambitious and risky projects out of their own rational self-interest. However, for all its merits, as Smith exposes, excess or unbridled self-interest can equally lead to undesirable value-destroying outcomes.

Several centuries later, it is hard not to witness the dual role of self-interest at work. Whereas the self-interest of men created important organizations such as Enron, WorldCom and Tyco at the end of the 20th century, and Bear Stearns, Lehman Brothers and AIG at the start of the 21st century, all of which created tremendous value for society, it appears that unbridled self-interest may also have been the root cause that led to their ultimate demise.

Self-interest, it appears, is a value that needs to be vigorously promoted, while, at the same time, acutely checked.

1.1.2 Ownership and Control

In 1932, Berle and Means agree with Smith in their legendary work *The Modern Corporation* that self-interest has indeed long been a potent force motivating and organizing economic activity:

> "Whereas the organization of feudal economic life rested upon an elaborate set of binding customs, the organization under the system of private enterprise has rested on self-interest of the property owner – a self-interest held in check only by competition and the conditions of supply and demand. Such self-interest has long been regarded as the best guarantee of economic efficiency. It has been assumed that, if the individual is protected in the right both to use his own property as he sees fit and to receive the full fruits of its use, his desire for personal gain, for profits, can be relied upon as effective incentive to his efficient use of any industrial property he may possess"[5].

However, Berle and Means warn that the self-interest paradigm may not longer hold in quite the same way in the context of modern corporations:

> In the quasi-public corporation, such an assumption no longer holds. […] It is no longer the individual himself who uses his wealth”[6].

Specifically, Berle and Means warn that due to a phenomenon they termed the “explosion of the atom of property”, ownership and control have been separated in modern corporations. The individuals who “control the destinies of firms” have control over large amounts of wealth without significant ownership, while the owners own such a small fraction of the wealth pool that they are in effect stricken from exercising any meaningful amount of control.

The traditional concept of property, as defended by Adam Smith, involved the reunion of ownership and control. An individual property owner had all the rights of possession over the property and could use them or dispose of as he thought proper. For example, an individual owner of a small family retail business could personally choose the managers of the store, could operate the business as he thought fit, could take the profit he deemed appropriate, could decide to close the trade and could even decide to sell the store if he owned it. Berle and Means summarize Adam Smith’s view this way: “To Adam Smith and his followers, private property was a unity involving possession. Ownership and control were combined”[7].

In this new form of organization, the modern corporation, Berle and Means suggest that the explosion of the atom of property inevitably leads to conflict as soon as the self-interest of the individuals owning the property does not align with the self-interest of the individuals controlling/managing the property. Conflict also arises, perhaps in a less obvious way, either when the self-interests of the individuals inside the “ownership” group itself do not align, or when the self-interests of the individuals inside the “control” group itself do not.

How exactly did the modern corporation bring about the explosion of the atom of property? How did this explosion lead to such a dis-alignment of incentives?

1.1.3 The Modern Corporation

The corporate form of organization was brought about in the 19th century by man’s ambition to undertake endeavours too large for himself to handle alone. Projects like railroads, industrial technologies or telecom networks were by their sheer size too risky for one party to manage, or to finance. Specialization of tasks became increasingly necessary to complete these ambitious projects, which gave rise to two classes of corporate agents: suppliers of management and suppliers of finance.

Suppliers of management are what Berle and Means refer to as those individuals who “control the wealth” or “control the destinies of the firm”[8]. They are often professional managers, who by their experience and industry knowledge, can “secure industrial efficiency and produce profits” for the firm. Suppliers of finance are what Berle and Means refer to as those individuals “to whom the profits of the corporation go”[9]. They can be either suppliers of equity or debt finance, although we will focus our analysis on equity suppliers, notably shareholders.

Modern corporations, enabled by corporate law, emerged as the vehicle for organizing the relationships between these two groups, especially in that its "legal personality" permitted the separation of management and finance, also understood as separation of control and ownership.

Of the five key tenants of the modern corporation cited below by Yale professor Henry Hansmann and Harvard professor Reinier Kraakman, two leading corporate governance scholars, all five support and enable greater separation of management and finance:

1. Delegated management
2. Limited liability of the shareholders
3. Investor ownership
4. Separate legal personality of the corporation
5. Transferability of shares

While the "explosion of the atom property" provides a sound conceptual base to help understand the separation of ownership and control, a brief review of history reveals a number of developments that have significantly accelerated the explosion of the atom and the emergence of the modern corporation. This review will help to complete our understanding of the root causes of the corporate conflicts this paper will seek to analyze.

1.1.4 Capitalism in the 19th and 20th Century

The power dynamics of the modern North-American corporation are a product of their heritage. Four key series of developments particularly shaped these power dynamics:

i) The Factory and The Industrial Revolution

The factory system was the foundation of the industrial revolution. The industrial revolution replaced an economy based on manual labour with an economy based on manufacturing, machinery and tools. The Industrial Revolution is generally divided into two periods.

The **First Industrial Revolution** began in England and Europe in 1780 but gained momentum around 1830-1840. The first factories were also opened in England, with a silk factory at Derby in 1721 and bronze factory in Bristol in 1746. In general, the first industrial revolution is characterized by early production breakthroughs in the mechanical industries of textiles, new techniques of metallurgy (including iron), expansion of roads and other commercial channels (including channels , railways, etc ...), and the introduction of new energy sources (including steam and coal). These developments introduce significant increases in productivity and capacity.

The **Second Industrial Revolution**, an extension of the first, began around 1850-70 and marked the development of new technologies, further increasing the productivity of enterprises, namely: the internal combustion engine, the development of ships with steam engines, electricity, communication facilities (including typography) and ultimately the assembly line. The second industrial revolution also marked the replacement of England by Germany and the United States as the dominant economies. In the United States, we associate this period to inventors such as Edison and Westinghouse, assembly line pioneers such as Taylor and Gantt, and to industrialists such as

Ford. It is through advances and inventions of such men that the grouping of workers in factories became both possible and desirable. It is therefore not surprising to see why, shortly after the formation of the first large factories, we observe the formation of the first major corporations (General Electric, U.S. Steel, Bayer AG and others). These large public or quasi-public corporations, emerging as early as 1890, are concentrated in important new areas, including: automobile production, steel, chemicals, petroleum refining, electrical and hydro and power, among others. According to Berle and Means, among the first corporations formed in the US were the Boston Manufacturing Company, which operated textile plants, in 1813 (although it would only attain diffuse ownership around 1830-1840) and the New York Central Railroad in 1853[10]. In addition to bringing about large corporations, the factories also contributed to the development of modern cities by attracting skilled workers around the sites of these factories, thus helping to organize overall economic activity.

Thus, the **factory plant** uniquely enabled the consolidation of a large number of workers under one roof, both in the physical sense and in the figurative sense of bringing employees under the control of a single, unified direction. The factory fostered the emergence of large public corporations, especially by promoting the concentration of managerial power in the hands of controlling leaders.

ii) The Liberalization of the US Charter System

Prior to the Industrial Revolutions, much of the economic activity was organized under the legal forms of “sole proprietorship”, “limited partnership” or “trusts”. In the US, corporations were initially created only by special act of government legislation under the **“Charter” system**. The Charter system was limited initially to public-vocation institutions like schools. It would seem that the oldest corporation was the “President and Fellows of Harvard College (Harvard Corporation)”, which received its charter in 1650. Furthermore, beyond this limitation, the government-run Charter system also imposed a number of important restrictions on business activity. First, it imposed restrictions on the mission and duration (e.g. 50 years) of the corporation, which allowed the government to control and organize competition, and allowed investors to know precisely the nature of the corporation’s business activities[11]. Second, it imposed contributions in capital as payments, which supposedly protected creditors against free-spending corporations which could not meet their obligations. Third, it imposed tight restrictions on the capital structure of the corporation, which allowed a standardisation of financial structures that eased government oversight.

In essence, the government had a very tight hold on corporations through its permit-style Charter system. This is why several noteworthy business pioneers chose to avoid this Charter system altogether. Andrew Carnegie’s US Steel was initially constituted as a “limited partnership” and John D. Rockefeller’s Standard Oil was constituted as a “trust”. Governments were however quick to recognize that **liberalization** of the Charter system would create important new revenue streams. States were progressively allowed to incorporate organizations under their laws, for an unlimited duration and with few restrictions. Interestingly enough, the notion of a perpetual life organization with a distinct moral personality was seemingly inspired by Canon law, where the Church was seen

as a separate entity with an eternal life beyond that of its mortal constituents. Berle and Means comment on how this liberalization of the Charter system impacted corporation ownership: "The gradual breaking up of this rigid situation always in the direction of granting to management (…) a wider latitude of power, roughly accompanies the appearance of large scale production and growth in the number of shareholders"[12].

The relaxed system of incorporation also brought to the forefront another very appealing feature of corporations distinct from other organizational options available at the time (trusts or partnerships): limited responsibility. Limited responsibility was made possible by the recognition of the corporation as an entity separate from the people owning it. Legal personality was recognized perhaps originally in an obiter dictum from the 1886 *Santa Clara County v. Southern Pacific Railroad*[13] case dealing with taxation of railroad properties, about which Justice Black later wrote that the court had "decided for the first time that the word 'person' in the amendment did in some instances include corporations."[14]. Prior, proprietors were personally responsible for the losses of their enterprise, making entrepreneurship riskier. Capital formation and **risk-taking** were greatly accelerated by allowing for proprietors to shield their personal wealth from that of the corporation. It also enabled growth in the sheer **size of corporations** from modest grouping into "great aggregations" organized under the corporate form, that were operated under "unified control and management" and that worked towards a common objective of production[15].

iii) The development of capital markets and the rise of the individual investor

Financial markets are a critical platform to efficiently mediate relationships between suppliers of finance and suppliers of management. In the United States, the first financial stocks began to trade in 1790 when the federal government issued bonds to refinance the Revolutionary War[16]. In 1792, the signing of the Buttonwood Agreement gave rise to the New York Stock Exchange, after which followed the **first meaningful exchange of financial securities**. But it was not until 1820-1830 that we can speak of an organized and consistent financial market, particularly following the establishment of the Constitution and the adoption of rules for the NYSE in 1817[17]. During this period, the securities of railroads and utilities dominated trading activity. Early on, large public corporations had access to reliable financial markets. Access to capital markets facilitated the transition of private enterprise to the open/public form. Through 1835, when the trading volume had already increased by a multiple of 50x in just 7 years, and until the late 19th century, the financial markets grew quickly to accommodate the capital requirements of large public corporations.

Financial markets would also gradually provide a **new way for individuals to save and invest** in the economic development of their country. The market managed to create an important new class of investors, small individual shareholders, that would be a growing source of capital for these corporations. These developments would eventually lead later, in the 20th century, to the era of "popular capitalism", where individual investors (not qualified managers for the vast majority) gradually flooded the market and abandoned their control to the management team. Berle and Means qualify this class as "a large body of security holders who exercise virtually no control over

the wealth"[18]. Government savings plans played an important role in further promoting to small investors the idea of allocating a fraction of their savings as an investment in large public corporations. In particular, the possibility for employees of holding shares in their personal pension or retirement portfolio (401k), whether or not sponsored by the corporation, was an attractive option.

Corporate shareholding plans also played a key role to enable individuals to massively become shareholders of public corporations. These special plans were generally offered by large corporations themselves and targeted to either their customers or their employees. A first category of special plans aimed to convert consumers into shareholders. According to Berle and Means, the first corporations to actively develop and use such plans were public utilities. For example, the campaign by National Electric Light Association distributed 45,000 shares to consumers between 1914 and 1919. The popularity of these campaigns grew and led to more sales (about 200,000 shares per year) as early as the 1930s. A second category of special plans aimed to convert employees into shareholders. A study cited by Berle and Means estimates that more than 800,000 employees became shareholders through these plans between 1900 and 1930 roughly. Today, we know such plans as employee stock purchase plans, and large public corporations still offer employees an option to receive a substantial portion of their compensation in shares of the company, or to buy shares in the company cheaply. Although they have experienced episodic popularity, these two categories of plans have contributed to promoting shareholding to the investing public and to increasing its participation in financial markets.

iv) The evolution of political and legal institutions

While economic factors, such as industrial development and the emergence of financial markets, can help to explain the explosion of the atom of property in America, legal and political elements should not be overlooked.

In his 2004 paper *Political Determinants of Corporate Governance*[19], Harvard professor Mark Roe offers a few arguments supporting the thesis that there were strong legal and political forces at play. A number of legal institutions, from proxy machinery to the Glass-Steagall Act, were shaped by politicians in response to contestations by various interest groups (notably managers and small business) in the first half of the 20th century. The main thrust of Roe's argument is that politics led to the **fragmentation of finance** in America. Barriers were erected to curb the power of financial institutions and to prevent institutional investors from buying large blocks of stock[20]. Banks, insurance companies, mutual funds and pension funds were all repeatedly barred through rule-making from owning large enough stakes to be able to provide oversight to corporate managers[21].

Rooting his analysis in chaos theory, path dependence and modern evolution theory, Roe explains why the US was put on the path of fragmented local finance rather than centralized finance, even though it seems evident that the US could today "absorb large-scale finance"[22]. Roe traces back the origins of the American financial system to US president Andrew Jackson's **destruction of the National Bank** (Second Bank of the United States) in 1832 and the ensuing depression. Jackson's

struggle to revoke the charter of the bank was not based in the comparative merits of a centralized vs. decentralized system, but was rather more a reaction to populist sentiment that feared concentration of wealth and the power that this wealth could exert over Congress. More specifically, Jackson's politics favored an "agricultural republic", and the Bank was thought to improve the welfare of elite commercial and industrial entrepreneurs rather than the welfare of farmers and laborers. Roe notes that in other countries like Japan or Germany, feudal roots made the "populace more comfortable with power" and facilitated the emergence of powerful banking institutions[23]. As for the depression, it also helped to shape the American landscape, since Roe suggests that the best-suited system to survive a downturn was a "relatively fragmented financial system of federally-guaranteed commercial banks with local branches"[24]. According to Roe, the current US economic system is not necessarily the most efficient outcome, especially considering the lack of a direct contest between the centralized vs. decentralized alternatives[25], but rather the product of path dependence stemming from politically-charged past decisions.

However, the corollary to fragmented finance and lack of presence of strong financial institutions is the development in the US of "substitutes" to the active role of banks in other countries, including strong capital markets but also a relatively **sophisticated legal environment**[26]. Roe cites a few of these institutions: the well-defined fiduciary duties of board directors, an "active bar that pursues lawsuits", professionalized managers, a well-developed incentive compensation system, antitrust rules and hostile takeovers[27].

1.2 Power Dynamics in the Modern Corporation

1.2.1 The Corporate Triad

In the corporation, three core agents shape a corporation's "focus, direction, productivity and competitiveness, and ultimately viability and legitimacy": Managers, Directors and Shareholders[28].

- *Managers* are essentially responsible for supplying management to the firm. More specifically, they are in charge of day-to-day operations of the firm towards meeting its corporate objectives. They are selected, compensated and can be removed by directors.

- *Directors* have two key functions: management and monitoring[29]. Management tasks include setting a strategic planning process and assess corporate business risks, while monitoring tasks include supervising the managers and implementing controls[30]. The Board of directors is the central governance body[31] seen to posses "all authority which is required to enable them to manage the corporation and to enable it to carry out its objects"[32], unless shareholders have reserved certain powers for themselves through special acts. Directors can delegate some of their powers either to other board members or committees (intra-board-delegation) or to non-director managers (extra-board delegation)[33], except when those powers cannot be delegated by law[34]. Typical committees include the Audit Committee, the Nominating and Corporate Governance Committee and the Compensation Committee[35]. Directors have a series of fiduciary duties to the corporation to act in its best interest.

- *Shareholders* are essentially responsible for supplying finance to the firm. The limited rights that accompany the equity of a shareholder are classically defined as:
    1. Right to sell/transfer the stock,
    2. Right to vote the proxy,
    3. Right to bring suit for damages if the corporation's directors or managers fail to meet their obligations,
    4. Right to receive certain information from the company
    5. Residual rights following the company's liquidation (or its filing for reorganization under bankruptcy laws) once creditors and other claimants are paid off"[36]

    While shareholders only own a "certificate representing entitlement to a proportional share of the corporation", this certificate gives them the above-mentioned rights in the jurisdiction of incorporation[37]. The right to receive a dividend is also frequently cited as a key shareholder right, although this right relates only to declared dividends. While management is not technically obligated to distribute dividends and may elect not to do so (unless the articles of the corporation state otherwise), the corporation is however obligated to pay the dividends it declares to shareholders.

Shareholders are often called the "owners", the "principals" or the "sole residual claimants" of the firm. That said, UCLA professor Lynn Stout adds an interesting layer to our understanding when she notes that, strictly speaking, "none of the three phrases commonly used to describe shareholders' relationship to the public corporation […] is factually correct"[38]. First, as to ownership, Stout comments: "Corporations are independent legal entities that own themselves; shareholders own only a security, called 'stock', with very limited legal rights"[39]. To this same point, UCLA professor Stephen Bainbridge also adds that if the corporation is in fact a 'nexus of contracts', it is not a thing that can be owned by shareholders in any meaningful way[40]. Second, as to the principal-agent problem, Stout states: "At law, a principal has a right to control his agent. Directors are not agents but fiduciaries largely insulated from shareholders' control, and they owe duties not just to shareholders but also to the firm as a whole"[41]. Finally, as to residual claims, Stout notes that employees, creditors and stakeholders can also have residual claims to the corporation.

However, recent developments in corporate law have established a variety of other stakeholders as key actors whose interests must also increasingly be considered and protected in the corporate governance process:

- *Stakeholders* are other agents who contribute different assets to the corporation and to which managers and directors may owe duties. They include, but are not limited to, creditors, employees, customers, suppliers, as well as the environment and society as a whole. For example, creditors, like shareholders, supply finance to the firm, while employees contribute labour. Stakeholders may have contractual relations with the corporation and may benefit from protections from wrongdoing or opportunism by other agents in the corporate triad.

We will further explore later the dichotomy between a shareholder primacy model and a stakeholder model of the corporation. In our analysis, similarly to Kraakman[42], we will often group Managers, Directors and Controlling Shareholders who play an active role in the governance of the corporation as "Insiders" for shorthand, while referring to Minority Shareholders as "Outsiders". We will also use the terms managers and officers interchangeably.

1.2.2 Ownership Structure

As Berle and Means precociously understood, the specialization of tasks between management and finance inherent to the modern corporation brought new efficiency gains, but also created the potential for ongoing "warfare" among corporate classes:

> « Such a great concentration of power and such a diversity of interest raise the long-fought issue of power and its regulation – of interest and its protection. A <u>constant warfare</u> has existed <u>between the individuals wielding power, in whatever form, and the subjects of that power</u>."[43]

Indeed, the leitmotiv of their work was to illustrate that the modern corporation is characterized by a concentration of power in the "control" class (suppliers of management) and a dispersion of capital in the "owner" class (suppliers of finance), a formula which can be handily summarized by the title of Roe's 1994 book *Strong Managers, Weak Owners*[44].

In keeping with the metaphor of the "explosion of the atom of property", Berle and Means explain the dual push-pull forces at work to create the new power dynamic of the firm:

> « Economic power, in terms of control over physical assets, is apparently responding to a centripetal force, tending more and more to concentrate in the hands of few corporate managers. At the same time, beneficial ownership is centrifugal, tending to divide and subdivide, to split into ever smaller units and to pass freely from hand to hand. In other words, ownership continually becomes more dispersed; the power formerly joined to it becomes increasingly concentrated; and the corporate system is thereby more securely established"[45].

Berle and Means show that between 1900 and 1930, the number of shareholders grew rapidly, leaping from 400K to 20M book shareholders for a basket of 30 representative companies. The size of ownership blocks started decreasing, with the largest shareholder of most of these companies (such as General Electric and Western Union) already owning less than 3% of shares.

With ownership units becoming ever smaller, it becomes increasingly complex to bond them together anew to act in unison. In other words, as ownership becomes more fragmented, the collective action problem grows. For these small owners, the cost of initiating action to combat the forces of separation becomes large and the most fruitful strategies are often inaction or free-riding. A natural consequence of this collective action problem is that it becomes impractical, impossible or costly for owners to exercise control over their wealth. Thus, the outcome of this scenario is that owners will in effect surrender control to suppliers of management, who will be chartered with managing their wealth on their behalf:

> "The surrender of control over their wealth by investors has effectively broken the old property relationships and has raised the problem or defining these relationships anew"

While this surrender of control does present some efficiency gains (in that qualified managers become responsible for administering the property), the result of this surrender is a power dynamic where owners/shareholders become relatively powerless.

> "The separation of ownership and control has become virtually complete. The bulk of the owners have in fact no control over the enterprise, while those in control hold only a negligible proportion of total ownership"[46].

To be sure, not all modern corporations are in the image of the Berle and Means corporation. The ownership structures of the modern corporation fall on a spectrum between two poles:

- *Widely-held corporations*, also called managerially-controlled corporations, "do not have one shareholder owning a sufficient amount of stock to have working control of the firm"[47]. There is complete separation of ownership and control.
- *Controlled corporations* have a dominant shareholder who can control voting. In majority-controlled firms, the dominant shareholder owns 50% or more of the shares, while in minority-controlled firms the dominant shareholder owns less than 50% yet still controls voting[48].

Most large US public corporations are widely-held. According to a 1996 study by Industry Canada considering companies of all sizes, 40% of US firms are widely-held but only 23% in Canada[49].

Obviously, isolating for larger companies would yield a much larger percentage of widely-held firms. For example, in a later 1999 study looking at only the largest firms in each country, La Porta, Lopez-De-Silanes and Shleifer concluded that 80% of large US firms were widely-held (using a stiff 20% control cutoff), while only 50% of firms in Canada were widely-held[50]. This is an interesting result, since one could assume that most, if not all, of the largest corporations would be widely-held. As far as controlled firms, they count for 56% in Canada but only 25% in the US[51]. This illustrates a very different, almost opposite, ownership landscape between the two countries who nevertheless share both physical proximity and ideological proximity at the corporate law level.

Indeed, the US-style "Berle and Means" big public corporation is far from a universal stereotype, and perhaps even in the minority worldwide. The influential empirical research from the team of economists and legal scholars from Harvard, Tuck and EDHEC composed of La Porta, Lopez-De-Silanes and Shleifer has shown in great detail that corporate ownership structures vary significantly across countries. In *Corporate Ownership Around the World*, they show through a study of large corporations in 27 wealthy economies that "relatively few of these firms were widely-held, in contrast to the Berle and Means' image of ownership of the modern corporation"[52]. The study rather shows that around the world, a high percentage of firms are controlled by families or the State. Family-controlled corporations are notably also quite prevalent in Canada and in small and medium corporations in the USA. In their 2006 study examining 487 Canadian companies, University of Montreal scholars Rousseau, Bozec and Laurin show that concentrated ownership is also particularly present in Quebec, where the dominant shareholder owns a larger percentage of the voting rights than in the rest of Canada and where the wedge between economic and voting rights is also larger[53]. La Porta et al point to a number of reasons, typically common versus civil law traditions and the quality of shareholder protection, to explain this variability of ownership structures.

As we will see, the potential for conflict is present in both widely-held and controlled firms, but it is the nature of the conflict that will generally vary with the ownership structure. A conflict-based approach to governance thus remains pertinent independent of ownership structure. Corporate conflicts however gain to be appreciated in the context of the corporation's ownership structure.

1.2.3 Dynamic Power Equilibrium

> "Management has a legitimate interest in wanting to have a strong role in running a company, and if they do a bad job, ultimately, they should be replaced. […] And in the meantime, they need an awful lot of discretion and authority to run the business of the company, and I think […] you only have to spend a couple of days running a $24 billion/year revenue company with 55,000 employees and you become very sensitive very quickly to how many decisions have to be made, and you can't always go get shareholder views or get board views. […] On the other hand, I just don't think you can sit here at this time in our country's history, having watched the string of these enormous companies where tens of billions of dollars of shareholder investments were blown away through rampant wrongdoing on the part of senior managers with boards that were sound asleep, and say there isn't a problem. There clearly is a problem"[54].
> -Richard Breeden, 2003, Former SEC Chairman (1989-1993)

Due to the specialization of management and finance responsibilities, a separation of powers or "power equilibrium", exists in a given corporation at any given time.

The power equilibrium is tributary not only to the ownership structure of the specific firm, but also to its existing internal corporate governance arrangements and the legal rules applicable in its jurisdiction.

For any corporation, the power equilibrium falls on a spectrum with these two poles[55]:

- *Managerial discretion:* Managers, directors and other Insiders are able to manage the firm without meaningful intervention of Outsiders. This pole is also called "director discretion".
- *Shareholder power:* Outside shareholders have meaningful intervention ability to review Insider behaviour. This pole is also sometimes referred to as "shareholder choice", although shareholder power is necessarily the larger umbrella concept[56].

There is consensus in scholarship that a well-governed firm requires a healthy dose of both managerial discretion and shareholder power. Managers need flexibility to meet business needs, while investors accept to finance the firm only if they can expect something back. That said, too much manager discretion can lead to opportunism, waste or exploitation. On the other hand, too much shareholder power might lead to poor decision-making or paralysis.

This equilibrium is dynamic because it is the product of the interplay of the exercise of rights and powers of Insiders and Outsiders.

A firm has at any given time an ownership structure and a power equilibrium. We can link together the concepts of ownership structure and the resulting power equilibrium. Widely-held firms, by definition, have a dispersed ownership base that often gives little other choice than the surrender of broad discretion to managers to guide the destiny of the firm on their behalf. Oppositely, controlled firms are more likely to have a few large and influent shareholders who can practically exercise power and control over the firm. That said, the power equilibrium in a firm is not necessarily directly correlated with its ownership structure. We could imagine a controlled firm that chooses to give wide discretion to managers, or a widely-held firm where shareholders have much power to enact meaningful changes – but these cases tend to be more the exception than the rule.

Through the exercise these rights or powers, either Insiders or Outsiders may seek to tilt the scale or equilibrium in their favour to address particular legitimate business risks or concerns. Corporate conflict occurs when the pendulum swings too widely in one direction, often but not always in the direction of managerial discretion.

1.3 Corporate Conflict

1.3.1 Conflict Configurations

There are 3 common types of conflict configurations in modern corporations:

1. *Manager opportunism / Vertical:* Conflicts between managers and directors, and shareholders. This type of opportunism is most prevalent in widely-held firms.
2. *Inter-shareholder opportunism / Horizontal:* Conflicts between controlling and minority shareholders. This type of conflict is most prevalent in controlled firms.
3. *Opportunism vis-à-vis other stakeholders*

Like Kraakman and Rousseau, we will constrain our analysis to the two first types, understanding that disputes involving stakeholders are in many ways a separate category of conflicts less directly related to the classic core conflict of ownership and control[57]. The two first types are also the most relevant to the small shareholder.

1.3.2 Conflict Theory

> "Let every eye negotiate for himself.
> And trust no agent".
> - Shakespeare, *Much Ado About Nothing*[58]

Economists qualify the aforementioned conflict configurations (manager opportunism, intra-shareholder opportunism, etc…) as agency problems. An agency problem arises when "the welfare of one party, termed the principal, depends upon actions taken by another party, termed the agent"[59]. The governance challenge lies in "motivating the agent to act in the principal's interest rather than simply in the agent's own interest"[60]. Michael Jensen and William Meckling introduced the notion of an "agency relationship" in their landmark 1976 paper *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure* as such:

> "A contract under which one (or more) person(s) (the principal) engages another person (the agent) to perform some service on its behalf which involves delegating some decision making authority to the agent. If both parties in the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal"[61].

This work from Jensen and Meckling sits on the shoulders of pioneering scholarship from Nobel laureate Ronald Coase. In 1937, Coase defined the firm, in his paper *The Nature of the Firm,* as a legal fiction serving as a "nexus of contracts", thus establishing "contractual relations as the essence of the firm"[62].

Harvard professor Michael Jensen posits that agency costs apply to many types of contractual relations[63]. In agency theory, since the principal cannot costlessly monitor the agent[64], the agent has an incentive to "act opportunistically"[65]. Jensen defines agency costs as the sum of:

1. The monitoring costs (expenditures by the principal)
2. The bonding costs (expenditures by the agent)
3. The residual loss (the opportunity cost)

Principals can try to align their interests closely with those of their agents. As Kraakman notes, "reducing agency costs is in the interests of all parties in a transaction, principals and agents alike"[66]. The principal accomplishes this through tools like compensation, reporting and supervision:

> "The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent"[67]

Vishny and Schleifer concisely explain why contracts alone cannot solve the issue of Jensen-style agency problems present in contractual relationships:

> The financiers and the managers sign a contract that specifies what the manager does with the funds, and how the returns are divided between him and the financiers. Ideally, they would sign a complete contract that specifies exactly what the manager does in all states of the world, and how profits are allocated. The trouble is, most future contingencies are hard to describe and foresee and, as a result, complete contracts are technologically infeasible"[68].

Jensen points out that the general framework of agency relationships and agency costs is clearly applicable to conflicts in the modern corporation:

> "Since the relationship between the shareholders and the managers of a corporation fits the definition of a pure agency relationship, it should come as no surprise to discover that the issues associated with the 'separation of ownership and control' in the modern diffuse ownership corporation are intimately associated with the general problem of agency"[69].

Building on the Jensen view of general agency problems in the modern corporation, Grossman and Hart, as well as others[70], qualified the benefits that can be extracted by managers as the "private benefits of control"[71].

Harvard economist Oliver Hart, and later Vishny and Schleifer, add an interesting layer of analysis by developing the concept of "control" and "ownership" rights. Hart assesses that external financing is a "contract between the firm as a legal entity and the financiers, which gives the financiers certain rights vis-à-vis the assets of the firm"[72]. In other words, outside investors agree to finance on the condition that they receive what Hart calls "control rights", the most important component of which are voting rights[73]. Few investors would invest without any control rights to allow them to enforce their rights. These control rights accompany the ownership or cash-flow rights that come as a by-product of shareholding. As we recall from Berle and Means in relation to economic rights, shareholders are those individuals "to whom profits go".

Vishny and Schleifer determine, in perhaps the most salient way for the purpose of this paper, that conflicts arise between agents in the corporate triad when "control"/"voting" rights do not accrue proportionately to "ownership"/"cash-flow" rights[74].

As a very basic example, a scenario where an individual investor holds 10% of the shares (and thus 10% of cash-flow rights) but 90% of the voting rights would likely be wrought with conflict relative to other shareholders, who do not have any meaningful right of exercising control over their property.

1.3.3 Conflict Object

Corporate governance academics have developed a relatively well-defined list of conflict objects in modern corporations. Harvard professor Lucian Bebchuk frequently speaks of conflicts relating to “rules-of-the-game” vs. “game-ending” decisions. Wharton professor Eric Orts speaks of “shirking” and “sharking” conflicts.

We will however opt for a slightly adapted version of the framework proposed by Harvard scholar Reinier Kraakman and colleagues in *The Anatomy of Corporate Law*[75], which examines with more granularity specific types of corporate decisions. Kraakman distinguishes between “general” governance structure decisions and “particular” corporate transactions. According to the authors, each subcategory of decisions poses a different set of issues and conflict risks. The high-level schema looks like this:

- General governance decisions
- Particular transactions
    - Related-party transactions
    - Major transactions

General governance decisions (which Black qualifies of “routine”[76]) tend to occur relatively frequently in the normal course of business activity, like nominating or replacing directors and selecting governance arrangements.

Particular transactions are special types of decisions that tend to happen infrequently, but that pose a distinct potential for conflict of interest or a threat of significantly reshaping the power equilibrium in the corporation. For these decisions, special attention is required by all agents of the corporate triad.

1.3.4 Corporate Governance

If, as we have seen, the corporation is the vehicle for value creation, the general role of corporate governance is to provide “the structure that is intended to ensure that the right questions get asked and that the checks and balances are in place to make sure that the answers reflect what is best for the creation of long-term sustainable value”[77]. Corporate governance thus plays a critical role in providing mechanisms for Outsiders to check and, if required, curb the power of Insiders. It also provides the tools necessary to resolve, or ideally prevent altogether, conflicts between agent groups.

The permanent importance of corporate governance to diffuse corporate conflict cannot be understated, especially if it is understood not as a set of particular rules or laws to follow, but rather as the sum and interplay of the levers actuating the underlying power structure of the corporation:

> “That corporate governance provokes political debate should not surprise us. Corporate governance—the authority structure of a firm—lies at the heart of the most important issues of society. That authority structure decides who has claim to the cash flow of the firm, who has a say in its strategy and its allocation of resources. As such, corporate governance affects the creation of wealth and its distribution into different pockets. It shapes the efficiency of firms, the stability of

> employment, the fortunes of suppliers and distributors, the portfolios of pensioners and retirees, the endowments of orphanages and hospitals, the claims of the rich and the poor. It creates the temptations for cheating and the rewards for honesty, inside the firm and more generally in the body politic. […]
>
> It is no wonder then, that corporate governance provokes conflict. Anything so important will be fought over. Anything that shapes wealth, opportunities, stability, and corruption is sure to attract the concerns of the powerful and provoke the anxiety of the weak. Everyone has a stake in the corporate governance system, and everyone has an interest in how it is structured".[78]

The importance of corporate governance also reveals itself in the positive correlation between good governance and firm valuation. In their paper *Investor Protection and Corporate Valuation*, La Porta and colleagues find that "consistent with theory, better shareholder protection is empirically associated with higher valuation of corporate assets", as measured by Tobin's Q[79]. A recent article in the McKinsey quarterly noted that "over eighty percent of investors surveyed stated that they would pay more for the shares of a well governed company than for a poorly governed firm of comparable financial worth"[80]. However, it must be noted that the empirical evidence of the causal link between better governance and higher firm value is mixed.

That said, effective governance is also "essential to the healthy growth of capitalism in a democracy"[81]. According to La Porta, strong shareholder protection also enables the rapid development of healthy financial markets. The La Porta study puts forward the following key thesis to explain how good corporate governance helps to stimulate the development of markets:

> "When their rights are better protected by the law, outside investors are willing to pay more for financial assets such as equity and debt. They pay more because they recognize that, with better legal protection, more of the firm's profits would come back to them as interest or dividends as opposed to being expropriated by the entrepreneur who controls the firm. By limiting expropriation, the law raises the price that securities fetch in the marketplace. In turn, this enables more entrepreneurs to finance their investments externally, leading to the expansion of financial markets"[82].

Corporate governance, in the context of this paper, is perhaps best defined by policy scholars Vishny and Shleifer, in that:

> "It deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment"[83].

Having understood the seminal role of corporate governance to diffuse corporate conflict and preserve corporate value, this paper will focus on how corporate agents can actively and efficiently leverage corporate governance mechanisms.

2 SHAREHOLDER CONFLICTS

In Part 2, we will explore how suppliers of finance, notably small shareholders, can assure for themselves a return on their investment. While US and Canada provide some of the most comprehensive shareholder protections in the world, we find that shareholders still lack in many cases substantive power to proactively counter managerial opportunism. Later, in Part 3, we will explore if and how this could be fixed.

We take the perspective of the small outside shareholder, because he is typically the party most vulnerable to exploitation and opportunism. We use this "Outsider" lens to explore what types of conflicts small shareholders should expect (Section 2.1), how Insiders can use their power to get away with opportunistic behavior (Section 2.2), and how Outsiders can counter by protecting themselves and defending their rights (Section 2.3).

2.1 Conflicts Between Insiders and Outsiders

In this section, we will survey the main families of conflicts in the corporation, which Black terms "systematic shortfalls"[84] of corporate governance. Following our prior definition of the main conflict objects, we will explore two main categories of conflicts: a) general governance conflicts and b) particular transaction conflicts. We will explore both categories at a conceptual level first, before analyzing in later sections how these conflicts play out in the US and Canada.

2.1.1 General Governance Conflicts

There are two main general governance conflicts: (1) mismanagement and (2) shirking.

On one hand, **mismanagement** is possibly the most basic and most common source of shareholder dissatisfaction. Although there is generally no wrongdoing in a legal sense, it implies that Insiders are not acting to maximize the value of the firm, usually measured by stock price and shareholder wealth. Mismanagement is typically synonymous with poor performance stemming from inefficient use of the corporation's resources, especially in the presence of more viable alternatives. Mismanagement reduces the pie of corporate value[85]. Insiders mismanage by either inefficiently (1) "taking cash out" or (2) "keeping cash in"[86].

First, for "taking cash out" conflicts, waste is often the by-product. Wasteful utilization of corporate resources is a source of conflict, since it deprives shareholders of profit streams that lead to share price appreciation and increased dividend streams. Waste can for example be caused through spending in pet projects, excess generosity or the pursuit of low NPV projects[87]. Another classic "take cash out" subcase is empire-building, where Insiders can choose to expand inefficiently the size of the firm, often by buying assets, creating new divisions or making acquisitions, mainly or reasons of influence, prestige, perks, job security or to gain private benefits of control. This is inefficient behaviour, since the failure to pursue higher NPV projects deprives shareholders of the cash-flows associated with those projects.

Second, for "keeping cash in" conflicts, the problem is usually dividend withholding or cash hording. Insiders control dividend policy and have the power to not distribute profits to

shareholders. Conflicts arise when the corporation withholds dividends and retains profits even though it has a poor slate of positive NPV projects on the horizon, in which case it should distribute profits to shareholders as dividends. This situation is exacerbated in corporations that limit or suppress other shareholder rights, since dividend payouts are often viewed as a substitute signal of efficient management, according to the substitution hypothesis of La Porta et al[88]. In their analysis of 4,000 companies across the world, they find that stronger shareholder rights reduce the need to make large dividend payouts to shareholders to establish a reputation for "decent treatment of shareholders". Therefore, the real problem seems to lay when management is hording profits in the absence of either positive NPV projects *or* a strong framework of shareholder rights. However, the larger theoretical dividend question remains: "if corporations can elect not to do so, *must* they pay dividends?" This is known as the dividend puzzle. In his influential paper *Agency-Cost Explanations of Dividends*, legal scholad and judge Frank Easterbrook explains both sides of the puzzle[89]. On the pro side, firms can pay dividends because (1) they believe higher payouts will lead to share price appreciation, (2) they want to establish a reputation with shareholders, (3) dividends can minimize agency costs between managers and investors (since managers can, through the dividend policy, shift the debt-to-equity ratio to alter the respective risks of shareholders and debtholders, which will have an impact on the long-term price of the share and the likelihood of bankruptcy[90]) or (4) pressure for distribution is exerted by shareholders on management. On the con side, firms can choose not to pay dividends for a few reasons: (1) it sends a negative signal to the market (that the firm has run out of NPV projects), (2) dividends are irrelevant since shareholders can "make their own dividends" (as explained in the classic papers by Nobel winners Modigliani and Miller[91]), (3) the "clientele effect" makes distributing a given amount of dividends unlikely to please all types of shareholders, or (4) internal financing linked to retention of profits is simply cheaper than external financing (floating new securities on the market).

On the other hand, **shirking** can be characterized by slack or the avoidance of key issues. We can see shirking as the opposite of the active forms of mismanagement describe above. As Eric Orts explains in his *Shirking vs. Sharking* paper[92], individuals can have a natural tendency to shirk:

> "Agents […] will shirk their responsibilities, if given half a chance. In other words, if not sufficiently monitored, they will not work as hard as they should, take too many breaks or behave selfishly, lazily or irresponsibly. In a word, the assumption of this economic theory is the neoclassical economic assumption of selfishness"[93].

A few examples of shirking include avoiding thorny corporate issues, "failing to take actions that are personally costly, like firing mediocre managers" or "continuing to run a company when [a manager] is no longer the best person for the job"[94].

2.1.2 Particular Transactions Conflicts

2.1.2.1 Related-Party Transactions

Related-party transactions, although they can become regular or frequent, imply such a high level of potential for conflict of interest that they are considered particular transactions.

In a related-party transaction, a director or an officer of the corporation enters into a transaction directly with the corporation. The director or officer typically has an "obvious" conflict of interest. He theoretically must act in the best interests of the corporation and its shareholders, yet may be tempted to act in his own self-interest to "get the best possible deal"[95]. Wrongdoing often occurs when directors prefer to act in their own interests rather than the interest of the corporation and its shareholders, thus breaching the fiduciary duty to the shareholder principal. For this reason, related-party transactions are controlled by, and intimately related with, fiduciary duties, especially the duty of loyalty.

While "the lore or Anglo-Saxon jurisdiction" once prohibited related-party transactions, directors can now engage in them for a number of practical reasons, such as efficiency, profitability or confidentiality[96].

Kraakman classifies related-party transactions in two categories following this schema[97]:

- Self-dealing
    - Traditional self-dealing
    - Compensation policy (Excess pay and perks)
- Misappropriation
    - Appropriation of corporate opportunities
    - Insider Trading

With generic self-dealing, "the law's concern is that an influential director or officer will transact with the company on terms less favourable [to the corporation] than could be obtained by arm's-length negotiating or open market purchases"[98]. Generic misappropriation happens when "officers and directors appropriate value belonging to the company or its shareholders by means of transactions with third parties, rather than the corporation itself"[99]. We will define and examine in turn all four of these related-party conflicts.

2.1.2.1.1 Traditional Self-Dealing

Traditional self-dealing can occur in a wide-range of situations, such as the purchase/sale of assets from/to the corporation and debt guarantees by the corporation[100]. It can result in unfair transactions terms (fair value not received by the corporation), kickbacks or other special advantages. Self-dealing concerns not only the director or officer, but extends to significant others and relatives[101].

2.1.2.1.2 Excess Pay and Perks

Pay-for-performance is a key incentive used to motivate executive management. Compensation is also a form of self-dealing, albeit "less suspect" since it is commonplace and necessary for the well-functioning of the corporation[102]. It is indeed a powerful way to reduce agency costs and to align the incentives of managers with the interests of the corporation. US corporate law allows much flexibility in setting compensation, including the use of lucrative stock option plans. Tax and disclosure rules also encourage pay-for-performance compensation[103].

Some have argued that recent compensation scandals have been limited to a "few bad apples" and that there was no need to overhaul executive compensation. Bebchuk argues that the problem may rather be systemic to the whole barrel. In only the 8 years between 1992 and 2000, the "median inflation-based compensation of CEOs of S&P 500 firms quadrupled from $3.5 million to $14.7 million"[104]. Option grants to CEOs increased by a factor of 9X during that same period[105]. Bebchuk synthesizes:

> "Flawed compensation arrangements have been wide-spread, persistent and systemic, and they have stemmed from defects in the underlying governance structure that enable executives to exert control influence over their boards"[106].

In the corporation, compensation is set through arms-length bargaining between two parties: directors and managers[107]. More specifically, managers negotiate a compensation contract with the company's compensation committee, a subset of the board of directors typically composed of 3 or 4 directors. In this context, directors represent the interests of the corporation and of shareholders, who generally do not intervene in the compensation-setting process:

> "What it amounts to is that there's no one representing shareholders. It's like having labor negotiations where one side doesn't care"[108].

In general, the conflict between Insiders and Outsiders regarding compensation occurs when pay is not proportional with performance, or even worse, when there is pay without performance, as Bebchuk and Fried term it in their influential book *Pay without Performance*[109].

Typically, managers use their power and influence in the corporation, especially their power over directors, to obtain pay that is disproportionately superior to their performance. This way, managers obtain compensation "more favorable than they would get under arm's length-bargaining"[110] and which cannot be justified solely by regular bargaining power or by their level of skill or expertise. Economists call this "rent extraction" by managers. We can understand rent as "extra returns that firms or individuals obtain due to their positional advantages"[111].

More specifically, problems tend to arise when compensation is designed with either of two key methods: (1) decoupling or (2) camouflage. First, the decoupling of pay and performance can be achieved through a variety of compensation mechanisms in order to construct a pay that is less sensitive to performance[112]. Second, Insiders use camouflage to make the rent extraction in compensation less transparent to scrutinizing shareholders or outside parties. Bebchuk notes: "To avoid outrage, compensation designers attempt to hide, obscure or justify – in other words, to 'camouflage' the amount or form of executive pay"[113].

As Bebchuk also advances, rents come in many forms[114]. There are at least 3 main forms of compensation that can be used for incentive alignment, but can also be abused for opportunistic goals: (1) non-equity compensation (ie. salary, bonus and perks), (2) stock options plans, and (3) compensation at exit. Bebchuk argues that all three forms are too often only "weakly linked to managerial performance"[115].

First, **non-equity compensation** is the most straightforward form of compensation, but it is still vulnerable to camouflage and decoupling. Non-equity compensation includes salary, bonus and

perks. Bebchuk argues that bonuses often reward other elements than managerial performance, which are not controlled by managers (ie. good performance in the sector of the company), and further encourage managers to set low goals in order to exceed them[116]. Managers also receive other forms of discretionary bonuses, like "golden hellos" upon hiring and acquisition bonuses. Both bonus types usually have little correlation with actual performance of the manager in the corporation. Managers also receive corporate perquisites (perks), which are in some cases extravagant. In the past, executives also received additional pay via executive loans (either through low rates, lax repayment terms or loan forgiveness) and split-dollar life-insurance policy. Both practices have however been prohibited or strongly curbed in the last few years[117].

Second, conventional equity-based **stock option plans** often make up the bulk of the compensation of managers, but are also prone to abuse when controlled or influenced by managers. Equity-based compensation ties the compensation of managers to the stock price of the corporation, rather than directly to the manager's performance. It is generally an efficient method to align the interests of the manager with those of the corporation, especially given the difficulty to evaluate the performance and contributions of executives with less holistic measures.

However, Bebchuk summarizes the dangers of equity-based compensation as such: "The huge gains from options for below-average performers should give pause to even the most ardent defender of current corporate pay systems"[118].

There are a number of general objections to why stock-option plans might not serve shareholders, such as: (1) concentration power, (2) downward insensitivity, (3) inability to filter large windfalls, and (4) unwinding freedom. First, stock-option plans in general have the **power to concentrate** too many options (especially considering decreasing marginal utility) in too few hands. It is questionable whether highly incentivizing a few people is the most efficient use of resources than more broad-based corporate compensation schemes[119]. Second, stock options as a vehicle have inherent features that can severely disalign the incentives of managers and shareholders. By definition, an option allows the manager to reap a profit when the stock price rises above exercise price, but lose nothing if the stock price does not rise above that bar. This **downward insensitivity** may provide the manager with an incentive for excess risk-taking. Third, conventional stock options also generally do not easily allow ways to **filter out large windfall profits** that may not be linked to the manager's performance, but rather to a lift of the sector or index[120]. Fourth, the broad **'freedom to unwind'** benefits managers, often at the detriment of shareholders. While managers do need a source of liquidity to 'cash in some of their chips' as time progresses, they face few or no restrictions regarding how they unwind their options. If they sell their stock immediately after vesting, they make a one-time profit. That portion of their incentive is no longer tied to stock price. Shareholders must provide new incentives to keep the manager aligned, which is costly. Furthermore, managers may also be tempted to use inside information to optimally unwind their stock. Trading profits made by managers come at the expense of shareholders and generally "go unnoticed by shareholders", since they do not show up in the official accounting reports[121].

Stock options are also very malleable and flexible, a feature which is sometimes used in option plan design to create plans that skew benefits towards managers, such as with these three common practices: (1) At-the-money option pricing, (2) Repricing and backdoor repricing, (3) Reload features. First, **at-the-money option pricing** is the default arrangement in the majority of corporations and sets the strike price equal to the stock price, while an out-of-the-money option has a higher strike price. An out-of-the-money option would more tightly couple pay with performance, since gains would be possible only when the stock price rises on the manager's watch. An at-the-money option provides a payout to the manager for the passage of time, since stock prices tend to generally rise over time[122]. According to Bebchuk, even though out-of-the-money options are cheaper to issue and empirical evidence has shown them to be effective to boost firm value[123], 95% of firms still use at-the-money options. Second, with **repricing**, managers are able to modify the strike price of their options ex-post grant, by cancelling the old options and issuing new options with a lower strike price. Bebchuk cites a study to the effect that out of 802 repricings, 800 aimed to lower the strike price, with an average strike price decrease of 39%[124]. The logic of repricing is that general market losses or one-time market shocks may have significantly reduced the share price. In these cases, executive with worthless or strongly "underwater" options may not have sufficient incentive to carry forward managing the affairs of the corporation with a view to maximizing shareholder value. Worse yet, managers may gain a perverse bet-the-farm type mentality. While repricing does provide a clean slate or a second chance, "ex-post repricing does undermine ex-ante incentives" and rewards managerial failure.[125] Although this practice has been curbed by accounting standards[126], backdoor repricing achieves the same result. Third, **reload features** allow managers who exercise their options to receive not only the underlying stock, but also a new option. This mechanism enables managers to exercise options more frequently after shorter term share price appreciations and lock-in profit, rather than holding a longer-term approach consequent with long-term value maximization.

Third, in addition to non-equity compensation and stock option plans, **compensation at exit** can provide substantial pay to executives after they leave the company. The decoupling between pay and performance is therefore particularly strong, often making exit compensation a quite contentious issue. Three events typically trigger such pay: (1) Firing, (2) Major transactions (merger/acquisition/takeover) and (3) Retirement. In all three events, directors make special payments to reward managers, often out of loyalty, gratitude or friendship[127]. Their generosity can be explained by the fact that these payments are "made with shareholder money, with little cost to directors personally"[128]. First, relative to **firing**, since the CEO exerts control and influence over the board, directors are often reluctant to fire even a poor-performing CEO. Instead, they will offer a gratuitous payment, often above and beyond what the severance package promises contractually, that acts as a "bribe to secure cooperation"[129]. Except in cases where the CEO is fired 'for cause' (which according to Bebchuk implies "felony, fraud, malfeasance, gross negligence, moral turpitude") and despite poor performance (or even "utter failure"), directors are inclined to grant a "soft landing" that will allow the CEO to gracefully exit the corporation[130]. Second, in the event of a **major transaction** (merger/acquisition/takeover), directors may seek to gain management approval

and push the deal through by sweetening the deal for managers. Directors can accomplish this either through "golden parachute boosting" or "golden goodbyes"[131], even if they are not contractually obligated to and even if the goal is ultimately to replace the CEO. Bebchuk qualifies these bonuses, which are paid out cash in 40% of large acquisitions, as a "reward for overseeing a transaction"[132]. Third, CEO and managers often receive generous **retirement** advantages that often go largely beyond what was convened under arms-length bargaining. This retirement pay can include supplemental retirement pensions (which can be camouflaged using SERPs[133]), retirement perks (use of corporate jet, travel, corporate office, financial planning aid, philanthropic donations), additional deferred compensation and consulting contracts. Bebchuk stresses that this pay is highly decoupled from performance, since most CEOs do not participate actively in the life of the company after retirement. For example, lucrative consulting retainer fees are offered to retired executives for "being available" a few days per month to consult with current management, only if this availability is needed and on terms highly favourable to the retired executives.

2.1.2.1.3 Appropriation of Corporate Opportunities

In the case of appropriation, managers take for themselves "investment opportunities that should have been offered to their companies instead"[134]. Thus, the agent extracts private benefits by usurping an opportunity that would have created profits for the shareholder principal[135]. Symptoms include withholding information, holding secret negotiations and concealing an opportunity.

A classic case that illustrates appropriation is *Guth v. Loft*[136], where the president and director of Loft (a retailer of food, candy and syrups) acquired effective control of the Pepsi-Cola Corporation for his personal profit without first giving Loft the chance to acquire Pepsi[137]. The director then made things worse by carrying on a "clandestine program" to develop Pepsi commercially using "Loft funds, facilities and employees"[138]. In later jurisprudential development, the Delaware court developed a test that can be used to help qualify whether or not the director must present the opportunity to the corporation: "(1) Is the corporation financially able to take the opportunity? (2) Is the opportunity in the corporation's line of business, (3) Does the corporation have an interest in the opportunity? (4) Does a director have a conflict of interest by taking the opportunity for himself"[139].

The court developed a similar yet different structured test to appreciate misappropriation in practice in *Gravino v. Enerchem Transport Inc*[140]*.* In this case, two ex-officers of marine transportation company Enerchem sequentially start negotiations to charter tankers from an oil company on behalf of Enerchem, decide to leave Enerchem, form a new company called Petro-Nav, and then lease those same tankers from that same oil company. The court concludes that although the ex-officers did owe an obligation of duty and loyalty to Enerchem, they had not misappropriated a business opportunity from Enerchem. The court cites the public knowledge of the opportunity and the early "exploratory" nature of the project as factors to support its decision[141]. One commentator summarizes the key factors considered in the four-prong test developed by the court to interpret misappropriation: "(1) the degree to which the interests of the director and the interests of the company were in conflict, (2) the degree to which the business opportunity had, at the time in

question, acquired its own specific and identifiable character, (3) the proximity in time between the emergence of the business opportunity and its exploitation and (4) the proximity in character between the business opportunity pursued by the company and the contract or business concluded by the director for his own profit or the profit of a third party"[142]. In *Gravino*, the court illustrates that the scope of misappropriation of a business opportunity is not however limitless, in a way reaffirming that "freedom of competition" is a key rule in a capitalist market economy[143].

2.1.2.1.4 Insider Trading

In the case of insider trading, officers or directors do not usurp a business opportunity from the corporation, but rather usurp "the market value of the company's investments from outside shareholders "[144]. Insider trading implies "trading in securities while in possession of material non-public information"[145].

Let's take a look at a few components of this definition. First, materiality is found when there is a "substantial likelihood that a reasonable investor would consider the omitted fact important in deciding whether to buy or sell securities"[146]. The timing of the materiality is also of critical importance[147]. Second, as for the non-public aspect, information is considered to enter the public domain when the news could be "expected to appear over the Dow Jones ticker tape"[148]. Material news of lesser importance is still considered non-public until widely-released, even if it is not via the tape. The aim of this restriction is to provide something akin to equal access to information for all parties, either inside or outside the corporation. Third, insider trading is applicable not only to 'classic insiders' (directors and officers), but also to 'constructive insiders' (legal counsel, underwriters, accountants, consultants) and possibly to other parties[149].

Insider trading has negative repercussions for shareholders. First, insider trading can divert profits from shareholders to Insiders, especially if the shareholder is on the other side of a transaction involving an asymmetrically better informed Insider. Insider trading can thus be unfair to shareholders since it generally puts them in a situation of inferiority in terms of access to information. Second, it can hurt the confidence of investors in public capital markets[150]. Third, as described by Easterbrook, the ability to carry out insider trading can create a perverse incentive for managers to choose often riskier projects that create short-term fluctuations in the stock price, while shareholders bare the cost of the eventual failure of these projects[151].

It should however also be noted that some scholars have proposed an interesting contrarian position that insider trading actually benefits the corporation. Manne's two-pronged argument summarizes well this perspective. First, insider trading can increase price accuracy, since stock purchases will move the stock towards the efficient price incorporating the new information into the price. Second, insider trading can provide a way to compensate managers for creating valuable information for the corporation[152]. Nobel laureate Milton Friedman adds: "You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that"[153].

2.1.2.2 Major Transactions

While a major transaction can be an "engine for efficient restructuring"[154], it also implies a significant change to the firm's ownership structure and usually to its power dynamics.

Major corporate transactions include two smaller subcategories: significant corporate actions and control transactions. Significant corporate actions include mergers, substantial sale of assets, reorganizations, liquidations, share issuance or change of legal entity. Control transactions include events like hostile takeover bids, management buyouts, and shareholder alliances that result in freezeout/squeezeout scenarios. Control transactions can be friendly (management-supported) or hostile.

There is a three criteria test to determine if a corporate transaction is significant enough to be considered a major transaction exceeding the usual bounds of managerial discretion: (1) it is of large value relative to the company, (2) it requires "broad gauge, investment-like judgements that shareholders are arguably equipped to make" and (3) it creates a possible conflict of interest for directors, even if it is not a self-dealing or related party transaction[155]. For example, a sale of assets will be considered a major transaction and thus require shareholder approval if it aims to sell "all or substantially all" assets of the company. In practice, this is thought to mean more than 75% of assets at market value[156]. If not, the board preserves authority and discretion to carry out transactions independently[157].

While many major transactions ultimately do require some form of shareholder approval, the board has many powers to control the decision-making process and affect the final outcome. For example, in a merger, the board can reject an initial bid, without any shareholder vote. Directors are also the sole body allowed to negotiate merger terms with potential bidders. Shareholders have no statutory power to initiate a merger and can intervene only to approve or disapprove the merger as a whole, as presented by the board[158].

Thus, in major transactions, the core governance problem relates to the role of the board. In many situations, directors have self-interested incentives to not always act in the best interests of shareholders[159]. As a result, shareholders may not obtain the value-maximizing outcome (highest bid price from acquirer). Also, corporate resources have a higher probability of being diverted from shareholders to directors.

Since major corporate transactions like takeovers are "structural", "final-period" or "game-ending" decisions, they put directors in a position with acute conflicts of interest. Bainbridge describes this scenario as:

> "Target boards and management are <u>no longer subject to shareholder discipline</u> because the target's shareholders will be bought out by the acquirer. Target directors and managers are <u>no longer subject to market discipline</u> because the target by definition will no longer operate in the market as an independent agency"[160].

Put another way, directors are well aware that while a successful bid may be the value-maximizing outcome for shareholders, it also means they will lose their jobs[161].

Therefore, directors may refuse to co-operate for a few reasons: (1) Retention of position and perks, (2) Hold-out for higher price for the transactions or (3) Hold-out for side-payments[162]. Example of side-payments include: “equity stakes in the surviving entity, employment or non-competition contracts, substantial severance payments, continuation of existing fringe benefits or other compensation arrangements”[163]. As Bainbridge notes, while the size of the side-payment will rarely influence the transaction price, it may be sufficiently large that Insiders accept an overall price lower than would be available in open bidding[164].

Conflicts in major transactions also often tend to gravitate around the price of the transaction, especially as to whether it is fair or not. In takeovers, successful bids typically generate about 30-50% premiums for the target shareholder[165], an amount that can vary based on the context of the negotiation and the amount of synergies available[166]. In assets sales, the market value of property can be defined as a price at which a seller and buyer would agree on, as long as they were both fully informed and not obligated to buy[167].

According to Kraakman, some of the other risks of significant corporate actions are asset looting, dilution and minority abuse (by altering the characteristics of a shareholder’s investment, possibly without his approval)[168]. In the case of minority abuse, the minority shareholder may face a prisoner’s dilemma compelling him to sell shares too cheaply and thus be cheated out of obtaining a “negotiated control premium”, especially when the buyer uses open market purchases to secretly acquire control (minority discount)[169], or he may find his liquidity to exit greatly reduced (marketability discount)[170]. Issuances of shares are another form of major transaction, which creates dilution and structural shifts in power (from Outsiders to Insiders, or by reallocating voting power among shareholders)[171].

2.2 Insiders: Power Capture and Opportunism

Corporate Insiders, once in a position of influence, exercise vast power over the governance of the corporation. Insiders are also able to capture some of this power for opportunistic use, which may lead to the conflicts explored in the previous section. Furthermore, as the last decade's corporate governance scandals have shown, the "rampant wrongdoing" was not confined to a particular company, sector, geography, jurisdiction or legal tradition. Rather, several enabling factors have permitted this power capture by Insiders and the perpetuation of conflicts over time.

We separate three types of sources of power: (1) Internal Governance, (2) Regulatory and (3) Market mechanisms. First, internal governance mechanisms have to do with the exercise of power by Insiders at the shareholder meeting. Insiders may not aim to directly harm Outsiders. They may aim to defend against a threat to their power or protect their own control rights. They do so by digging trenches around their power base. Second, regulatory mechanisms are a product of the legal environment rather than a direct result of Insider action. Third, several market factors also strengthen Insider power.

While internal mechanisms mostly lead to entrenchment by Insiders, regulatory mechanisms rather confer discretion to Insiders. In summary, all three types of mechanisms lead to power capture by Insiders, which enable entrenchment and discretion, which then leads to scenarios of opportunism and conflict.

2.2.1 Internal Governance Mechanisms

Insiders can use several mechanisms to perpetuate corporate conflicts, most notably: control over elections and compensation (Section 2.2.1.1), proxy voting advantages (Section 2.2.1.2) and anti-takeover measures (Section 2.2.1.3).

2.2.1.1 Control over Elections and Compensation

Insiders hold a great deal more influence than Outsiders over two separate, but intimately related, key aspects of the corporation: (1) Elections and (2) Compensation. Insiders can use this influence to capture power and perpetuate opportunistic behavior, without much real opposition potential from shareholders.

First, in terms of **elections**, Insiders have sufficient power to exert control in practice over the nomination process, leaving little real influence to shareholders. The right to elect and nominate directors is one of few cornerstone rights of shareholders. If shareholders are not satisfied with the performance of directors to which they have delegated management of their property, they cannot directly intervene in the business of the firm. The corporate model is based precisely on this separation of tasks between suppliers of management and finance. That said, unhappy shareholders are thought to be able to at least "vote out" and replace these directors. This is what Bebchuk, in his influential papers on corporate elections, refers to as the shareholders' "safety valve"[172].

Bebchuk argues that this safety valve is a necessary component to align the interests of shareholders and Insiders. Even putting aside the lofty goals of increased 'shareholder voice', 'shareholder power' or 'representative corporate democracy', Bebchuk argues that the right to replace directors is essential for accountability and effective corporate governance. The Delaware Supreme Court in *Unocal* agrees, recalling that "shareholder displeased with the actions of their elected representatives have the powers of corporate democracy at their power"[173]. Furthermore, Delaware has vigorously rebutted any attempt to "unduly interfere with the shareholder franchise"[174], despite its traditional pro-manager leaning. Legal observer Martin Lipton synthesizes Delaware's position as "don't mess with the ability to vote"[175].

However, it appears this safety valve is in fact "missing". In practice, contested elections are rare and the threat of removal for directors is low. Directors tend to get routinely re-elected as long as they stay on the management slate put forth in the proxy[176]. Shareholders face a number of barriers separating them from real ability to contest, notably the difficulty of accessing the proxy machinery to propose their own director choices. Shareholders are not able to propose candidates on the same proxy as management, and must circulate materials and solicit proxies on their own. Further difficulties lie in collective action problems, legal hurdles, power asymmetry (especially when the CEO sieges on the nominating committee) and the high legal costs of mounting a proxy contest[177]. Replacing directors is made even more difficult in the presence of staggered boards, since shareholders can typically only change 1/3 of the board per year[178], making board replacement an onerous multi-year activism task.

Bebchuk points to a wealth of data suggesting that contested elections are rare in the US. For example, between 1996 and 2002, contested elections occurred 215 times (but in only 80 companies out of the thousands of public companies), and numbered about 30 per year[179]. Only about 2 contests per year out of those 30 occurred in companies with more than 200 million in market cap, so it appears that election contests were particularly infrequent in large public companies[180]. Bebchuk summarizes his position as such:

> "The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. […] But the safety valve is missing. Although shareholder power to replace directors is supposed to be an important element of our corporate governance system, it is largely a myth. Attempts to replace directors are extremely rare, even in firms that systematically underperform over a long period of time. By and large, directors nominated by the company run unopposed and their election is thus guaranteed"[181].

Harvard professor and ex-dean Robert Clark also supports Bebchuk's opinion that shareholder voting rights in corporate elections are extremely weak:

> "A cynic could easily conclude that shareholder voting in a public company is a mere ceremony designed to give a veneer of legitimacy to managerial power"[182].

As a consequence, the Board of directors becomes more like a self-perpetuating body with a very high re-election rate of incumbents. This heightens the risk of stagnation, homogeneity and cronyism. More generally, in practice, shareholders simply relinquish the disciplining power of removal (or threat of removal) that aligns their incentives with those of Insiders.

Second, in terms of **compensation**, as we have seen previously seen, Insiders can easily use their "positional advantages" to derive various forms of excess pay and perks. Bebchuk summarizes:

> "There is a link between managerial power and pay. The more power managers have, the more favorable their compensation arrangements are"[183].

To explain rent extraction in the compensation-setting process, the strongest argument given by Bebchuk and Fried relates to a power dynamic where directors and managers mutually ensure their own survival via the election process. While directors are responsible for selecting and appointing executive managers, managers carry reciprocally vast influence on the director nomination process[184]. This bilateral appointment scenario ensures that both parties have strong interests to collaborate collegiately, and possibly collude, to retain power.

Since the position of corporate director carries great benefits (a median salary of $116K for the top 1,000 US companies, in addition to additional perks, prestige and valuable social connections[185]), directors have considerable reason to want to be re-elected. In theory, since directors are supposed to monitor management on behalf of the corporation and its shareholders, one would assume that "making shareholders happy" would be paramount for a director's re-election. In practice, shareholders have little if any involvement in director re-election. Historically, as Bebchuk notes, "candidates placed on the company's slate […] have virtually been assured of being reelected"[186]. Thus, it turns out that the reelection of directions is much more dependent on the benevolence of management than the involvement of shareholders. As Bebchuk notes, "CEOs have had considerable and sometimes decisive influence over the nominating process", citing the role of CEOs sitting on nominating committees and the blocking power of CEOs.

In addition to the central theme of power retention via elections, Bebchuk cites a number of other economic incentives, as well as psychological factors (such as collegiality, friendship and loyalty, and authority) to justify why managers and directors prefer not have fall-outs over pay issues. Furthermore, short of outrage-provoking compensation that would jeopardize the reputations of the parties involved, it would appear that there is little outside pressure to heavily scrutinize pay contracts. Courts have also been almost unanimously opposed to reviewing compensation arrangements, preferring to defer to managerial discretion[187].

In the end, compensation contracts are often only loosely negotiated. Since managers can capture directors, it appears they can play a direct role in setting their own compensation. As economist John Kenneth Galbraith reminds us:

> "The salary of the chief executive of the large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself"[188].

Directors can also be relied upon to approve other self-dealing transactions (other than executive compensation), which can provide additional compensation and private benefits to directors. While director approval can be an effective review mechanism for self-dealing transactions, it must also be noted that "rampant self-dealing approved by disinterested board of directors appears to have been an important contributor to the Enron debacle"[189]. Because of their

loyalty or dependence on management, directors may be less likely to derail inefficient self-dealing transactions than they should otherwise be[190].

In Canada, shareholders used to have a certain say on pay via the approval of a rule setting the compensation packages of corporate officers[191]. However, through corporate law reforms, the power of officers and board members to set their own compensation (as long as it is consistent with the corporate rules, statutes and shareholder agreements) has grown[192]. Corporate officers now have considerable latitute to set their own compensation. That said, similarly to the US with SOX and other recent legislative reforms, Canada has sought to make compensation arrangements more transparent to shareholders. Notably, boards must now comply with more aggressive compensation disclosure standards through the CSA's Rule 51-102 (*Continuous Disclosure Obligations)*[193].

2.2.1.2 Proxy Voting Advantages

Insiders benefit from general advantages in the proxy voting process that increase their discretion, help them to gain an upper-hand in most if not all proxy-related issue and allow them to capture power. Directors and officers can leverage these advantages to actively impede shareholder activism. Academics typically refer to them collectively as 'agenda control' advantages[194]. Not only do Insiders have a high level of control over their own proposals, they also have "partial control" over the proposals of dissidents[195].

In the US, such Insider advantages include: (1) access to shareholder lists, (2) access to corporate resources, (3) bundling and packaging (4) timing and (5) vote tabulation.

First, Insiders have control over the **shareholder list**. Rule 14a-7 states that directors have the choice of either giving access to the shareholder list upon request or mailing dissident proxy materials to shareholders themselves[196]. In practice, Insiders choose to mail the materials, so they can avoid disclosing the shareholder list and control the timing of the dissident mailing. While state law in the US may provide shareholders a right to inspect the corporate shareholder list for a "proper purpose"[197], Insiders can contest this inspection right in court, which will cause delays, increase legal costs for shareholders and reduce the list's value[198].

Second, Insiders have **access to corporate resources** to defend against any shareholder insurgency. Black states that "Managers can spend corporate funds, essentially without limit, to lobby for a favourable result"[199]. Bainbridge casts this power in a slightly different light: "In theory, incumbent directors do not have unbridled access to the corporate treasury. In practice, incumbents rarely pay their expenses"[200]. Insiders also have access to the corporation's litigation team. On the flipside, dissident shareholders must bare their own costs. The corporation has no obligation to reimburse the expenses of the proposing shareholder, but may choose to do so (usually to bargain or to push through a compromise, which many not be in the shareholder's best interest)[201]. A corporation will typically reimburse the dissident when the proposal aims to resolve a substantive matter (not linked to a "power struggle") and obtains a majority vote of both the board and shareholders[202].

Third, Insiders can **bundle and package** proposals by tying together a bad and a good proposal for shareholders[203]. Shareholders will need to vote on the combined proposal. Insiders can use this bundling of a good proposal to make shareholders accept a bad proposal. As an example, Black cites *Holiday Corporation*, which issued a large one-time special dividend bundled with a revision to the corporate stock option plan that would greatly increase executive compensation[204]. Insiders can also choose to split a proposal into smaller pieces across multiple proxy statements to increase the risk each proposal will be passed. As an example, Insiders could phase anti-takeover measures over multiple proxy statements[205]. As for packaging, Insiders can choose the optimal order of presentation that will maximize their chance of a successful vote. Insiders can choose to put more negative proposals at the bottom of the list, knowing that they would be more likely to get voted down if they were the first items on the list[206].

Fourth, Insiders have **timing advantages**. Insiders are not subjected to the same 6-month proposal submission requirement as shareholders. This affords them greater latitude to make targeted and timely proposals more likely to garner support. Also, shareholders only receive the proxy statement about one month before the meeting, giving them little time to organize a dissidence, develop a proposal, lobby shareholders, receive SEC approval, submit the proposal to the company and/or send materials to shareholders[207]. On the flipside, the company will know 5 months ahead of time the nature of the dissident proposal, leaving them with ample time to prepare lobbying strategy and materials. If all else doesn't work, Insiders also control the date of the shareholder meeting, and can seek to modify or adjourn a meeting, with some constraints, if they think another timing will increase the likelihood of a favourable vote[208].

Fifth, Insider control **vote tabulation**, which means they can "count the votes as they come in and withdraw and modify in mid-vote a proposal that seems likely to fail, or adjourn the shareholder meeting to allow more time to gather support"[209]. While shareholders only learn of the result after the vote, Insiders can use a number of tactics to intervene mid-course, including "increased campaign efforts, target lobbying of shareholders who have voted against them, strategic withdrawal of proposal, and compromise on favourable terms"[210]. Insider vote tabulation with little oversight heightens the risk of miscounting or corruption. As the oft-cited maxim from Josef Stalin states: "It's not the people who vote that count. It's the people who count the votes"[211]. Furthermore, the lack of voting confidentiality also makes Insider vote tabulation more problematic. Except in those few companies who adopt confidential voting[212], managers can use their insight into voting results to lobby or re-solicit shareholders, or worse, indirectly reprimand them in the future[213].

In Canada, management benefits from similar agenda control advantages. For example, while shareholders are constrained to 500 words to explain their proposal, the board faces no such limit. The board can also choose not include proposals judged irregular, not linked to the business of the corporation or that reflect personal grievances[214], although recent reforms have seeked to limit the board's direction to reject proposals in certain situations[215].

In addition to these 'agenda control' advantages, proxy rules also make proxies a cumbersome and costly mechanism for Outsiders. We will explore proxy rules more in depth later in our analysis on the legal limitations weighing down the activism of institutionals.

2.2.1.3 Anti-Takeover Measures

Anti-takeover measures are adopted by Insiders to protect against opportunistic attacks from external corporate raiders. However, their real impact is often to contribute to entrenchment, either by significantly increasing the removal cost of Insiders or by prohibitively increasing the cost of the takeover attempt itself.

Bainbridge proposes an interesting way to analyze more closely the key role of the board in different contexts of major transactions. He distinguishes between two types of transactions: (1) statutory and (2) non-statutory. In statutory transactions (like mergers and the sale of substantially all assets), the board's approval is required. In non-statutory transactions (tender offer, open market stock purchases, proxy contests), the board's approval is not required. Of course, shareholder approval is usually required in both types of transactions[216].

In both statutory and non-statutory transactions, the board may refuse to cooperate or seek to intervene to preserve its private benefits, but they will do so in different ways. In statutory transactions, since their approval is required, directors can simply refuse to cooperate, which will in itself often create "insurmountable barriers" for the bidder[217]. In non-statutory transactions, directors will need to more proactively defend their private benefits against outside attack. Enter anti-takeover measures as extensions to the power of directors. As Bainbridge summarizes: "Takeover defenses reasserted the board's primacy by extending their gate-keeping function to the non-statutory acquisition setting"[218].

The most commonly used takeover defenses can be classified as such: (1) staggered boards, (2) super-majority requirements, (3) poison pills, (4) "just-say-no" defenses, (5) golden parachutes, (6) special shareholding structures and (7) reactive takeover defenses[219].

First, **staggered boards**, also called classified boards, are designed to "postpone the time at which the raider can gain full control of the board after a takeover"[220]. According to Bebchuk, 62% of firms had staggered boards in 2002[221]. Staggered boards make it harder to replace the board in either a proxy contest or a hostile takeover[222] by dividing the board in a few classes (typically 3), with only a fraction of the board seats (typically 1/3) made renewable at every shareholder meeting. The raider may need to be very patient, incur significantly larger costs due to the delay, and wait 2 annual shareholder meetings in order to eventually gain full board control[223].

According to Bebchuk, 90% of staggered boards are implemented through a charter provision, which requires both board and shareholder approval[224] and cannot be later amended by shareholders only. The other 10% are implemented through corporate by-laws amendable by shareholders, except in RMBCA states, which prohibit by-law staggered boards altogether[225]. While staggered boards are increasingly included in corporate charters at IPO time (up from 34% in 1990 to 70% in 2001[226]), they are also paradoxically increasingly subject to midcourse dismantling by

shareholders[227] (average vote for de-staggering up from 16% in 1987 to 53% in 2000[228]). That said, precatory proposals to modify by-laws being non-binding, Bebchuk cites that 90 of the 130 such resolutions between 1997 and 2003 had not been adopted by directors[229].

Bebchuk suggests that staggered boards play a strong role in deterring takeovers. He cites evidence that since 1996, "no hostile bid has even persisted long enough to win two elections"[230]. Also, studying hostile bids between 1996-2000, he found that:

> "Not a single hostile bid won a ballot box victory against an "effective" staggered board (ESB). We also find that an ESB nearly doubled the odds of remaining independent for an average target in our data set, from 34% to 61%, halved the odds that a first bidder would be successful, from 34% to 14%, and reduced the odds of a sale to a white knight, from 32% to 25%"[231].

Bebchuk also finds that there is evidence that staggered boards reduce shareholder wealth and moreover are "correlated with lower firm value"[232]. Bebchuk also finds staggered boards are "the key arrangement" of takeover defenses and one whose "effect [on market value] is several times larger than the average effect of other provisions" in a index of corporate governance measures[233]. Yet, he also concedes that the potency of the defense standalone is only mild or weak[234]. The staggered board is most potent when combined with a poison pill in the "just-say-no" defense, which we will also examine in this section.

On the downside, staggered boards entrench management, reduce the threat of removal and prevent efficient takeovers that would create value for shareholders (often to serve the self-interested motives of directors, like preservation of job and private benefits). On the upside, they do have the merit of helping directors to fetch larger acquisition premia through increased bargaining power, to reduce director turnover, to increase board stability[235], to increase board transparence, and to reduce appealing but inefficient transactions (including those based on private information, notably related to long-term prospects)[236].

Second, **super-majority amendments** are deployed to "raise the majority rule above 50% in the event of a hostile takeover"[237], typically to 80%[238]. The aim is to protect against "structurally coercive"[239] two-tier offers where shareholders are offered a "higher price for the first *n* shares tendered than for the remaining ones"[240]. Two-tier offers are illegal in many states, since they can unfairly prime the pump for only a few shareholders in the first step of the takeover attempt and "freeze-out" others in a second step.

The takeover defense must also ensure that it can only itself be de-activated or amended by a vote equal to the supermajority threshold, rather than a simple majority vote.

Fair price amendments are a "variant"[241] of the super-majority amendment. They ensure that all the company shares are tendered at the same fair price. Insiders can thus reduce the threat of removal from office with a fair price amendment, since it further protects the company against swift hostile attacks. They were used in 25% of companies as of 1999[242].

Third, **poison pills** allow Insiders to "issue more voting shares at a low price to existing shareholders in the event that one shareholder owns more than a fraction *x* of outstanding

shares"[243]. According to Bebchuk, 60% of Delaware firms had pills in place in 2002 and 58% in non-Delaware firms[244].

This is accomplished by giving rights or warrants to shareholders as part of a "shareholder rights plan"[245]. The rights are attached to the common stock but become exercisable upon the triggering of a "distribution event" like a merger or acquisition of a given percentage of stock, typically 10-20%[246]. Issuance of rights does not require shareholder approval[247], so directors have in effect substantial discretion to craft their defense. There are 'flip-over' and 'flip-in' pills, but both types can also be used in tandem. Development in the design of poison pills has been particularly rapid. Many new variants have evolved, such as pills with "back-end plans", "poison debt", "dead hand" and "no-hand" provisions.

The poison pill often dooms the takeover attempt, leaving the raider with the sole remaining option of taking control of the board to rescind the pill before proceeding with the takeover[248]. Redemption provisions are particularly important to allow the board to rescind the pill in order to proceed with an efficient transaction, such as the "window" or "white knight" provisions[249]. Redemption enforced through judicial means is highly improbable. In fact, Bebchuk cannot cite one case that "invalidates or requires the redemption of a standard poison pill"[250].

As Bainbridge states, poison pills must also be protected from an acquirer coming in and either removing directors or adding directors (the "packing the board" strategy) by reserving to the board the power to determine its size[251].

A less used variant of the classic poison pill is the "contractual" poison pill, where the takeover target will seek to attach a "change of control" clause to important corporate contracts with third parties. For example, a key contract between a licensor and the corporation could be made to become void in a change of control scenario[252]. This will make the company less attractive to the acquirer, since it will need to cancel or renegotiate contracts to eliminate the negative effects of the contractual poison pills.

Fourth, the **"just say no defense"** refers to the combined use of poison pills and staggered boards. Rousseau notes that the "just say no defense" theoretically is the "perfect" takeover defense, since shareholders will not sell their shares to the acquirer (the pill "blocks stock acquisitions beyond the trigger level"[253]) and the acquirer cannot quickly replace board members through proxy contests (the staggered board will only allow replacement of a fraction of the board at a given meeting), leaving the acquirer with little or no other alternatives than triggering the pill and assuming its potentially devastating dilutive consequences[254]. This defense is practically insurmountable, yet is still generally permitted in several key jurisdictions. In Delaware, the defense was allowed, even indefinitely, via the *Time* and *Unitrin* decisions[255].

Fifth, **golden parachutes** can be used as a takeover defense to raise the price of the takeover attempt. Large compensation can be promised to target directors and officers in the event of an acquisition, merger or change of control, in some cases above and beyond compensation negotiated through arm's-length bargaining with the target corporation. A key aspect of the golden

parachutes of officers and directors are their stock option plans, which typically fully vest in the event of an acquisition[256]. Golden parachutes were used in 65% of firms as of 1999[257].

This defense can be particularly egregious since it concentrates private benefits in the hands of Insiders rather than rightfully passing benefits on to shareholders, or even to other employees (in the case of tin parachutes). While the payoffs of golden parachutes and stock option plans may better motivate directors to actively consider efficient takeover bids, it may also bring them to consider inefficient transactions that reduce shareholder wealth. That said, Jensen suggests that golden parachutes can be overall quite useful in takeover attempts to reduce the agency costs of directors and to make them more open to consider takeover offers. The proposed severance package in the event of a transaction (the golden parachute) compensates directors for the likely risk of job loss typically associated with a successful takeover[258].

Sixth, Insiders can create **special shareholding structures** that give them disproportionate control rights relative to their cash flow rights. A special shareholding structure is one that deviates from the standard arrangement of a single class of common voting stock applying the 'one-share, one vote' rule, where "voting power is in proportion to economic interest"[259]. The general idea is that "an incumbent who cannot be outvoted […] cannot be ousted"[260].

According to Kraakman, it is important to note however that the 'one-share, one vote' rule[261] is "widely accepted across jurisdictions […], and the dominant rule in the US and the UK"[262], making it more difficult for directors to market these structures to shareholders. The structures are typically created at inception of the corporation or post-IPO, but can be pushed through in rarer cases at a later time if the dominant shareholder has a large enough ownership block or coalition. Therefore, the conclusion from Bozec, Laurin et Rousseau that Canadian companies deviate more frequently from the "one-share one-vote rule" than their US and UK counterparts is a logical outcome given Canada's more concentrated ownership structure[263].

The result is what Bebchuk calls "a lock" on the control of the company by Insiders[264]. Indeed, through these schemes, which are generally legal but heavily circumscribed by the law, Insiders cumulate powers and small shareholders can become almost completely disenfranchised. In a way, these are extreme variations on the theme of separation of ownership and control.

Bebchuk qualifies these special shareholding structures of "controlling-minority structures" (CMS) and identifies them as a separate species of ownership that does not fall on the identified spectrum of widely-held (here called dispersed ownership: DO) or controlled firms (here called controlled structures: CS). Bebchuk warns of their wicked potential, since they cumulate the problems and agency costs of both ownership structures:

> "The CMS structure resembles CS insofar as it insulates controllers from the market for corporate control, but it resembles DO insofar as it places corporate control in the hands of an insider who holds a small fraction of the firm's cash flow rights. Thus, CMS threatens to combine the incentive problems associated with both the CS and the DO ownership in a single ownership structure"[265].

These special structures are also often ripe for conflict, since they create high private benefits of control for the controlling party. As Kraakman astutely points out, if corporate control

has a price set by supply and demand, the buyer who will pay the most will be the party that can extract maximum private benefits of control, possibly through abuse, fraud or misappropriation:

> From a theoretical perspective, control (like other assets) tends to move to those who value it most. Multiple-class voting structures create incentives for control to move from good hands to bad because those who are willing to abuse control will often value it more than those who will not"[266].

Bebchuk demonstrates further that special minority-controlled structures lead to poor project selection (low value, but high private benefits of control), distorted incentives for the controller to grow the corporation inefficiently large (by refusing to sacrifice private benefits of control and not distributing profits to other shareholders), and inefficient transfers of control[267].

We will briefly examine the three prevalent special shareholding structures that Insiders use to retain control, as laid out by Bebchuk, Kraakman and Triantis: (1) Multi-class equity with differential voting rights, (2) Pyramids, and (3) Cross-ownership.

First, the **multi-class equity** structure with differential voting rights is perhaps the most basic special shareholding structure and the only type not to require creation of multiple corporate entities. As Bebchuk notes, all that is needed is that "a planner attach all voting rights to the fraction of shares that are assigned to the controller, while attaching no voting rights to the remaining shares that are distributed to the public or other shareholders"[268], although certain restrictions may be placed on the voting to control rights ratio. Bebchuk cites a DeAngelo study showing that the median fraction of voting rights for Insiders was 57% with only 24% of the ownership rights[269]. An interest variant of the multi-class equity structure is the French model, where some companies gradually increase voting rights over time. Second, **pyramids** are created with only one class of stock when "a controlling minority shareholder holds a controlling stake in a holding company that, in turn, holds a controlling stake in a operating company"[270]. Through this vertical-structure, the minority shareholder can control a firm with a small fraction of ownership. La Porta and Schleifer have determined that pyramids are the most common type of special shareholding structure that Insiders use to retain control[271]. Third, **cross-ownership** structures are conceived so that "voting rights used to control a group remain distributed over the entire group rather than concentrated in the hands of a single company or shareholder"[272]. This horizontal structure was notably used by the Bronfman family in Canada to retain control over Hees-Edper-Brascan, a "web of interlocking companies" which has since been simplified due to investor demands[273].

That said, there are valid reasons why a corporation may want to adopt a special structure, such as (1) the controlling shareholders may want to set up an optimal value-maximizing structure for a given purpose (freedom of choice argument), (2) the founding family wants to retain absolute control over the activities of a company, (3) the owner wants to prevent opportunistic attacks by rivals to seize and extract the private benefits of control[274], or (4) there exists a liquid market that values these control-heavy shares with a control premium[275].

Seventh and last, **reactive takeover defenses** are another option managers can consider to draw power and preserve their jobs, typically after an initial hostile bid manifests itself. A few examples of strategies include: (1) Distributing a special dividend, (2) Share repurchasing, (3) Fixing

break-up fees, as well as the following defenses: (4) White Squire, (5) White Knight and (6) Pac-Man[276].

First, directors of the target board can **distribute** away to shareholders some of the cash reserves that make the corporation such an attractive takeover target. Second, the target board can make an offer to **repurchase** shares of the corporation, which provides shareholders with an alternative to the acquirer offer and allows Insiders to increase the size of the control block to better defend against takeovers. Third, a **break-up fee** is "commonly paid to a prospective purchaser if a contemplated transaction is not consummated for reasons specified in the purchase agreement, including the seller's acceptance of a competing bid"[277]. The target board can use break-up fees with a prefered takeover partner to dissuade other competing bidders from taking over the company. Fourth, the target board can seek to make a control alliance by issuing a large block to an outside partner, a **white squire**, who will not seek to exert control over the corporation. Directors accomplish this through a "stand-still agreement"[278]. Fifth, the target board can choose to negotiate with a white knight acquirer, rather than a hostile acquirer, who directors think is more likely to provide value for shareholders (or who may be more likely to include better side-benefits for directors themselves). Directors accomplish by inviting the **white knight** to sign a "confidentiality agreement" which gives the knight access to precious corporate information in its "data room", and creates an information asymmetry that puts hostile acquirers at a significant disadvantage[279]. Sixth, in the less used but ambitious **Pac-man defense**, the target board can try to buy the target acquirer, which both recognizes the synergy potential of the combined entity and allows directors to preserve their jobs and authority.

Overall, despite the wide variety and widespread nature of several of the defenses[280], it must also be noted that many states have anti-takeover laws prohibiting such methods of director entrenchment. According to the *Unocal*[281] test, defensive tactics should only be permitted when they are "reasonable in relation to the threat posed"[282], implying some form of economic analysis. The negative impact of permitting entrenchment via takeover defenses is seemingly justifed by the court's insistence that shareholders have the power to replace directors with others directors proposing alternative defensive measures. That said, the weakness of the shareholder franchise gives Insiders wide discretion to promote defenses that may not be truly in the shareholder's favor.

As for all takeover defenses, it is also important to remember that while many observers see them to be "against shareholder interests and put in place by managers of companies with weak corporate governance structures"[283], others generally see them as a "weapon enabling the target firm to extract better terms from a raider"[284] in the form of increased negotiating power.

2.2.2 Regulatory Mechanisms

The discretion of Insider is also shielded by a number of regulatory mechanims, including the business judgement rule (Section 2.2.2.1), legal limitation on institutional shareholder activism (Section 2.2.2.2) and a permissive legal approach (Section 2.2.2.3).

2.2.2.1 Business Judgement Rule

Perhaps the strongest force protecting managerial discretion in corporate decision-making is the deference shown by the courts using the "business judgement rule". Bainbridge considers it the "central doctrine in corporate law, […] which permeates every aspect of corporate governance"[285].

The business judgement rule is a presumption that, as long as directors and officers follow a basic decision-making process and act in the best interests of the corporation and its shareholders, they are in essence free from liability relative to those decisions. This exculpation is necessary in a corporation with a central decision-making authority who must make multiple decisions rapidly on behalf of the shareholder principal, and is thus an "inevitable corollary of […] the separation of ownership and control"[286]. However, this discretion should not be used to make selfish or self-interested decisions[287].

The business judgment rule also theoretically confirms the board as the central and final decision-making unit. The American Law Institute justifies the business judgment rule with the need to "encourage risk-taking and innovation"[288] by directors and officers.

Although there has been large controversy and confusion, and thus extensive scholarship, around both the right standard to use to interpret the rule and the proper application of the rule in specific circumstances, the vast undercurrent of protecting managerial discretion over most business decision-making remains intact.

In the **US**, a structured test exists for the court to gauge what type of business judgement qualifies for judicial deference. As Rousseau reports, the American Law Institute has summarized this test:

> "A director or officer who makes a business judgement in good faith fulfills the duty under this Section if the director or officer: (1) is not interested in the subject of the business judgement, (2) is informed with respect to the subject of the business judgement to the extent the director or officer reasonably believes to be appropriate under the circumstances, and (3) rationally believes that the business judgement rule is in the best interest of the corporation"[289].

Bainbridge comments that this test can be decomposed in a number of pre-conditions necessary to shield the director from litigation: (1) an exercise of business judgment, (2) disinterested decision-making, (3) absence of fraud or illegality, (4) rationality, (5) an informed decision-making process. First, the director who does not make a decision is not protected by the rule. Second, the director who is "subject to […] extraneous considerations or influences"[290] and who cannot evaluate decisions on merit is also not protected. Third, the director is not protected when decisions are "tainted by fraud, illegality or self-dealing"[291]. Fourth, the director is not protected when the decision is irrational or proof of "incredible stupidity"[292]. Fifth, directors will not be protected if they do not act with a reasonable amount of care and diligence and if they do not seek material information on key aspects of a decision[293].

When these conditions are met, the courts will defer to the director's judgement, and will not question further if the decision is "equitable, reasonable or wise"[294]. As famously stated in

Aronson vs. Lewis by the Delaware Supreme Court, it is not the role of the court to "substitute its own notions of what is or is not sound business judgment"[295].

In **Canada**, Section 122(1) of the CBCA incorporates a principle that is "essentially comparable to the American common law business judgement rule"[296]. McGuiness summarizes the baseline situation in Canada:

> "In the ordinary case, the day-to-day management of the corporation by the directors is not subject to review by the courts. The members of a corporation are bound by its constitution and cannot complain concerning decisions made by directors as a governing body within the general mandate of the corporate constitution. They directors are not servants to obey directions given by the shareholders; they are not agents appointed by and bound to serve the shareholders as their principals"[297].

Therefore, the court will refrain from action and tolerate simple errors, as long as conditions similar to those in the American test are met:

> The directors are bound to discharge their duties of care, loyalty and good faith to the corporation, but they are not liable for simple errors of business of judgement that they may make in the management of a corporation. Nor will the courts assist the shareholders of a corporation in restraining the directors from acting in what the directors considered to be in the best interest of the corporation"[298].

McGuiness suggests that courts would abstain from interference as a general rule, unless one of the following situations is met: (1) Directors are defrauding the corporation or some of its shareholders or (2) Directors are acting over their power or are causing the corporation to exceed its powers[299]. These exceptions are quite similar to those stated in *Dodge v. Ford Motor Co.*[300], one of the earliest cases to establish the bounds of the court's authority relative to corporate decision-making in the US.

The deference of the courts following the business judgement rule is also well established in several key Supreme Court of Canada decisions, including *Peoples*, *BCE* and *Danier Leather*.

The business judgment rule was formulated in the 2004 *Peoples v. Wise*[301] case, where the court judged that they should confer "deference to management decisions on matters of business so long as the decision falls within a range of reasonableness"[302]. One commentator notes that the formulation of Canada's business judgement rule in *Peoples* was essentially imported from US corporate law, in that it gives wide discretion but not free reign to directors in their decision-making[303]. In the 2007 *Kerr v. Danier Leather*[304] case, the Supreme Court also upholds the business judgement rule, while giving additional insights circumscribing its applicability, this time in the context of earnings forecasts to be included by Danier in their prospectus to investors. The prospectus is subject to mandatory disclosures under Ontario's securities law. The court's analysis is that the business judgement "would not have relieved Danier from its obligation to disclose a material change" and that "traditional justifications for the business judgment rule, namely the relative expertise of management and support for reasonable risk-taking, do not apply to disclosure obligations"[305]. In other words, while the business judgement rule gives considerable discretion to officers in matters relating to business decisions, it will not however shield them from fulfilling their legal obligations. Finally, in the 2008 *BCE*[306] case, the Supreme Court once again strongly reaffirms

the business judgement rule. Provided that a board is "well-informed and follows a fair process", the courts should defer "not only to the manner in which competing interests are balanced, but also to a board's reasonable judgment as to which interests to take into account"[307].

Overall, in both US and Canada, we believe the reasoning behind this strong non-interventionist position by the courts also reflects two types of practical constraints: (1) capacity and (2) competence.

On one hand, **capacity**-related constraints preclude shareholder involvement due to volume issues. First, given the number of business decisions that need to be made in the ongoing course of business, directors do not have the capacity to consult shareholders in an efficient and timely way each time. Second, given the variety of interests that exist inside the ownership base, the courts would not have the capacity to intervene to mediate all conflicts between shareholders.

On the other hand, Rousseau also puts forward two additional **competence**-related constraints that underlie judicial deference. First, he argues that directors as a group are the most competent body to take corporate decisions. With the business judgement rule, the board of directors can focus on making the right decisions for the firm without omnipresent litigation risk. This is key, he argues, since most decisions have a probability of loss, and most directors would be overcautious and reject high net present value (NPV) projects without the shield of the business judgement rule[308]. Second, he argues that the court, in most situations, is not the competent body to review business decisions. This situation can be in part explained by the general difficulty of 'ex-post facto' decision analysis, but also by the judge's lack of knowledge or expertise as pertains to the company or its industry. Rousseau cites *Brant Investments v. KeepRite* Inc to show that the court is not optimally suited to retrospectively interpret business decisions:

> "A trial judge […] is dealing with the matter at a <u>different time and place</u>; it is unlikely that he will have the background <u>knowledge and expertise</u> of the individuals involved; he could have little or knowledge of the <u>background and skills</u> of the persons who would be carrying out any proposed plan; and it is unlikely that he would have any knowledge of the <u>specialized market</u> in which the corporation operated. In short, he does not know enough to make the business decisions required"[309].

2.2.2.2 Legal Limitations on Institutional Shareholder Activism

The emergence of institutional investors, who have a sufficiently large interest in the corporation, as well as expertise to instigate or actively coordinate value-maximizing governance in the corporation, has strong potential to invigorate corporate governance[310]. There are several types of approaches for institutional intervention in corporate governance: (1) influencing or "jawboning" managers or directors to achieve a change[311], (2) using their voting power to enact governance changes, (3) presenting, or threatening to present, a shareholder proposal, and (4) taking, or threatening to take, legal action.

Many authors refer to this potential as the "promise" of institutional involvement. Black sees institutionals as the best agents to monitor Insiders, partly however because there are simply

few or no other agents available. Black points to a number of factors to explain the promise of institutional investors:

> "Common themes in my response to these concerns include the limited incentives of money managers to breach fiduciary duties or other legal rules because they are agents and lost much more if they're caught than they gain if they succeed; the ability of money managers to watch each other; the role of diversification in giving money managers incentives to preserve reputation and in reducing incentives to cheat; money manager fear of political reaction to abuse institutional power; and the need to balance the risk of institutional abuse of power against the certainty of corporate manager abuses under the existing system"[312].

Institutions can be key players to monitor directors and managers in widely-held firms (vertical conflicts), but they are also able to "have an important role in policing the conduct of controlling shareholders"[313] in controlled firms (horizontal conflicts), which are proportionally more prevalent in Canada[314]. That said, MacIntosh argues that the need for institutions is generally lesser in controlled firms, since the controlling shareholder performs monitoring functions[315]. Nevertheless, if institutions can stave off Insider abuse and raise the quality of corporate governance, this creates a wave of benefits for more vulnerable free-riding minority shareholders.

However, as we will quickly understand, severe limitations weigh on institutional investors' ability or incentives to act. Institutionals, like individuals, are prone to exhibit passive behaviour. Bainbridge paints a rather disheartening picture of institutional shareholder activism:

> "Today, there is relatively little evidence that shareholder activism has mattered. Even the most active institutional investors spend only trifling amounts on corporate governance activism. Institutions devote little effort to monitoring management; to the contrary, they typically disclaim the ability or desire to decide company-specific policy questions. They rarely conduct proxy solicitations or put forward shareholder proposals. They tend not to try to elect representatives to boards of directors. They rarely coordinate their activities"[316].

Pozen posits that this observed passivity might be tributary to the only "modest returns" expected by institutionals from governance interventions[317]. In fact, many if not most institutionals tend to stay away from conducting expensive proxy fights and proposing nominees for corporate elections. It appears very few institutional investors have ever submitted shareholder proposals to affect corporate governance. A 1996 study by Daily finds that only 13 of the 975 institutions surveyed had ever submitted a proposal over a period of 8 years[318]. Furthermore, institutionals appear to spend very little on corporate governance. A 1997 study by Del Guercio and Hawkins finds that "activist institutions spend less than 0.005% per year on governance issues, while they spend 100x more on stock picking management fees[319]. Not only do they participate infrequently and spend little, they tend to deploy limited efforts when they do vote. According to Black, they either support management, follow the ISS recommendation or follow a pre-existing voting guideline[320].

Many other factors also help to justify the passivity displayed by institutionals in firm governance. Black summarizes:

> Legal rules, agency costs within the institutions, information costs, collective action problems, and limited institutional competence are all plausible partial explanation for the relative lack of activity[321].

We will focus the bulk of our analysis on the legal rules hindering activism, distilling the key issues from the frameworks put forth in two seminal papers on institutional activism: Black's *Shareholder Passivity Re-Examined* on the US side and MacIntosh's *The Role of Institutional Retail Investors in Canadian Capital Markets* for a Canadian perspective. We will also complete our analysis with a brief discussion of the secondary arguments of agency costs and competence identified by Black.

As for legal rules, they can be boiled down to regulatory constraints that relate to: (1) Proxy rules, (2) Insider trading rules, (3) Takeover rules (incl. poison pill triggering), (4) Antitrust rules, (5) Ownership disclosure, (6) Controlling person liability, (7) Fiduciary liability of pension managers, (8) Institutional ownership caps and (9) Ownership aggregation.

In many ways, it is the sum of these legal rules that in effect discourage institutionals to own large blocks of equity and to actively exercise control rights over their blocks. While none of the rules by itself prohibits activism, both MacIntosh and Black agree that it is the cumulative effect of these rules that slows the impetus of activism[322]. In other words, they make solving the collective action problem of fragmented shareholding that much harder. Black synthesizes this situation in the following formula:

> "Owning 5% is easy if you're passive; hard if you're active. Owning 10% is hard even if you're passive, but much harder if you're active. Going beyond the threshold for triggering the poison pill, often only 10-15%, is impossible without the company's approval."[323].

Let's see how this "complex web "[324] of legal rules impedes institutional activism.

First, **proxy rules**, in addition to these "agenda control" advantages, also make proxies a cumbersome and costly mechanism for institutionals. Overall, the rules make it more difficult for institutional investors to own large blocks and to coordinate action amongst themselves. The rules include both substantive and procedural constraints. Substantively, in the US, proxy rule 14(a)(8) "bars access in three key areas: directors nominations, statements in opposition to management proposals, and alternatives to management proposals"[325], which greatly reduces the disciplining power of the proxy for shareholders. Procedurally, the proxy rules impose "costs, delays, and legal risks on shareholder efforts to communicate with each other"[326]. In the US, a shareholder can only make one proposal per year, must redact it in 500 words or less (while Insiders can redact a text of any length[327]), and must submit it 6 months prior to the shareholder meeting[328] (while Insiders are not subject to this requirement). It must focus on a 'proper subject' of significant importance, which is not an issue of ordinary business[329]. Furthermore, regarding disclosure, proxy rules mandate that "anyone who solicits proxies from shareholders to give each shareholder a written proxy statement containing various specific disclosures, and to clear it with the SEC before use"[330]. The terms used to qualify solicitors are "sweeping"[331], which can have a "chilling effect"[332] on shareholder communication. Management can sue shareholders soliciting proxies (or communicating amongst each other to that goal) if they are not properly disclosing their activities. Shareholders must go to great lengths not only to disclose their solicitation, but also to include all materials facts in its disclosure – or risk future litigation. As for the approval process of the solicitation materials,

shareholders must deal in some cases with "nitpicking" and with what some practitioners refer to as a pro-management bias of SEC staff[333]. Due to the complexity and risk of the procedural aspects, costly legal counsel is inevitable to navigate proxy waters[334].

It must be noted that in Canada, recent corporate law and securities law reforms have gone to great lengths to ease proxy rules to favour shareholder activism. The CSA's 2003 National Instrument 51-102 provides a number of provisions exempting shareholders from disclosure obligations in various situations and relaxes the definition of proxy solicitation, with the benefit of enhancing shareholder communication. Because of these reforms in the last 5 years, coalitions of instititutionals investors, such as the highly influent CCGG group in Canada, have been able to effectively play an increasingly larger role in jawboning poorly-governed firms to change their governance practices. In many cases, the benefits of this activism also profit smaller free-riding shareholders. At this time, there does not seem to be a coalition exerting such influence in the US market, most likely because of stricter sollicitation restrictions. While the smaller size and tightly-knit nature of the Canadian financial community may be responsible for this outcome, the emergence of a private coalition of institutional investors, who have the potential to self-govern the corporations in their portfolio with minimal resort to the courts, seems an exciting avenue of "promise" for insititutional shareholder activism and better corporate governance in the future.

Second, **insider-trading rules** can add reporting burden and litigation risk, while reducing liquidity for the large institutional shareholder. In the US, under article 16 of the SEC rules, 10% beneficial owners are treated like corporate directors and officers, in that they need to report all stocks purchases and sales on a monthly basis and are prohibited from swing trading profits[335]. Most importantly, the shareholder becomes subject to article 10(b) rules, which bans trading based on material non-public information. Perhaps the most interesting aspect of this rule is that US case law recognizes a shareholder who nominates a director in a similar category as a 10% owner under the "deputization" principle[336]. Under this principle, a nominating shareholder cannot trade on material non-public information, so the institution must either make public the information before it trades, which will reduce its liquidity, or abstain from trading[337]. This recognition is of critical importance, since it will discourage institutionals both from owning a block larger than 10% (which would help to mitigate collective action problems) or from electing representatives to the Board (which may ensure better monitoring and reduce information costs). If they do carry forward with deputization, they can try to shield themselves from litigation by isolating the nominated director from the institution with a Chinese wall[338]. Institutions also want to avoid the large damages and negative publicity associated with insider trading violations.

Third, **takeover rules** also discourage institutionals from owning large blocks of shares. As detailed earlier, poison pills are widely-used and effective methods of defending against a control attempt from an external shareholder building a large block. The poison pill can be triggered if another shareholder "acquires beneficial ownership of more than threshold percentage"[339], usually between 10-20% of the corporation's equity. Institutionals can thus run a risk of accidentally triggering the pill, especially because the threshold percentage can be revised downwards rapidly[340],

which can provoke dilution, a drop in share price and massive losses for the institution. As Black comments: "Institutional financiers can't take even a small risk of triggering a poison pill. The downside risk is simply too great. Thus the pill is a near absolute barrier to forming a shareholder group larger than the threshold percentage"[341].

Fourth, **antitrust rules** also discourage institutionals from becoming large and active block holders. In the US, because of the *Hart-Scott-Radino Act*[342], shareholders seeking to buy 15% or $15 million of stock must pay a $20,000 filing fee and seek FTC approval. Certain exemptions are made, notably if the stock sale is made "solely for the purpose of investment" or if the shareholder has "no intention" of participating in firm governance[343]. This leads Black to comment that "the concept of an active investor, it seems, isn't in the FTC's vocabulary"[344].

Fifth, **ownership disclosure requirements** impose cost and legal risk for institutional investors[345]. In the US, the SEC's Rule(13)(d) requires ownership disclosure from any person or group owning more than 5%[346]. In schedule (13)(d), the group must reveal its identity but also its purpose (acquisition, proxy fight, hostile takeover, undervalued investment, etc…). Company managers can sue the group for various reasons, typically misdisclosure of its purpose[347], forcing the group to bear the cost of the suit. This leaves institutionals with a catch-22 that Black describes as "If they don't organize, they're unlikely to succeed. […] If shareholders do organize, they've formed a group with attending reporting requirements and litigation risk"[348]. In Canada, buying a 10% stake triggers the "early warning system", which requires immediate filing of a press release and new reporting obligations[349] to notify minority shareholders of a potential change of control event.

Sixth, **controlling person liability** imposes a number of additional obligations on large institutional shareholders. According to SEC rule 144, the "control person" can only sell shares through a "registered offering of the 'dribble-out' provisions […], which involves delay, expense and [...] liability"[350]. The dribble-out provisions also hamper the shareholder's liquidity. The control person, a term that is again widely interpreted, becomes "liable for the company's securities law violations"[351]. In Canada, MacIntosh states that stock sales from control persons (set at 20% threshold of ownership) are subject to additional reporting obligations and a hold period between 6 and 18 months on the sale, which significantly reduces the liquidity of the controlling person[352].

Seventh, the **fiduciary liability of pension fund managers** steer them away from activism into the prudent pastures of passive ownership. In the US, corporate pension plan fiduciaries are liable under ERISA, while public pension fund managers are liable under the "common law of trusts"[353]. As Black paraphrases: "Broad diversification and passivity are safe; concentrated ownership and activism are dangerous"[354]. Trust law also suggests that "active management of an operating business violates the prudent investor rule", which could trigger criminal prosecution for the fund managers.

Eight, institutional investors face myriad **ownership limits** that impede their capacity to own large blocks. The nature of the institution might impose stock-holding limitations. In the US, bank holding companies can own stock only through their 'trust' arms and never above 5% of a single

company, while savings and loans are completely forbidden from owning stock. Insurance companies face limits on "how much they can invest in the stock of a single company". Mutual funds in the US cannot invest more than 10% in a stock to preserve tax benefits linked to the 'diversified' status of its fund[355]. Mutual funds in Canada are also subject to the 10% rule and cannot "purchase securities for the purpose of exercising control or management of the issuer"[356]. Also, the institution might be restricted in terms of the fraction of the portfolio it can invest in equity. MacIntosh points out that "most federally chartered institutions cannot invest more than 70% of their capital in common shares"[357]. The thrust of these restrictions usually lays in either a) trying to constrain risk by avoiding losses associated with imprudently large positions (an argument that can be easily voided by diversification[358]) or b) aiming to preserve healthy capital adequacy ratios for financial institutions by limiting their exposure to risky assets relative to capital[359].

Ninth, **ownership aggregation** issues complicate accounting of stakes, which has the potential to inadvertently trigger obligations associated with any or many of the rules listed above. For example, pension and mutual funds, who typically have assets with many money managers (either internally or externally) making their purchase decisions independently[360], may cross a beneficial ownership threshold when shares are considered in aggregate.

In addition to this web of legal rules, agency costs and competence are two secondary, while still critical, issues to consider in order to foster institutional activism.

First, **agency costs** and conflicts of interest are present across the institutional board. These conflicts can be at the manager level or the institutional level. At the manager level, institutional managers have "limited incentives to monitor because they keep only a fraction of the portfolio gains"[361]. Managers may be swayed by psychological factors or a short-term profit motive, since their own compensation may depend on producing short-term results (which Black terms "money manager myopia"[362]). They may also have close business relationships with the firms they invest in. At the institution level, different institution types have different sources of conflict. Black advances that public pension funds and mutual funds are the two groups who have "fewer conflicts of interest" and are best positioned to lead institutional governance efforts[363], but also adds that "no institution is conflict free"[364]. Corporate pension fund managers, banks and insurers face particularly strong pro-manager pressure, since they must please corporate clients to attract or retain business[365].

Second, in terms of **competence**, the expertise of fund managers as investors may not translate into an executive decision-making expertise[366]. Black's argument that "economies of scale" exist when managers learn to intervene on recurring issues (such as director nominations and antitakeover measures) across many corporations[367] needs to be counterbalanced by the low number of managers who have the practical competence to efficiently harness those corporate governance mechanisms (and their often complex afferent rules)[368].

For all these reasons, institutional activism is relatively limited or rare.

For many authors like Black, this situation is unfortunate and reduces the quality of corporate governance. Black suggests there is a “strong case for reform”, especially through deregulation of the legal barriers impeding activism[369]. He argues that a new facilitating regime should “facilitate joint shareholder action not directed at control”[370] and calls for a larger “institutional voice” that would lie somewhere in the center on the continuum spanning from passivity to control[371]. However, Bainbridge disputes this position by arguing that institutional activism “undermines the role of the board of directors as the central decision-making body”, is not necessarily beneficial to passive investors (who have another agenda), does not solve the principal-agent problem, and generally reduces the quality of corporate governance[372].

2.2.2.3 Permissive Legislative Approach

Another contextual force strengthening the hold of Insiders on corporate power is the “permissive” legislative approach, which promotes self-regulation rather than strict mandatory rules. It “abstains from imposing one set of governance norms on corporations” and lets firms select on their own what they believe are “value-maximizing governance norms”[373]. In other words, corporate governance is viewed as a “private matter left to the discretion of corporate actors”[374].

As Rousseau notes, the permissive or enabling approach is well rooted in corporate law theory. If the corporation is a nexus of contracts, corporate law should be principally to “facilitate the formation of contracts”[375]. The corporation itself was created as a “simple and flexible” procedure to dispense businessmen from “unnecessary formalism”[376]. The permissive approach is also consistent with the business judgment rule that pervades corporate law[377].

While the permissive approach is widely recognized in corporate law literature as more appropriate than prohibitive law in order to give corporations sufficient flexibility to meet business needs, the absence of more binding law may fail to deter opportunistic acts by Insiders.

Private norms are also often referred to as “non-legally enforceable rules and standards (NLERS)”[378], which are typically self-enforcing but can also be enforced by guilt, shunning or shaming[379]. Corporation themselves can make their own informal rules or can choose to follow more official norms proposed by stock exchanges. Most stock exchange norms relate to the structure and function of the Board, especially regarding its composition, independence, monitoring and committees.

While a permissive or deferential legislative approach is generally favoured by both US and Canada, the legal environment in Canada is particularly permissive due to many factors inherent to the Canadian financial marketplace, including higher ownership concentration and smaller capitalization of its companies[380]. The Canadian landscape makes it even more important for corporate and securities law not to impose oppressive or high-cost compliance burdens on corporations. For these reasons, we will explore more in depth the history of permissive legislative decisions on the Canadian side.

In Canada, the permissive nature of the legislative framework is particularly visible through the reform efforts of the last two decades. In three separate instances, corporate governance

reform taskforces have focused on the central role and function of the Board of Directors, but suggested that the decision to adopt or implement their recommendations should generally be left up to corporations themselves.

The 1978 *Bryce* taskforce preferred that its recommendations not be made into law:

> "We think the results will be better if these views are adopted voluntarily rather than being imposed by law upon an antagonistic group, and then observed only with reluctance and formality. The final result might then be tokenism or cosmetic "window dressing". […] We hope that major Canadian companies will respond to these suggestions in a positive way, and will incorporate them into their formal operating activities"[381].

The 1993 *Dey* taskforce elaborated in its *Where Were the Directors?* report a number of guiding principles for publicly-listed corporations, but the Toronto Stock Exchange in the end preferred not to make the principles imperative. As Rousseau notes:

> "The Manual encourages issuers to take into consideration the guidelines enacted but leaves it to issuers to determine the extent of their compliance"[382].

The 2001 *Saucier* taskforce also preferred not to make their recommendations mandatory:

> "While there may be a place for regulating some aspects of corporate governance, our view is that disclosure is a much better approach than attempting to regulate behavior, if one is seeking to build a healthy governance culture. Indeed, we believe that regulation aimed at changing board behavior may turn out to be counterproductive"[383].

The 2003 securities laws reforms also generally shied away from more invasive legislation:

> Market participants and regulators debated over adopting a US-style, rules-based system. In many cases, Canadian regulators have been reluctant to impose regulations, choosing instead to encourage good corporate governance through voluntary best standards and guidelines[384].

In many cases, the reform committees preferred "disclosure-based" approaches, where corporations simply disclose their governance practices and to what extent they adhere to recommendations, rather than more binding approaches. However, letting corporation "regulate themselves"[385] often affords corporations with too much creativity relative to their compliance statement. As was noted famously in the *Cadbury* report, the "How much is enough to establish compliance?" question for directors quickly becomes "How much can I get away with?"[386].

For this reason, Rousseau points out that the effectiveness of private norms should "not be overstated"[387]. Also, if shareholders do not have access to adequate information (only 51% of TSX firms produced compliance statements in Canada, and even those statements were often of a general nature[388]) or if that information is not credible (it is impossible or too costly to ascertain the veracity of the statements), shareholders will not be able to actively discriminate between firms with good and bad governance practices. Therefore, they cannot easily discipline firms with bad governance by selling their shares in the open market[389]. That said, it should be noted that security law reforms in 2003 considerably strengthened the quality of the disclosure, notably through the adoption of multi-lateral instruments MI 52-109 (*Certification of Disclosure in Issuers' Annual and Interim Filings*), MI 52-110 (*Audit Committees*), MI 52-111 (*Internal Controls*), as well as national instruments 58-101 (*Disclosure of Corporate Governance Practices*) and 51-102 (*Continuous*

Disclosure Obligations), via the involvement of the Canadian Securities Administrators (CSA) and the Ontario Securities Commission (OSC)[390].

While the improved transparency accompanying these new disclosure requirements may in some cases deter some officers from opportunistic behaviour, the permissive environment that generally reins in both Canada and US still confers significant discretion to Insiders.

2.2.3 Market Mechanisms

In addition to internal governance and regulatory mechanisms, the discretion of Insider is also shielded by a number of market mechanims, including the passivity of individual shareholders (Section 2.2.3.1) and the blind-eye of external gatekeepers (Section 2.2.3.2).

2.2.3.1 Individual Shareholder Passivity, Collective Action and Rational Apathy

The passivity of individual retail shareholders, which manifests itself by a preference for non-interventionism and a sort of "rational apathy" related to governance affairs, is another very powerful force conferring discretion to Insiders.

The passivity and apathy of the individual shareholder can be explained by a few main issues: (1) general collective action problems, (2) the cost of action relative to free-riding, (3) management control over the agenda and corporate resources and (4) the lack of power to initiate action.

First, **collective action problems** of a general nature prevent concerted shareholder action. One shareholder must bare all the costs and reap only a part of the rewards produced by action. Also, since small individual shareholders typically do not own a significant share block, they are unable to meaningfully exercise control over the corporation. This is the "drop in the bucket" argument made by Black[391]. There are additionally a number of regulatory obstacles hindering communication and co-operation in the shareholder base, which could help to mitigate collective action problems. Co-operation, while naturally difficult with a fragmented shareholding base, is made even more difficult with legal requirements relative to the size of the co-operation group. In the US, Kraakman points to the "registration requirement for any '5%' group of shareholders who agree to coordinate their voices" as a "significant barrier" to co-operation[392].

A form of "rational apathy" ensues, where shareholders have little incentive or interest in matters of firm governance, unless the problem is so large that the benefit of intervention makes it worthwhile to intervene. Given this baseline context of apathy, the shareholder will typically prefer to exit and sell his shares, rather than trying to proactively improve governance. This shareholder choice of selling their stock or getting involved in corporate governance is known in corporate literature as the choice between 'exit' and 'voice'[393]:

> When unsatisfied with the management of the portfolio corporations, it appears <u>more rational for them to sell their shares</u> rather than initiate measures to address the problem. Indeed, an investor

> choosing to launch a campaign to contest the leadership of managers or propose governance changes will bear all of the costs of the intervention while receiving only a fraction of the benefits that it can generate, based on the size of his or her investment"[394].

Shareholder apathy is common in widely-held firms and indeed "magnifies the agency problem" by giving Insiders more discretion, heightening the risk of opportunistic behaviour. However, as Rousseau, Daniels and MacIntosh also note, this apathy is equally present in controlled firms:

> "Apathy by minority shareholders enables the dominant shareholder to use the control of the corporation to realize self-serving operations detrimental to the corporation as a whole"[395].

Second, **action is costly relative to free-riding**. The costs that shareholders must bare are tributary of the general regulatory hurdles they must face to enact change in the corporation. Shareholders have little motive to exercise rights or instigate often expensive governance mechanisms. Shareholders adopt a wait-and-see approach while "free-riding" the beneficial changes enacted by larger shareholders[396] rather than instigating themselves. According to Kraakman:

> "Waging a full-scale proxy contest requires a multi-million dollar investment to satisfy the SEC's disclosure requirements, obtain the target's shareholder list, hire proxy solicitors and public relation experts, and defend against hostile litigation"[397].

Third, as we have seen, **management's control of the agenda** can be a strong deterring or discouraging force to action, since shareholders know the odds of success are stacked against them.

Fourth, even if an individual shareholder wanted to play an active role in firm governance, he would find that his **power to initiate action** would be extremely limited. We will explore later more in depth the weakness of shareholder "initiation rights". As a quick example, we can note that most shareholders proposals must receive board approval before being presented to shareholders.

For all these reasons, passivity is the default stance of individual shareholders, conferring large discretion to Insiders. On the other hand, this must be tempered by a few factors. Proxy rules, like those of the SEC in the US, do force Insiders to "make sweeping and embarrassing disclosures, to guarantee the insurgent solicitation materials will reach the company shareholders, and in some cases to allow shareholders to piggyback proposals opposed by management at negligible cost"[398]. Kraakman also points to the US as possibly the "only jurisdiction to permit corporations to compensate successful insurgents ex post for their campaign costs"[399]. While this provision allows the instigating shareholder to recuperate some costs, our understanding is that it neither allows reimbursement of unsuccessful insurgents nor allows for a practical mechanism for cost-sharing across the shareholding base to reduce free-riding. As Rousseau notes, the force of shareholder apathy must also be tempered by the modest activism of large institutional shareholders[400].

In Canada, the collective action conundrum is tempered by a more concentrated shareholder base. The presence of dominant shareholders with substantial voting power mitigates the collective action problem, since shareholders have a subtantial economic interest that warrants getting involved in decision-making if necessary[401]. However, as Crête and Rousseau astutely point out, this often simply changes the locus of the conflict, replacing vertical manager-shareholder

conflicts with more horizontal conflicts between shareholders, where the dominant group may have an interest to act opportunistically towards smaller shareholders[402]. In this event, small shareholders may still be apathetic towards more in-depth involvement in corporate governance matters.

2.2.3.2 Blind Eye of External Gatekeepers

Insiders can also use external market agents to perpetrate opportunistic behaviour. Perhaps one of the most interesting observations about recent governance scandals is that they were not perpetrated by corporate Insiders alone, but rather with the complicity of institutions external to the firm. Indeed, Columbia professor John Coffee insists that gatekeeping institutions were a key source of failures leading to several high-profiles US governance scandals[403].

For example, fraud at Enron relied heavily on dormant accounting work from Arthur Andersen. In this case, Andersen sought to preserve lucrative consulting business by glossing over suspicious off-balance sheet transactions. More recently, the demise of financial institutions like Bear Stearns and Lehman Brothers was intimately linked to external credit rating agencies like Moody's and Standard and Poor's. In that case, credit rating agencies gave healthy ratings to special-purpose vehicles (SPV), for example mortgage-backed securities, while at the same time being compensated by these same financial institutions for their rating reports. Although these high ratings facilitated the securitization of low-value assets and their commercialization to the public, they proved artificially optimistic about the cash-flows linked to the assets underlying the SPV. Even though, in a post-Enron world, tough new laws like SOX and new professional standards limit the scope of action of certain participants, there remains a risk of opportunistic collusion, whether active or passive.

We will explore at a basic level potential conflicts of interest for two of the most common external market agents that interact with the corporation: Accountants and Financial analysts.

First, **accountants** review and verify financial statements of corporations. Their mission depends on their independence, professional judgment and objectivity[404]. Rousseau summarizes the main perils likely to corrupt these core values: personal interest (if an accountant has a direct interest in a corporation), self-review (if an accountant is reviewing his own work), familiarity, representation and intimidation[405]. As illustrated by Enron, accounting firms offering multiple services may have a higher threat to independence, if performance in one business stream influences the winning of lucrative business in another stream.

Second, **financial analysts** are the "watchdogs" that monitor the evolution of a corporation's performance and financial situations[406]. While analysts are theoretically encouraged to be independent and objective by their professional code of ethics and Securities law standards, various business circumstances may alter this default mode. Financial analysts can trade in the securities of the corporation as personal investors, typically on the open markets and possibly through derivatives, giving them a particular interest which may taint their independence. In some cases, they can also have business relationships with outside corporations. Such conflicts typically need to be formally disclosed to the institution by the analyst. When a corporation does business with a

financial institution, an analyst may be pressured to treat the corporation favourably for the institution to keep that business, especially when part of his compensation comes directly from the outside corporation. Like accountants, this conflict of interest problem compounds when an institution offers multiple services (research and rating, financing, M&A, consulting, etc…), and where an institution may act favourably or give special benefits in one business service stream to win lucrative business in another. Since institutions often trade or perform a market-making role for the security of the corporation, conflict of interest may arise between the business services and the trading activities of the institution.

In the most serious cases of abuse, corporate Insiders drive the conflict of interest with the external gatekeeper, using control over gatekeepers for an entrenchment purpose. In many cases, however, Insiders are not directly party to the conflict, but benefit from the discretion that results from less vigilant surveillance by external gatekeepers in the marketplace. Due to agency problems, gatekeepers are often self-interested in turning a blind eye to Insider opportunism.

In the US, SOX reform has imposed tough new regulations to structure the corporation's interactions with various external gatekeepers. Later in section 3.3.1., we will explore more in detail a few of these regulations, notably the changes in the audit process for accountants. In Canada, similar reforms have been modeled on SOX, notably the CSA's 52-108, 52-109 and 52-110 rules, which aim to increase the confidence of shareholders in the financial statements produced by corporations and verified by their auditors[407]. It is particularly interesting to note that securities authorities in Canada chose to implement these rules more imperatively, while preferring a more persmissive approach for other reforms echoing SOX that were however imposed at a manadatory level in the US[408].

2.3 Outsiders: Rights and Remedies

Happily, small shareholders benefit from many protections against Insider opportunism, especially in Canada and the US. In this section, we analyze this "multi-strand web of imperfect constraints on managers"[409].

These protections are scattered through multiple sources of law, encompassing but not restricted to the corporation's constitution act, the civil or commercial code, case law and jurisprudence, stock market act and securities regulations, stock exchange listing rules, civil procedure, the criminal code, banking law and bankruptcy law. This complexity can be compounded by the fact that both in Canada and in the US, substantive law exists both at the federal and province/state level respectively.

We attempt to distillate what seems to be a daunting array of sources of law into an overview of the core protections available to a small wronged shareholder. We separate again between three categories of protections: (1) Internal Governance, (2) Regulatory and (3) Market mechanisms.

We will explore similarities across Canada and the US for most mechanisms. We will also point, when useful, where mechanisms may apply differently in Quebec due to the civil law heritage. It is important here to consider the difference in Quebec because, while Canada adopted a number of new remedies specific to the context of corporations in its corporate law modernization project in the late 1970s, Quebec rather opted to integrate some of these principles with a "flexible" approach in its body of civil law[410]. As a result, Quebec minority shareholders stand today significantly less protected than their Canadian counterparts[411].

2.3.1 Internal Governance Mechanisms

Internal governance mechanisms that confer power to shareholders can be separated into three categories: board approval (Section 2.3.1.1), voting rights (Section 2.3.1.2) and transaction rights (Section 2.3.1.3).

2.3.1.1 Board Approval

Shareholder protection mainly lies, fittingly but also somewhat paradoxically, in the hands of the board's central decision-making authority. Perhaps above and beyond any other mechanism (even shareholder voting), the board is the safeguard destined to protect shareholders. As the rightful agent of the shareholder principal, it is indeed the duty of directors to act in the best interest of shareholders of the corporation. This is what Kraakman refers to as the "trusteeship" strategy[412].

Of course, it should already be clear by now that particular transactions (both related-party and major types) present an "omnipresent spectre"[413] of director opportunism that comes at the expense of shareholders. As Kraakman justly notes, the efficiency of the trusteeship is a "matter of degree"[414]. Several elements may strengthen the trusteeship, notably: (1) the ownership structure of the corporation, (2) the presence of disinterested directors, (3) the absence of a staggered board,

(4) the separation of managerial and director positions and (5) the ability for shareholders to select and remove directors[415].

The link between ownership structure and the effectiveness of the trusteeship strategy is interesting to explore. Trusteeship is particularly useful for US widely-held firms, since small-block minority shareholders cannot directly elect their own candidates. In theory, large public corporations have regulatory incentives to try to find motivated, competent directors to act as objectively as possible[416]. On the flipside, in controlled firms, dominant shareholders can influence elections and elect representatives that do not necessarily favour minority shareholder interests. Therefore, as a minority shareholder, trusteeship will make more sense in a widely-held context[417]. This can be somewhat counter-intuitive. It should be logical that the more shareholders are able to design the board, the more they should be able to trust their decisions. However, if some shareholders have too much facility designing the board to match their own interests, minority shareholder interests are more likely to be neglected. Therefore, it would appear that the trusteeship can actually be a more valuable protection where shareholders are able to have a board that serves the interests of all shareholders at large, but where no one shareholder constituency is able to have a stronghold on the design of the board[418].

Although we have already in other sections cast important doubts on the potential motives of directors in many corporate decision-making situations, there are several observers who think that directors can generally indeed be “trusted to do what is best for shareholders”[419]. Bainbridge is among the strongest advocates of a model based on a central decision-making body that makes unreviewable, informed and binding decisions, which he calls “director primacy”. Director primacy installs directors as a “Platonic guardian” at the center of the corporation to act as the “coordinator” of the nexus of contracts[420]. Bainbridge sees the Board as a highly-efficient body that reduces the transaction costs associated with a more distributed shareholder decision-making or approval system. This is similar to how the corporation reduces transaction costs relative to free contracting in the marketplace, as advanced by Nobel-winners Oliver Williamson and Ronald Coase[421]. Bainbridge goes so far as to suggest that the “preservation of managerial discretion should always be the null hypothesis”[422]. In his model, team dynamics, reputation and the market act as strong forces limiting opportunism. Based on director primacy, board approval should be the default step and the most essential force protecting shareholders.

In **related-party transactions**, the board has a strong incentive to get a conflicted transaction approved by a disinterested directors. With this disinterested approval, this decision will either be completely shielded from judicial review following the business judgment rule (in RMBCA states) or it will “shift the burden of proof of unfairness from the defending director to the challenger” (in Delaware and other states)[423]. As for related-party transactions regarding executive compensation, all compensation of top officers must be approved by the board, but is once again heavily protected by the business judgment rule[424]. That said, courts will review some decisions, especially when they are tainted with bad faith or infringe on fiduciary duties. Plaintiffs can obtain damages and nullification. Kraakman mentions that ex-post damages make sense in the context of

US widely-held firms, since small-block minority shareholders are unlikely to hold-up decisions ex-ante[425]. Board approval is cheap, fast and provides few “false positives” (blocking efficient transactions). However, it may also lead to high “false negatives” (failing to block inefficient transactions) if directors do not have the interest to intervene[426]. In Canada, related-party transactions must be examined through an independent evaluation by a special committee of board members and is subject to “majority of the minority” voting, which we will explore in the next section, involving all shareholders affected by the potential transaction[427].

In **major transactions**, board approval is generally required, but must often be accompanied by shareholder approval for certain important corporate changes. In the US, board review alone does not suffice when “corporate actions are large, investment-like and potentially self-interested”[428]. In such situations, it is thought that the benefits of shareholder approval almost always exceed its costs. In Canada, shareholder approval is required in a defined set of major transactions: 1) mergers, 2) liquidation, 3) distribution or sale of assets and 4) going-private transactions[429]. Approval is usually required by a 2/3 majority, although there are some substantive and procedural differences in corporate law between the approval of major transactions at the federal level in Canada and in Quebec. For example, in the event of a liquidation[430], Quebec companies must gather the votes of 2/3 of present and voting shareholders, while Canadian corporations need 2/3 of present shareholders only, voting or not[431]. Another striking difference lies in the sale of assets. In Canada, the board must obtain a 2/3 majority of all shareholders (voting or not, for each category of shares) in order to sell all or a substantial portion of the corporation’s assets when the sale is not performed in the regular course of business[432], while in Quebec the board is in theory free to dispose of the company’s assets without any shareholder approval[433]. Several other major transactions also may not require shareholder approval, such as making an investment in another corporation, as well as short-form vertical amalgamations (a holding and its subsidiary) or horizontal short-form amalgamations (two wholly-owned subsidiaries of a same holding) in Canada[434]. Therefore, shareholder power of approval is relatively well-defined in cases of major transactions. Generally, the board is the first line of defense in analyzing and approving major transactions. Board members have duties to perform these tasks in the best interests of the corporation and its shareholders. This is why board approval is, even in major transactions, a source of protection for shareholders. However, to curb potential opportunism, there is of course the backstop of more direct shareholder approval in the situations we have examined above.

In the next section on voting rights, and particularly in its sub-section on decision rights, we will also examine in more in detail how shareholders can be called upon to approve other important corporate changes, such as modification to the articles and by-laws of the corporation.

2.3.1.2 Voting Rights

Voting is theoretically the central governance right of shareholders.

However, as we have seen earlier, ownership structures impose important practical limitations on the effectiveness of shareholder voting in the corporation. In a widely-held firm, a

shareholder is likely to own too small a block of stock to meaningfully participate in a vote based on representative interest. In a controlled firm, a minority shareholder is not likely to be able to naturally vote down a dominant shareholder, who is mostly free to vote for corporate proposals that serve his own interests best, rather than those of all shareholders.

That said, there are many ways shareholders can participate in corporate voting. We will focus our analysis on the most important voting roles of shareholders: (1) electing directors (appointment rights) and (2) voting on important corporate decisions (decision rights).

2.3.1.2.1 Appointment Rights

There are three key components of shareholder appointment rights: (1) board composition, (2) selection and removal of directors and (3) electoral voting ground rules.

First, the power to affect the **composition of the board** plays an essential role in shaping power dynamics in the corporation. Shareholder can help to define a few important characteristics of the board. According to Kraakman, these characteristics are: "the size of the board (small boards are better), the committee structure of the board (independent audit, compensation and nominating committees are good), the frequency of board meetings (more meetings are better), and the ratio of insiders to independent directors (a majority of independent directors is good)"[435]. Shareholders are also increasingly bringing forward propositions to repeal staggered or classified boards.

There are several guidelines or best practices that shareholders can look to in order to improve the quality of the board, notably those published by stock exchanges. While most of these recommendations are not binding on management, shareholders can try to pressure Insiders to adopt them, either by disclosing their compliance to the guidelines or by bringing forth proposals on issues in a piecemeal way. Given the central importance of the board, it is in the interest of the shareholders that it be the most efficient, transparent and independent possible.

Second, shareholders have **selection and removal rights** for corporate directors. Shareholders have selection and removal rights for directors, which are in theory proportional to their economic rights[436]. These rights can be exercised at the shareholder meeting, by mail or through proxies. Again, this is the "safety valve" of the corporate governance system[437].

Terms are also a critical aspect of the ability to remove directors. In the US, directors have a term of 1 year, which as we have seen can be extended to 3 years in the event of a staggered board[438]. Mid-term replacement of directors is notoriously difficult and costly due to the need to call a special shareholder meeting[439]. However, absent staggered boards, the comparatively short duration of director tenure should make it easy to replace underperforming directors with new blood at the end of their terms. The issue lays either when directors run opposed (due to the inability of shareholders to nominate candidates to the slate) or when staggered boards preclude efficient replacement of poor-performing directors. Thus, the removal power of directors by shareholders is quite weak given the power dynamics of the corporation[440].

Shareholders have a few mechanisms to exercise more forcefully their selection and removal rights: (1) Proxy contests[441] and (2) Withhold-the-vote campaigns. On the one-hand, in proxy contests, a dissident group of shareholders can propose an alternative slate of directors. Other shareholders may vote their shares for the dissident slate to displace entrenched directors. As we have seen, proxy fights are expensive for shareholders who must bare their fees while being at a relative disadvantage to management's control of the agenda. On the other-hand, withhold-the-vote campaigns (also known as just-say-no voting) allow shareholders to vote their shares against the slate of directors proposed by the incumbent board. Shareholders can therefore express their dissatisfaction by abstaining during voting in order to send a message to management.

Third, modifications to **electoral voting ground rules** can augment the impact of shareholder voting. While some of the voting powers come from default provisions (ex: the 1:1 rule), other provisions can be initiated by shareholders (ex: cumulative voting) through a variety of methods. In an interesting turn, shareholders actually have significant power to increase the efficiency of their own voting, by putting together and voting on proposals that change the "electoral ground rules" of voting. In other words, shareholders can "boost" their own voting power[442].

There are several key electoral ground rules that can often be set by shareholders: (1) cumulative voting[443], (2) majority voting (3) voting caps and (4) other procedural aspects.

First, **cumulative voting** can help to protect minority shareholders by ensuring representation on the board of directors. In a cumulative voting process, each board member is elected individually and shareholders can vote all their shares to support one specific board member, which gives smaller shareholders a much better chance to contribute to elect at least one board member to represent their interests[444]. While cumulative voting is mandatory in other jurisdictions, shareholders in the US must explicitly vote to enact it in order to change the default 1:1 electoral ground rule. The elected minority directors will benefit from access to corporate information in board meetings and can also participate in board committees to gain more specific powers. That said, not all shareholders automatically prefer cumulative voting. Shareholders may fear that cumulative voting will challenge the regular authority of the board, especially through "hold-ups" by other minority shareholders, board deadlocks, and slower decision-making[445]. Cumulative voting usually applies to electoral decisions only, not to other substantive corporate decisions.

Second, **majority voting** strengthens the ability for shareholders to send a message to the Board by in effect voting against directors. The CCGG, which is a strong proponent of this technique in Canada (especially in conjunction with voting for directors individually), explains the current landscape: "Currently, the voting of directors is based on a 'plurality system' whereby shareholders vote either 'for' a director or 'withhold' their vote (i.e. do not vote) for a director. In a plurality system, withhold votes do not count and technically a director needs only 1 'for' vote to be elected to the board"[446]. This peculiar situation is due to the voting form, which does not present a "No" or "Against" option to shareholders, limiting the power of shareholders to discipline directors. Majority

voting, in the event that 50% + 1 of votes for a given director or slate are withheld, converts these withheld votes to "No" votes, forcing the resignation and replacement of the board member.

Third, **voting caps** limit the presence and influence of large controlling shareholders on the board. Strong voting caps place an absolute threshold (i.e. 5%) on the maximal voting rights that can be exercised by a shareholder in the US, independently of his economic rights[447]. Weak voting caps also protect minority shareholders by restricting the possibility of controlling shareholder exercising voting rights "in excess" of their economic rights[448]. A weak voting cap might be useful in the event the controlling shareholder has multi-voting rights that confer disproportional voting rights relative to economic rights.

Fourth, **procedural aspects** of voting can include: the confidentiality of voting[449], proxy access by mail[450], the non-blocking of shares before the shareholder meeting[451] and independent vote tabulation.

In Canada, as far as voting rights in general, the CBCA confers many voting rights to shareholders[452], the most fundamental of which is likely the right to elect[453] or remove corporate directors. In terms of voting procedure, the CBCA establishes the 'one-share one-vote' rule as the shareholder default[454] but permits adoption of a cumulative voting procedure[455], which allows for accrued representation of minority shareholders, although this is not mandatory. It allows shareholders to receive information about the shareholder meeting agenda[456]. It also creates a proxy-voting regime[457], which is however not available in Quebec corporate law. Canadian law also allows shareholder to vote for individual directors, rather than full slates. According to a recent 2009 CCGG report, 75% of companies now allow shareholder to vote for directors individually[458].

2.3.1.2.2 Decision Rights

Shareholder decision rights are composed of both (1) veto rights (ie. shareholder approval) and (2) initiation rights.

First, the **veto rights** of shareholders are only moderate at best.

Corporate law highly discourages direct voting by shareholders, notably due to process and information costs. Shareholder voting on everyday business issues is thus largely out of the question. As we have seen, corporations follow a representative system where the voice of shareholders is proportional to their interest. Under this form of 'government', directors manage the basic governance arrangements of the corporation, while shareholders have "little direct say in the running of the corporation"[459]. Judges confer to Insiders a high level of decision making authority "not unlike that possessed by the members of a Legislature"[460].

Rather, corporate law encourages shareholder involvement only in situations where "full-delegation to management is clearly inappropriate"[461], like when directors face conflicts of interest (related-party transactions) or when directors make decisions that fundamentally alter the corporation (major transactions). While managers are theoretically "disinterested" in their decision-making, there is no doubt that shareholders are "affirmatively interested in preserving corporate

value"[462]. As we have mentioned, shareholder approval thus makes a good safeguard for board approval in decisions laced with the potential for managerial opportunism. For those important decisions, the benefits of "short-circuiting" the usual corporate governance model of board authority are thought to outweigh the costs[463].

In terms of ownership structure, shareholder approval is important in both widely-held and controlled firms. In both cases, the danger is that the Insider (either managers or the controlling shareholder) will "misuse power to extract gains unavailable to all shareholders"[464]. However, there is a "suspicion" that conflicts may be even more acute in controlled firms, since even "disinterested" directors in controlled firms may have close ties with the controlling shareholders[465]. According to Kraakman, in controlled firms, shareholder approval is often a safer method of review than board approval[466].

Veto rights exist through these three types of voting methods: (1) supermajority voting and (2) minority of the majority voting and (3) class voting.

First, **supermajority** voting is required for many particular transactions[467]. A 2/3 majority is the common requirement for supermajority voting. In the context of supermajority voting, "large-block minority shareholders will sometimes have the power to block corporate actions"[468]. While a 2/3 supermajority is the requirement in most jurisdictions worldwide, the US in theory requires only a simple majority of outstanding shares, even for important transactions like mergers, asset sales, dissolutions and charter amendments[469]. This may be tributary to the widely-held ownership structure of US corporations or to the power of directors to review transactions. That said, Kraakman notes an important technical detail in the US system, which "implicitly"[470] brings the US closer to the supermajority voting rule. If only 70% of outstanding shares vote, "71% of voting shareholders must approve the transaction"[471]. In cases of low turnout, the 71% percentage (even above the 2/3 supermajority rule) is therefore required to make sure that minority shareholders have their voices heard. In Canada and Quebec, corporate law mandates a 2/3 supermajority shareholder vote of all shares, including non-voting shares, to approve a merger[472].

Second, **majority of the minority** voting is another way shareholders can have their voice heard in particular transactions, especially control transactions. While less widely used, courts have looked to this type of vote as providing "the most reliable method of screening conflicted transactions with controlling shareholders"[473]. Since this type of vote in essence removes the influence of the controlling shareholder, it can provide a veto right that allows minority shareholders to voice their dissatisfaction with a transaction. It is interesting to understand why majority of the minority is particularly present and useful in the US. Since most corporations are widely-held, most shareholders are minority shareholders. Majority of the minority makes sense in the context of widely-held firms, since it will poll the interests of a significant fraction of the ownership base. Majority of the minority also makes sense in controlled firms with a dominant shareholder, where risks of oppression of the minority are likely highest, yet the issue is that it can also "significantly limit the control rights" of controlling shareholders. A strong veto right exercised in the context of controlled firms may cause too many strategic hold-ups.

Third, **class voting** also protects shareholder interests, in that each class has a separate vote in the event of a potentially oppressive decision taken by corporate Insiders. There are many ways insiders may want to modify the corporate structure, such as add new classes of shares (which may infringe on the rights of other classes), modify the rights and privileges of a given class, modify the right to the dividend of a given class, modify the number of shares in a given class, divide a given class of shares, transfer the ownership of shares in a given class, modify the overall number of shares or modify its stated capital. In Canada, article 173 of the CBCA[474] defines the specific changes to the capital structure that may trigger a shareholder class to be unfairly impacted. If the board wishes to modify the corporation's statutes, it must call a special shareholder meeting according to article 176 of the CBCA[475] where each shareholder class will vote as a separate category and where each class must approve the change at a 2/3 supermajority[476]. Non-voting shares become voting shares for this exercise. Unless the Insiders proposing the measure own more than a 2/3 stake, class voting can effectively protect the rights of minority shareholders[477]. Class voting is thus a way shareholders can veto an undesirable change that affects their rights. In the event of an Insider ownership stake larger than 2/3 of a given class, shareholders who have had their rights affected by a fundamental change may seek protection through appraisal rights[478], which we will discuss shortly and which will allow shareholders to sell back their shares to the corporation to exit their investment. In Quebec, we should note that there are differences in how minority shareholders are protected through class voting. Through the "conversion" procedure[479], in corporations who have explicitly set an approval procedure, board members can submit a modification of share rights directly to shareholders for approval via article 48(7) of Quebec's Companies Act[480]. If such an approval procedure has not been defined, then the "compromise" procedure[481] dictates that changes to share rights must be approved by 3/4 of shareholders of the impacted class(es), and then subsequently ratified by the courts (unless the shareholder vote was unanimous to approve the changes) according to article 49 of Quebec's Companies Act[482].

Secondly, in addition to modest veto rights, shareholders have mild **initiation rights**.

As Kraakman comments, the US is one of the jurisdictions that "does the most to restrict direct decision rights"[483]. Shareholders lack the power to initiate significant decisions like mergers, sales of assets or dissolutions. By way of comparison, France, Germany and the UK all allow shareholders to initiate and approve important transactions, as long as this is accomplished with a supermajority vote[484].

That said, there are proactive ways by which shareholders can initiate action over substantive issues in Canada and the US, although their breadth and effectiveness may vary. In both US and Canada, shareholders can exercise their decision rights mainly through 3 types of interventions: (1) Amendment to corporate articles or by-laws, (2) Shareholder proposal or (3) Unanimous shareholder agreement.

First, shareholders can seek to make an **amendment to the articles or by-laws of the corporation**. Shareholders can look to make an amendment to regulate or restrict the exercise of the power of directors[485]. The amendment requires a supermajority shareholder vote and have

binding power over management[486]. Although no board approval is required, the amendment typically needs to be initially presented by the board. Furthermore, according to McGuiness, there is a long common law tradition of blocking shareholder interventions that meddle with firm governance: "So great had the restrictions become that in many jurisdictions it was no longer possible for the shareholder to initiate amendments without prior director consent"[487]. For example, it seems "unlikely" that shareholders on their own could initiate a substantive corporate decision (ie. like limiting director authority to issue a poison pill) by amending corporate by-laws[488]. As Bebchuk adds: "Regardless of how many shareholders want a given charter amendment and of how long they supported the amendment, shareholders may not vote on it unless the board first elects to have such a vote"[489]. Furthermore, while shareholders have "concurrent authority" with the board to amend by-laws, by-law amendments are subordinated to both the company charter and state laws[490]. Shareholders cannot initiate charter amendments or changes to the state of incorporation to resolve this subordination issue. It should also be noted that only charter amendments (and not by-laws) can exclude state law provisions[491]. In Canada, modifications to the corporate charter or by-laws require shareholder approval. A special resolution to modify the corporate articles requires a 2/3 majority of voting shareholders[492], while a proposal to adopt, amend or revoke a by-law requires a simple majority[493]. The shareholders' veto right relative to charter amendments is protected by law at the federal level, while it must be explicitely included in the company articles in Quebec[494]. Also, shareholders in Canada have initiation rights to present a proposal to modify a by-law, while shareholders in Quebec do not[495]. Shareholders in Quebec only have a passive power to approve proposals put forth by management. In any case, proposals to adopt, amend or revoke by-laws must initially be approved by the board at all times[496].

Second, **shareholders proposals** in the US are usually presented under the SEC 14(a)(8) article and are of a precatory nature, meaning they are not binding on management. Management regularly ignores or disregards the results of a shareholder proposal, even if it succeeds. The freedom of directors to ignore proposal results is protected by the business judgment rule. Shareholder proposals have the advantage of being included on the management proxy, reducing the steep cost to prepare a separate proxy. Proposals typically aim to "redeem or weaken a poison pill, eliminate staggered boards, adopt cumulative voting for directors, put the company up for sale, separate the positions of chairman and CEO, and create a nominating or compensation committee composed entirely of independent directors"[497]. On the downside, as noted previously, the proposal must be redacted 6 months before circulation of management proxy, reducing its timeliness and effectiveness. It also presents important limitations, the most severe being the inability to present a nominee for director in the corporate elections. Black comments on the limitation: "Rule 14(a)(8) excludes the most important issue on which shareholders might want a voice, precisely because of its importance"[498]. In Canada, shareholders can make a shareholder proposal that will be included in the management proxy circular and voted on at the shareholder's meeting via article 137 of the CBCA. Shareholder proposals can aim to have adopted, modified or revoked an administrative rule in a corporation[499]. According to 137.4, a proposal can also be made to nominate a director if it supported by at least a 5% group of shareholders. If adopted, the proposal can have in some cases

binding power over management, but the binding nature may in practice vary depending on whether the proposed measure infringes on a key competence of the Board. In Quebec, corporate law does not allow shareholders to make such proposals[500].

Third, shareholders can make a **unanimous shareholder agreement**, which is a powerful written agreement that can restrict, or even sterilize[501], the exercise of power by directors. It can even remove power that was vested to directors under corporate law. Furthermore, it has a status "vastly superior to that of a by-law of the corporation of a simple contract", since it will bind the corporation even if it is not party to the agreement[502]. McGuiness lists a number of possible uses for the shareholder agreement, other than the main reason of curbing director power, such as changing procedures around voting majority rules, issuance of shares, dividend policy, information disclosure, borrowing, delegation of authority, veto power linked to modifications to the corporate structure, approval of significant transactions, election of corporate officers and shareholder representation[503]. However, the unanimous approval needed to create the agreement makes it of limited relevance for widely-held firms, or even controlled firms with a fragmented base.

Now, let us examine how these three types of interventions, as well as how shareholder decision rights in general, actually stand up in practice. To accomplish this, we will again take as an example the crucial self-dealing issue of executive compensation. With regards to excess compensation, shareholders have very few efficient ways to intervene through internal governance structures. According to Bebchuk and Fried, shareholders can try to rein in executive pay via two mechanisms: (1) voting against employee stock option plans and (2) putting forward shareholder proposals[504].

First, shareholder can vote against stock-options plans. In the US, as Bebchuk and Bainbridge note, the SEC approved in 2003 "revisions to stock exchange rules requiring a shareholder vote on most stock option plans"[505], although shareholders had some power in the past to vote on shareholder action plans in order to have them eligible for a tax deduction. However, there remains a number of issues that will limit the meaningful intervention of shareholders. Stock-options plans are presented to investors in a very broad brush, offering few details beyond the quantity of options issued. Shareholders cannot seek to reject the compensation plan for a given executive, but must vote on the plan in its entirety[506]. The visibility of the voting procedure also heightens the perverse incentive for managers to apply more camouflage, like substituting stock options with potentially more costly "share appreciation rights" or cash payments to managers[507]. Managers can typically count on institutionals and corporate employee stock-option plan managers to vote with management and force shareholders to accept the plan. According to Bebchuk, it appears that only 1% of stock option plans presented to shareholders have been voted down[508], illustrating that managers can get their way with only weak or no resistance from shareholders.

Second, shareholders can put together shareholder proposals that can be voted on the company's proxy statement. Bebchuk cites evidence that 40% of the 427 proposals voted on by shareholders in 2003 were related to compensation issues[509], definitely making it a key topic on the minds of shareholders. However, as we have seen, management has clear advantages in the proxy

machinery which gives it an upper-hand, not to mention they can choose to ignore the result of a non-binding precatory proposal.

Finally, as pertains to other important transactions, it should be noted that while the US allows a veto right to shareholders on most important transactions, *both* initiation and veto rights are lacking in "scaling-down" decisions like corporate distributions or spin-offs. Directors have significant freedom to act and do not require any shareholder approval of any kind[510].

2.3.1.3 Transaction Rights

Shareholders also dispose of two transaction rights in particular transactions: (1) appraisal rights and (2) pre-emptive rights.

First, **appraisal rights** allow minority shareholders to sell their shares at a "reasonable price" back to the corporation in the event they disapprove of certain transactions that fundamentally alter their investment[511]. The appraisal right, where shareholders "to 'put' their shares to the corporation on the occurrence of designated corporate fundamental changes, was primarily designed to allow dissenting shareholders a mechanism for exiting the corporation on the undertaking of a fundamental change without suffering a loss in value, while at the same time not impeding majority action"[512].

For shareholders, appraisal rights are costly to enforce and must be thought of as a remedy of last resort, since they are plagued by "cumbersome procedures, delay and uncertainty"[513]. As MacIntosh states, appraisal rights "discourage all but the bravest and largest institutionals"[514]. As far as cumbersome procedures and delays, shareholders must file a "written dissent", abstain from voting and "pursue the valuation claim in court for several years"[515]. Valuation also makes appraisal rights complex, since courts must use several different valuation methods to appraise the company's stock, must consider the timing of the appraisal and must take into account the minority discount and liquidity of the stock.

In the US, appraisal rights are available for certain particular transactions, depending on the jurisdictions. Delaware only allows appraisal rights for mergers, while other US states allow appraisal rights for other types of oppressive decisions, like "asset sales or charter amendments that limit voting rights or eliminate cumulative voting"[516]. Even when appraisal rights could be available, Delaware and the RMBCA limit appraisal rights in stock-based mergers when a liquid market exists for the acquirer's stock[517], since shareholders should in theory be able to manifest their disapproval through a regular stock sale on capital markets (even if they often do so in practice at a significant discount).

In Canada, appraisal rights are referred to as "dissidence rights" or "dissent rights". Article 190 of the CBCA allows shareholders "to be paid by the corporation the fair value of the shares in respect of which the shareholder dissents"[518] in the event their rights are significantly affected by a number of possible fundemental changes undertaken by the corporation. Such fundamental changes include (1) modifications to its articles of incorporation to change the rights attached to that class of shares, (2) modifications to change the line of business of the corporation, (3) mergers

(other than short-form amalgamations), (4) change of jurisdiction, (5) sale or lease of substantially all of its property, or (6) go-private or squeeze-out transactions. At the federal level, shareholders also receive by law a dissidence right in the context of class voting[519].

There are also reasons why appraisal rights may not be in the best interest of the corporation or all of its shareholders: (1) The payout raises the cost of a transaction, (2) The higher cost may cause management to abandon the proposed change or can even jeopardize an efficient transaction that would create wealth for shareholders[520], (3) The payout can lead to a liquidity crunch for the corporation, if many minority shareholders chose to exercise their appraisal right, and (4) The right facilitates exit rather than encouraging shareholder voice or activism[521].

Second, **pre-emptive rights** also protect shareholders by "allowing existing shareholders to purchase new shares pro-rata before any shares are offered to outsiders"[522]. This prevents dilutive deals at lower stock prices that may be the result of opportunistic dealing by managers or controlling shareholders. Pre-emptive rights allow minority shareholders to participate on the same terms. Pre-emptive rights are available in the US only if the corporation's charter provide for them[523], while they are available by default in many other important jurisdictions.

2.3.2 Regulatory Mechanisms

Regulatory mechanisms include elements of both corporate law (Section 2.3.2.1) and securities law (Section 2.3.2.2).

2.3.2.1 Corporate Law

Corporate law protections include fiduciary duties (Section 2.3.2.1.1), the oppression remedy (Section 2.3.2.1.2), direct and derivative action (Section 2.3.2.1.3) and piercing the corporate veil (Section 2.3.2.1.4).

2.3.2.1.1 Fiduciary Duty Standards

The fiduciary duties of directors are a strong mechanism curbing managerial opportunism in a wide variety of circumstances. Directors, as fiduciaries to the corporation, are subject to duties of care, loyalty and good faith[524]. Director liability can be lead to: (1) regulatory or administrative penalties, (2) personal civil liability or (3) criminal liability[525]. Although fiduciary duties are a strong mechanism to hold directors responsible, shareholders need to enforce their rights through derivative action, since directors are fiduciaries to the corporation and not to shareholders[526].

Following the business judgment rule, the courts defer to directors and presume that directors act in good faith and make informed decisions that are in the best interests of the corporation[527]. High-ranking managers of the corporation[528], as well as controlling shareholders[529], are also subject to these duties. The duty of a fiduciary may be breached either by action or by failure to act[530].

In the **US**, the main fiduciary duties are the (1) duty of care and (2) duty of loyalty.

First, the **duty of care** requires directors to demonstrate "that amount of care which ordinarily careful and prudent men would use in similar circumstances"[531]. However, there seem to be very few cases (possibly as few as a dozen[532]) involving straight vanilla cases of director 'negligence', in part due to the strong influence of the business judgment rule, but also since most of the cases deal additionally with conflicts of interest or self-dealing. For this reason, one observer mentions it is like searching for needles in a haystack[533]. The classic reference case is *Smith v. Van Gorkom*, where a board was deemed negligent by founding its decision to accept a particular price in a leveraged buy-out based on a 20-minute oral presentation and without outside consultation[534]. In a similar vein, board members at Disney approved a $100 million compensation package with "shocking carelessness" in a 1-hour meeting, without seeing the agreement draft, advance materials or expert opinions[535]. However, there seems to be a few ways directors can avoid liability linked to breach of fiduciary duty of care[536]: (1) Shareholder ratification (2) D&O Insurance, or (3) Exculpation via by-law amendment. First, directors can seek protection of their contested decision by approval of a majority of shareholders. However, as seen in the *Van Gorkom* case, the approval needs to be "fully informed" (i.e. the board must present all material facts)[537]. Second, directors can take out D&O insurance to shield themselves from costs of fiduciary duty litigation[538], weakening the effectiveness of the shareholder lawsuit as a disciplining mechanism or threat. Third, state law may allow shareholders to approve a by-law amendment exculpating directors of their breach of fiduciary duty, such as Delaware's 102(b)(7) provision "eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director"[539]. However, while this widely-used amendment in essence allows for the overturning of the *Van Gorkom* requirement of informed decision-making, it only applies to directors[540] and does not shield directors from breaches of their duty of loyalty, or breaches involving bad faith, violations of the law or self-dealing[541].

Second, the **duty of loyalty** is linked with self-dealing or conflict of interest scenarios. While duty of care typically engages "the board as a whole", more often than not, the duty of loyalty engages only one particular director[542]. Bainbridge notes that judges are less inclined to apply judicial deference rule with the duty of loyalty than with the duty of care, since judges are "less concerned about destroying internal team relationships" since only one director is concerned[543]. Of course, it also remains possible that a few directors on a board, or even the whole board (for example, if they vote on a pet project that clearly does not serve the interests of the corporation), collectively violate their duty of loyalty. Directors can try to find immunity through three avenues, corresponding to the three exceptions presented in DGCL art 144: (1) board approval, (2) shareholder approval, or (3) fairness. First, if the director gets his decision approved by a disinterested board majority, the court will defer to the business judgment of the well-informed board. Second, shareholder approval of the conflicted decision will limit judicial review of the breach and can shift the burden to the attacking party rather than to the director[544]. Such state law again invalidates other jurisprudence that goes in the opposite direction. Third, directors are shielded when the conflicted transaction is fair at the time of approval by directors or shareholders, even if disinterested directors did not obtain the board approval or if the shareholders were not presented

with all material facts[545]. In other words, this gives directors another liability exit if they are not able to obtain the specific types of approvals demanded by DGCL art 144(1) and 144(2).

Now, let us again take the key issue of executive compensation to see how easily shareholders in the US can use litigation based on fiduciary duties to contest excess compensation. Shareholders can sue the board over breach of fiduciary duties to control self-dealing. However, litigation to curb excessive pay seems quasi impossible, due to both substantive and procedural constraints. Substantively, courts will show deference, citing the business judgment rule and satisfying themselves with only basic requirements, such as review by independent directors or a “minimal amount of deliberation and seriousness”[546]. Bebchuk cites a study pointing to the result that in “almost all 1900 cases” courts had refused to overturn compensation arrangements[547]. The *Disney*[548] case illustrates particularly well the court’s policy to stay out of compensation agreements, no matter how egregious. In this case, Disney executive Michael Ovitz left the company with $100 million thanks to a “counterproductive no-fault termination clause”[549] despite very poor performance. Both the lower courts and the Supreme Court of Delaware “refused to hear arguments that the package was undesirable”[550]. It was only on the basis of carelessness in the decision-making process (duty of care violation, detailed earlier) that the lower courts were later allowed to hear the decision[551]. Indeed, only ‘waste’ is likely to be a sanctioned motive to examine pay cases, although a study also shows that even this motive has not yielded any appellate court decisions to reduce compensation[552]. Procedurally, there are several hurdles to jump through to have a case heard. Shareholders must first make a “demand” to investigate the problem or the board can have the suit dismissed[553], unless shareholders can prove that such a demand is futile[554]. Even then, the board can appoints a “special litigation committee” who can intervene to judge whether “continuation of the suit is in the best interest of the firm”[555]. In the event all requirements are met, the shareholder can only present his suit as a derivative suit, since the corporation (and not him personally) is the victim of the excess pay contract.

In **Canada and Quebec**, fiduciary duties are similar with a few exceptions. They are listed in the CBCA and the QCA, supplemented with the Civil Code in Quebec. Director duties are composed of a duty of management and oversight[556], general fiduciary duties, and other statutory responsibilities. We will focus mainly on the general fiduciary duties, which can be further decomposed into duties to (1) uphold the law[557], (2) act honestly and in good faith, with a view to the best interests of the corporation”[558] and (3) act with competence, care, prudence and diligence[559].

First, the **duty to uphold the law** implies that the fiduciary will respect not only the CBCA laws and rules, but also the articles, by-laws and unanimous shareholder agreement of the corporation. Also, subject to unanimous shareholder agreement rules (when shareholders take on the equivalent of director liability)[560], the director cannot exonerate himself of responsibility by delegating authority. The fiduciary must respect the law and make sure the corporation respects the law.

Second, the **duty to act honestly and in good faith**, with a view to the best interests of the corporation is a controversial duty. The "honestly and in good faith" portion is usually understood to imply several more specific obligations[561], including: maintaining confidentiality of information, disclosing material facts to the corporation, making informed decisions, keeping an independent judgment, avoiding conflicts of interest, not competing with the corporation, seeking approval for related-party transactions, abstaining from self-dealing, asset looting or misappropriation of corporate assets, and not exceeding powers ("proper purpose" doctrine[562]). The "best interests of the corporation" portion of this duty is highly controversial, especially since the Supreme Court of Canada's landmark decision in *People v. Wise*[563] stating that the interests of the corporation may not only be limited to the interest of the corporation's shareholders (the "classic" theory of shareholder primacy[564]), but may further extend to other stakeholders (stakeholder theory). This requirement to consider stakeholder interests is also echoed in the *BCE* case[565], where the court judged that the duty of directors to act in the best interest of the corporation implied the consideration of the interests of the firm's debenture holders, "not only their legal rights but also their reasonable expectations"[566]. *BCE* also states that the fiduciary duty of the directors to the corporation is a "broad, contextual concept […] not confined to short-term profit or share value"[567]. The jurisprudential turnaround, which started with the opinion of Judge Berger in *Teck*[568] and was recently consecrated in the two high-profile Supreme Court decisions *Peoples* and *BCE* (as we will discuss in detail later), is inspired by the Commonwealth jurisprudence and also the American Law Institute's *Principle of Corporate Governance*[569], which all allow directors and managers to take into account the stakes of employees, creditors, suppliers and other groups when making decisions. While the standard of appreciation of the "best interests of the corporation" rule was previously deeply rooted in the maximization of the corporation's share price, recent jurisprudence leaves managers with the need to factor the interests of multiple stakeholders in their decision-making. That said, by eliminating the clear, mathematical and one-dimensional yardstick of shareholder value, the court seemed to have emptied the duty of much of its meaning, following the principle that a body that is responsible to everyone is in fact responsible to no-one[570]. Directors can also theoretically hide behind this multi-party model to favour one stakeholder rather than another, justifying their choice with a trade-off analysis.

Third, the **duty to act with competence, care and diligence** circumscribes the decision-making ability and process used by directors. The "competence" portion of the duty, prior to the *Peoples* decision, imposed a responsibility to the director that was proportional to his personal baggage of expertise or knowledge[571]. This subjective test was established in UK cases *Re City Equitable Fire Insurance Co* and *Re Brazilian Rubber Plantantion* and confirmed in Canadian decisions *Soper c. Canada*, *Lassonde c. Canada*, *Edison c. Canada* and others[572]. With *Peoples*, the Canadian court implemented a new objective competence test that focuses on the analysis of the specific facts and circumstances surrounding the decision, rather than on the background of the director. The interpretation of the "care and diligence" is also now subject to an objective test, where the court seeks to determine if the director acted as a reasonable "prudent person" would in "similar circumstances"[573]. Several elements that are likely to be considered in the judge's analysis are the

director's presence and voting in corporate meetings[574], the director's information gathering prior to making decisions (again considering many facts such as the costs of acquiring information, the timeframe of the decision, the nature of the decision, the variety of sources of the information collected, the collection of information from management, the consultation of experts, etc…)[575], as well as the director's role in setting up governance and control systems to provide adequate information for decision-making and supervision[576]. In summary, although there has been some controversy in the past about the standard of review of director duties, McGuiness states that: "What is now clear is that the director is to be assessed according to an objective standard"[577]. In general, it seems the objective standard is positive news for shareholders, since it adds a standardized benchmark of action, promotes an analysis based on specific facts, and reduces the risk of directors evading liability through loopholes of the subjective tests.

Across all of these duties, but especially for the third one, it is important to recall that the court will generally ponder its analysis using the business judgment rule. The court does not expect that the directors make perfect decisions, or even the best decision possible. They expect directors to make reasonable and informed decisions given the facts available at the time of the decision. When this can be established, courts will often defer to the business judgment of directors. That said, fiduciary duties provide a great deal of comfort to shareholders that directors are acting in the interest of the corporation, rather than their own.

2.3.2.1.2 Oppression Remedy

In the **US**, there is no explicit oppression remedy available to shareholders, although McGuiness states that "an extensive body of case law has evolved in which a high standard of utmost good faith has been imposed on the main shareholders of a closed corporation […] with a view towards the protection of minority shareholders within a close corporation"[578].

In **Canada**, the oppression remedy allows a shareholder to initiate a proceeding asking the tribunal to stop or to repair prejudicial behaviour or inequitable treatment by the corporation or its directors[579], even in the absence of fraud or illegality[580]. McGuiness notes that it has recently "emerged as the most important available remedy, in terms of the scope of protection that is afforded and by […] the extent to which it has come to dominate corporate litigation"[581]. The classic case of oppression arises when "a corporation conducts its business to confer a benefit on some of its shareholders that it denies […] to its shareholders generally, or seeks to impose excessive or risks on one group rather than another[582]. For example, in *Lunn vs. BL Holdings*, the oppression remedy was used when two shareholders were unfairly expulsed from a corporation for not agreeing to sell their shares at a given price after the purchase of a warehouse[583]. As McGuiness notes, 95%+ of cases implicate private companies and the claimant is a minority shareholder in 70% of cases[584]. By far the main reason for seeking the oppression remedy is exclusion from management in 65% of cases[585]. The remedy is relatively open-ended in its scope and allows the instigator to target either the corporation or its directors directly. The instigator is often an oppressed shareholder, although the recent Supreme Court decision *BCE* reveals that other stakeholders may also have access to the oppression remedy, such as creditors. That said, as one observer notes, while debtholders regularly

get standing to plead their case to the courts, "very few constituencies other than the shareholders and debtholders have the remedial tools to take a run at a board of directors"[586], implying some limits for other stakeholders to access to the oppression remedy. Art 241 of the CBCA supplies a non-exhaustive list of 14 remedial actions that confer meaningful power to the courts. Courts can not only order redress for the prejudicial conduct, but can also implicate themselves in the governance of the corporation to prevent further wrongdoing in the future. That said, as McGuiness points out, the oppression remedy remains subordinated to the business judgement rule and is ineffectual in cases of "mere incompetence in management (unwise, inefficient or careless performance of duties)"[587]. Rather, it requires "real evidence of misconduct"[588].

In **Quebec**, this remedy is not directly available in statutory corporate law, although the tribunal seems to be leaning towards its jurisprudential development[589]. From a study of 71 oppression conflict cases from 1995 to 2001, it appears that the oppression motive was used only 8% of the time in public corporations, and 92% of the time in close corporations[590]. A key reason that oppression is used mainly in the context of close corporations is that shareholders do not have access to a liquid secondary market to exit their investment, like those of widely-held corporations[591]. Crête detects that Quebec judges seek to interpret oppression-type conflicts in two different lights: (1) either in the light of concepts of good faith, equity and abuse[592] causing prejudice to personal interests of shareholders or (2) in the light or of the fiduciary duties of directors to defend the interest of shareholders[593]. In both options, judges try to draw parallels to law concepts received in Quebec corporate law, like good faith and the fiduciary duties of directors. That said, the inheritance by the Quebec judicial system of the powers to interpret "equity" claims seem highly questionable, despite the influential 1973 UK judgement *Ebrahimi v. Westbourne Galleries*[594]. Furthermore, a particularly difficult dichotomy to reconcile emerges between the protection of individual interests with "equity" concept and the widely-accepted business judgement rule, which clearly states that the courts will only interfere in limited circumstances that do not include inequitable treatment[595]. This has been a sticking point for judges in many cases dealing with oppression in Quebec. Some observers fear the dangers of increased interventionism by the courts, on the basis that (1) vague concepts like equity or good faith with undefined contours will attack the binding nature of contracts and that (2) judges do not have the expertise or knowledge to evaluate the business decisions at hand. Crête points out that judges have so far preferred to side with received notion of judicial deference rather than act prematurely on risky terrain. For that reason, Crête and Rousseau conclude that there has been no consecration of a full oppression recourse in Quebec law, even though such an remedy might prove a desirable protection for shareholders[596].

2.3.2.1.3 Direct and Derivative Action

A direct action is brought by a shareholder to repair an individual injury not shared by the other shareholders[597], while a derivative action is "an action brought in the name or on behalf of a corporation or any of its subsidiaries […] by a shareholder or other complainants, to assert or defend rights to which the corporation or its subsidiary is entitled[598]. In a derivative action, the injury is caused to the corporation, not the individual shareholder.

While the shareholder has "no standing to bring civil action at law against faithless directors and managers, equity allowed him to step into the corporation's shoes"[599]. Derivative action was created in the spirit of countering implementation difficulties of the *Foss v. Harbottle* rule[600]. The rule, which stems from the famous 1843 decision in the UK, stipulates that only a corporation may seek to recover damages caused to it. Although McGuiness states that the rule "makes perfect sense in the abstract"[601], the sticky issue arises when the damages are caused to the corporation by managers or other corporate Insiders. Interestingly, Lord Denning comments:

> "The rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue. But suppose it is defrauded by insiders who control its affairs […]. Those directors are the wrongdoers. […] In one way or another, some means must be found for the company to sue. Otherwise the law would fail in its purpose. Injustice would be done without redress"[602].

That said, one of the main benefits of derivative action is that it avoids the waste linked to duplicate suits being brought to the courts by combining them in a way similar to a class action suit.

In the **US**, direct suits have dealt with issues like oppression of minority shareholders, reorganizations, special dividends, inspection rights, pre-emptive rights and voting rights[603]. Derivative suits have dealt with issues like corporate mismanagement, fraud, waste of corporate assets, executive compensation and stock issuance[604]. In direct suits, individual shareholders bear litigation costs. In derivative suits, the corporation can reimburse claimant fees if "litigation results in a monetary recovery or confers substantial nonmonetary benefit"[605]. This can be readily explained by the free-rider problem present if one shareholder were to personally bare the costs of a suit that generated benefits for all shareholders. Derivative litigation in the US presents a number of procedural aspects, such as verification of the conflict, stock ownership by the plaintiff, and the quality of the shareholder as an 'adequate representative'[606]. However, the most important and contentious aspect is the "demand requirement"[607] that forces shareholders to ask permission to the board to bring the suit in the name of the corporation. As Bainbridge advances, the key question is "who gets to control the litigation: the shareholder or the board of directors"[608]. If directors allow shareholders to bring forward suits that the board has chosen not to pursue (perhaps because of some internal wrongdoing), the problematic situation occurs if directors are also able to terminate the shareholder claim before it is ever heard. If the corporation refuses the demand, the plaintiff must then "bare the burden of proving the refusal was wrongful"[609]. The demand requirement can be excused by the courts in cases of demand "futility", a standard that is interpreted differently according to state law. However, it is generally invoked when a board is interested, conflicted or acting irrationally[610]. According to Bainbridge, "if demand is required, the shareholder has very little prospect of success"[611], increasing the importance of proving futility at the outset. Even when futility is proved and the demand excused, the board may again assemble a special litigation committee (SLC) to review the transaction. Courts will often defer to this committee if it is indeed disinterested and performs an informed review, terminating the hopes of the shareholder's claim.

In **Canada**, shareholders can initiate a proceeding in the name of the corporation to repair a prejudice it has been the victim of[612]. McGuiness also qualifies this as a way to "assert a claim on the

misuse of managerial power on behalf of the corporation”[613]. Contrary to the oppression remedy, a derivative action is “always a class action brought or conducted in a representative capacity and therefore it is binding for all shareholders, not just the complainant”[614]. In other words, a derivative action should be brought about to defend collective rights, not simply the individual rights of one shareholder. Derivative actions seems to confer remedy for shareholders in a wide-ranging list of scenarios: “loss in share value, loss of employment, loss of business opportunity, slander of title, improvident administration, failure to account, additional liability of the plaintiff under a guarantee or indemnity, breach of fiduciary duty, and all other claims that may be properly characterized as “consequential” in the sense that they flowed from the damage caused to the corporation, rather than from damages, injury or loss caused to the plaintiff directly”[615].

In **Quebec**, this remedy is not directly available in statutory corporate law, except by way of jurisprudential interpretation or by the limited scope of article 316 of the Civil Code, which only permits the remedy in cases of fraud (a higher barrier than the CBCA)[616].

2.3.2.1.4 Piercing the Corporate Veil

Piercing (or lifting) the corporate veil allows the tribunal to see beyond the distinct legal personality of the firm and hold individual shareholders responsible for fraud or abusive behavior. Therefore, it derogates to the core principle of the limited liability of the shareholder. Or, as put by Easterbrook and Fischel, lifting the veil is a mechanism that “allows the control of the externalities generated by the concept of limited liability”[617].

In the **US**, piercing of the veil is controversial and highly litigated[618], mainly due to the absence of bright line rules for judicial interpretation and the reliance on common law jurisprudence[619]. The criteria test used to pierce the veil, which problematically varies significantly across state jurisdictions, typically rests on the core notions of: "unity of interest and ownership", "wrongful conduct" and "proximate cause"[620]. In terms of unity of interest and ownership, the court typically seeks to prove that the firm is used as “alter ego”, “corporate dummy” or “instrumentality” for the shareholder[621]. Judges rely on a list of 20+ factors (which Bainbridge calls the “laundry list”[622]) to determine if a company is a vehicle being used to commit fraud, including undercapitalization of the business entity, intermingling of corporate and shareholder assets and the absence of corporate governance inside the firm[623].

In **Canada**, lifting of the corporate veil is also not expressly codified in the CBCA, but rather applied through jurisprudence. The main cause of application is when the corporation is used as a cover for fraud or “deliberate wrongdoing”[624]. As McGuiness notes, “absent such abuse, the instances in which the courts are prepared to ignore the separate personality of the corporate entity are very rare”[625]. Since fraud is the usual motive accepted to lift the veil, Canadian tax legislation will often play a key role to help define the fraudulent behaviour.

In **Quebec**, lifting of the corporate veil was codified in article 317 of the 1994 Civil Code, establishing more defined contours to more than a century of jurisprudential evolution[626]. It aims to prevent fraud, abusive behaviour or actions contrary to public order committed by shareholders.

The central element is the qualification of the relationship between the shareholder and the corporation. It is only when the shareholder can be qualified as the corporation's "alter ego" that his personal responsibility is to be engaged, typically through (1) control of the corporation's assets or (2) legal control over the corporation[627]. According to Rousseau and Smaili, there are 2 core applications of article 317: (1) when the shareholder manipulates the corporation to legitimize fraud, abusive behaviour or actions contrary to public order, and where the act in question would have been illegal without the juxtaposition of the corporation, and (2) where the shareholder uses the corporation as an intermediary to commit fraud, abusive behaviour or actions contrary to the public order, in his personal interest and without engaging his personal responsibility[628]. It should come as no surprise that this remedy, in Quebec, is almost unanimously used by shareholders of close corporations[629]. According to Rousseau's study of 220 "veil" decisions between 1994 and 2004, which accrue at a rate of perhaps 20-30 per year, the "lifting" rate was about 34% in Quebec, compared to 40% in the US and 47% in the UK. Despite the new codification, Rousseau comments that the contours of this remedy are still flexible, remarking that Judge Cardozo's 1926 remark about the "mist" surrounding the metaphor of the lifting of the veil is still present today[630]. Some commentators observe that the lifting of the corporate veil is an unpredictable recourse that further jeopardizes the legal personality of the corporation[631] through the "anarchist erosion" of this key principle of the corporation in Quebec. Rousseau states that these fears seem unwarranted, since the judiciary considers this remedy an "exception" and that the rate of lifting of the veil is lower in Quebec than in other jurisdictions[632].

2.3.2.2 Securities Laws

Securities laws also play a role to curb Insider opportunism by imposing substantive legally-binding obligations and important disclosure requirements on corporate directors and officers, relating to both primary and secondary market transactions[633].

In the US, security law is of federal competence and is enforced by the SEC, yet state corporate law also applies to certain major transactions involving securities, like takeovers.

In Canada, while security law was usually of provincial competence, recent efforts have sought to standardize rules and concentrate regulatory power at the federal level. Canadian securities laws generally aim to insure healthy capital markets and to protect individual investors[634].

Securities law protections include insider trading rules (Section 2.3.2.2.1) and takeover rules (Section 2.3.2.2.2).

2.3.2.2.1 Insider Trading Rules

In the **US**, Rule 10b(5) on the *Employment of Manipulative and Deceptive Practices* states that Insiders may not make deceitful trades based on material non-public information. Rather, under the "equal access theory", Insiders must abstain or disclose the information. Plaintiffs have the

burden of proving materiality, manipulation/deception, and the context of a securities transaction[635].

In **Canada**, Section 131 of the CBCA has similar insider trading provisions, which can be supplemented when applicable by the Criminal Code, provincial corporate law and provincial securities authorities. More general self-dealing rules also exist to protect shareholders. For example, multilateral instrument 61-101 on the *Protection of Minority Shareholders in Special Transactions* (replacing Ontario's 61-501 and Quebec's Q-27 instruction) imposes particular procedural steps during related-party transactions to protect minority shareholders, such as additional disclosure and shareholder participation in the review of the transaction[636].

2.3.2.2.2 Takeover Rules

Perhaps the largest difference between the US and Canada is that, following the *Santa Fe Industries* decision[637], the competence in takeover rules in the US lies not in the SEC at the federal level, but rather in state corporate law[638].

In the **US**, takeovers are subject to mandatory disclosure of cash tender offers, an alternative to proxy contests, under the *Williams Act* at the federal level[639]. Reviews of takeovers rely more on director duties than mandatory rules[640]. When directors are interested in the transaction, the level of review of the takeover will likely increase, with such tests as "Entire Fairness" or "Enhanced Judicial Scrutiny"[641]. While takeovers are relatively rare, even in the US, there is still more influential jurisprudence in the US than in Canada or other parts of the world, with key decisions like *Unocal* and *Revlon*[642]. To distillate the essence of this jurisprudence, the courts try to strike a balance between shareholder freedom of choice (to accept an offer) and the expertise of the board (to appreciate an offer)[643].

In **Canada**, as part of the federal repatriation and harmonization of security laws, takeover rules are in the process of being consolidated in the Rule 62-104 on *Takeover Bids and Issuer Bids*[644]. At a high-level, the objectives of the law is to ensure to security holders: 1) equality of treatment, 2) access to adequate information and 3) transparency and impartiality in the takeover process[645]. Therefore, security authorities in Canada have the power to legislate relative to issues like takeover defenses[646] and the protection of minority shareholders[647].

2.3.3 Market Mechanisms

Market mechanisms that protect shareholders include stock sale (Section 2.3.3.1), concentration (Section 2.3.3.2), takeovers (Section 2.3.3.3) and the job and reputation market (Section 2.3.3.4).

2.3.3.1 Stock Sale

Assuming a liquid secondary market for a corporation's stock, dissatisfied shareholders of a widely-held corporation have the opportunity to apply the "Wall street rule" and exit an investment trough a stock sale.

Shareholders also have the option to diversify their holdings to mitigate a particular risk. This is possible since they will own typically a small share of one or more widely-held firms. On the other hand, the shareholders of close and controlled corporations may not have ready access to liquidity or to the possibility of meaningful diversification, since the size of their ownership block is typically larger and is typically tying up a significant portion of their personal wealth.

That said, the ability to sell their stock on secondary markets will likely lessen the incentives of dissatisfied shareholders to become active in corporate governance. In other words, “when monitors can easily ‘exit’ the firm they tend not to exercise their voice”[648]. It has been advanced by many commentators that the highly liquid US markets may be a core reason why institutional monitoring is weak[649].

2.3.3.2 Concentration

The opposite of a stock sale, buying more stock, is another market mechanism for the shareholder to consider. While small shareholders are often “frozen out” of corporate governance[650], they can typically exert more influence as the size of the ownership holding increases. For example, their effectiveness at jawboning management increases[651].

Obviously, institutional investors are concentrated shareholders of the companies in their portfolio. Beyond that, as we have seen, institutional investors can collaborate or league together (with some limitations, especially in the US) to increase their power to discipline Insiders. Such an example is the CCGG coalition in Canada, with 40+ financial institutions as members representing more than $1 trilliion in assets[652].

There is also some evidence that concentration can lead to better governance at a market/ecosystem level. MacIntosh mentions that “a growing body of empirical literature suggests that concentrated ownership is likely to enhance firm value”[653]. That said, growing bigger is not a panacea. Rousseau advances that concentration may have the effect of shifting vertical conflicts (managers vs. shareholders) to horizontal conflicts (between larger shareholders), or simply displacing the locus of the conflict. Also, the presence of a controlling or dominant shareholder, as we have seen, may facilitate power capture and increase opportunistic behavior.

2.3.3.3 Takeovers

When agency costs related to poor governance result in a depressed share price, third parties are often likely to step in and try to take control of the firm if they believe they can readily rectify the situation[654]. In other words, "takeovers are useful both because they reduce the informational monopoly of the incumbent manager about the state of the firm and because they allow for the replacement of inefficient managers”[655]. Takeovers also usually result in one-time abnormal returns for the target shareholder.

The takeover market will provide an incentive to Insiders to reduce their opportunistic behavior or risk being ousted. This threat is usually more valid for widely-held firms, where a

controlling shareholder is not likely to have the ownership stake needed to block the takeover attempt outright[656].

Raiders start with obtaining 50% control of voting rights and progressively replace Insiders at the shareholder meeting[657]. Takeovers are a highly disruptive, costly and rarely used mechanism to discipline Insiders, even in the US[658]. The cost stems from the premium (typically around 30-50%[659]) the acquirer typically pays to get control, in addition to legal fees, and the opportunity cost of management distraction. Even at the height of the takeover market, takeover activity was still below 1% of publicly-listed firms[660].

2.3.3.4 Job and Reputation Market

Managers and directors will refrain from opportunistic behaviour when they perceive a high reputational risk, especially if it is possible they will be returning to the external job market for future employment. They will also limit opportunistic behaviour if they perceive they are in a competition with other internal managers or directors to retain the position of control[661].

In addition to the four mechanisms examined above, there are a number of other market mechanisms that can curb Insider opportunism. Among them, product markets and the press can provide threats or discipline to Insiders. That said, the strength of the threat is generally low[662].

Perhaps then the most important takeaway of Part 2 is that three key types of mechanisms interact to curb Insider opportunism: internal governance, regulatory and market. In many ways, market mechanisms are the default forces in play, while regulatory mechanisms are a safeguard when internal governance and market mechanisms fail.

In the ideal free-market conception of business, internal governance and market mechanisms would be strong, and the regulatory remedies would need to be few and exceptional. As MacIntosh puts it, “the appropriate extent of legal rules constraining managerial or other corporate misbehaviour can only be judged in the context of the efficacy of market mechanisms in redressing problems of opportunism”[663].

In Part 3, we will seek to more precisely understand what in fact the “appropriate extent” of legal rules should be.

3 TOWARDS EQUILIBRIUM

Corporate governance is at the heart of the balance of powers in the corporation. While Part 1 taught us that every firm has a dynamic power equilibrium between Insiders and Outsiders, Part 2 taught us that this power equilibrium is shaped by the evolving forces of three types of mechanisms: internal governance, regulatory and market.

Realizing that building a one-size-fits-all regulatory framework that would provide for optimal power equilibria for all firms is likely impossible, it is nonetheless critical to question what type of system would be most likely to produce superior governance outcomes. In other words,

what type of legal framework should a legislator aim to build towards, given the specific context of its country?

Recall that in Part 1, we defined the dynamic power equilibrium in one firm at a given time as lying somewhere between the poles of managerial discretion and shareholder power. Can we somehow infer that one of these two models is superior? If this cannot be determined, can we find that one model is better suited to the specific context of a country? For example, as La Porta and Kraakman have hinted, could a "shareholder power" model be better suited to developing economies, while a "managerial discretion" model be better suited to large mature economies?

Let us note that this dilemma can also be viewed under Bainbridge's well-known model: authority and accountability. In his model, the authority of the board to create value for the firm must be balanced with a need for accountability to the shareholder owners of the corporation. Perhaps Bainbridge's most interesting contribution is to note that, in the end, both objectives can never be fully reconciled. Increasing authority necessarily reduces accountability. In other words, there is always a trade-off. Every proposed regulatory framework thus needs to be appreciated in terms of the authority and accountability trade-off, or in terms of the managerial discretion and shareholder power trade-off.

While the search for convergence and optimality across jurisdictions is better left to expert scholars like Kraakman, there is one generally shared consensus: elements of both poles are required. Trying to understand how to achieve this right balance is the subject of Part 3.

3.1 Why Reform: The Case for Strengthening Protections for Outsiders

Pursuant to our analysis in Part 1 and 2, we will argue that the rights and remedies of shareholders are currently insufficient to curb Insider opportunism. We describe how a new equilibrium, closer to the shareholder power pole and farther from managerial discretion than the current equilibrium, would be beneficial for corporate governance and value creation.

We will first summarize the key elements for and against increasing shareholder power.

3.1.1 The Case For

Perhaps the most basic argument for protecting shareholders is that their powers are too weak or insufficient against Insiders who wish to do harm. In its most general form, this argument recalls the populist credo of protecting the mass from the powerful few who wield influence. Berle and Means introduce this argument in *The Modern Corporation*:

> « The economic power in the hands of the few persons who control a giant corporation is a tremendous force which can harm or benefit a multitude of individuals, affect those districts, shift the currents of trade, bring ruin to one community and prosperity to another"[664].

Although this version does have some merit, more sophisticated and persuasive arguments however will promote shareholder power as a way to increase (1) the value of firms and (2) the liquidity of capital markets.

First, if shareholder powers allow for more efficient and better governed firms, this should be reflected in the **value of firms**.

At a theoretical level, this hypothesis is relatively easy to prove. As Bebchuk notes:

> "If the interests of management do not fully overlap with those of shareholders, management thus cannot be automatically counted on to take actions that would serve shareholder interests. As a result, agency costs that reduce shareholder value might arise"[665].

In Part 2, we have examined in some depth a number of conflicts (such as executive compensation, self-dealing and major transactions) where Insiders are able to capture power in order to obtain important private benefits, extract rents and reduce shareholder value. Firm value would necessarily be higher absent these diversions and inefficient transactions.

At an empirical level, the evidence for the link between good corporate governance and higher firm value is modestly strong. One of the studies most strongly affirming the value of good governance is the 2003 paper by Gompers, Ishii and Metrick[666], which reported that "companies with strong shareholder rights had higher annual returns, profits, and sales growth than companies with weak shareholder rights"[667]. The 2004 study by Bebchuk, Cohen and Ferrell[668] also indicates that six pro-Insider corporate governance provisions reducing the power of shareholders (staggered boards, limits to shareholder by-law amendments, supermajority requirements for mergers, supermajority requirements for mergers, poison pills and golden parachutes) were "monotonically associated with economically significant reductions in firm value"[669]. Another 2004 study by Brown and Caylor[670] shows a strong link between a "gov-score" (index of 50+ governance factors) and firm performance. Finally, there are the landmark studies from La Porta et al on the link between shareholder protections and firm value. In their 2002 study *Investor Protection and Corporate Valuation* analyzing 539 firms in 27 countries, La Porta et al conclude that "firms in countries with better shareholder protection have higher Tobin's Q [measuring firm value] than do firms in countries with inferior protection"[671].

Second, increased shareholder power should in theory result in more **liquid capital markets**. Better shareholder protections should make shareholders more willing to invest their capital in companies, since they are better assured of getting a return on their investment. La Porta et al astutely describe the steps of this process:

> "How does better protection of outside investors both shareholders and creditors promote financial market development? When their rights are better protected by the law, outside investors are willing to pay more for financial assets such as equity and debt. They pay more because they recognize that, with better legal protection, more of the firm's profits would come back to them as interest or dividends as opposed to being expropriated by the entrepreneur who controls the firm. By limiting expropriation, the law raises the price that securities fetch in the marketplace. In turn, this enables more entrepreneurs to finance their investments externally, leading to the expansion of financial markets"[672].

La Porta et al also provide empirical evidence that better shareholder protections lead to more liquid capital markets, which they survey in their 1999 paper *Investor Protection and Corporate Governance*[673]. In their 1998 paper *Law and Finance*[674] and their 1999 study *Corporate Ownership Around the World*[675] surveying 27 countries, La Porta et al find that economies with very good

shareholder protection facilitate the dispersion of capital and the emergence of widely-held firms. Finally, in their 1997 paper *Legal Determinants of External Finance*, La Porta et al show that countries with better shareholder protections have "more valuable stock markets, larger numbers of listed securities per capita, and a higher rate of IPO" relative to other countries[676].

3.1.2 The Case Against

It seems legitimate to briefly review the general risks and dangers of the corporate governance reforms that propose to increase shareholder power. The case against can be summarized by the following arguments: (1) the Darwinian evolutionary perspective, (2) the increased decision-making costs, (3) strategic hold-ups, (4) the potential for excessive power, risk-taking and opportunism, (5) the marginal benefit of change, and (6) the incertitude of alternatives.

First, the most persuasive argument for keeping the status quo of an equilibrium tilted towards managerial discretion is probably the **Darwinian evolutionary perspective**, in either of its two variations on the theme of "survival of the fittest". Roe nicely introduces this perspective:

> "In the classic story, the large public firm survived because it best balanced the problems of managerial control, risk sharing, and capital needs. In a Darwinian evolution, the large public firm mitigated the managerial agency problems with a board of directors of outsiders, with a managerial headquarters of strategic planners overseeing the operating divisions, and with managerial incentive compensation"[677].

The first variation of the "survival of the fittest" story would advance that since the US economy has survived and thrived, and is likely the most prosper in the world, managerial discretion is likely the fittest approach to governing firms.

The second variation would advance that since the board of directors has survived and thrived, and has become the central decision-making institution of the firm, it is likely the fittest body to govern firms. In this view of the world, we need to believe that since boards have better information, deeper expertise and a higher similarity of interests than shareholders, they are the rightful decision-making authority[678]. We also need to believe that there is an inherent need for authority in the corporation, and that the board is the body that has best adapted over time to fulfill this role. As Ken Arrow notes: "[given] the need for speed in decisions, authoritative control at the tactical level is essential for success"[679]. We also need to believe that even if we were able to have every board decision reviewed by shareholders at no cost (a thoroughly unrealistic assumption), all we would be doing is essentially "shifting the locus of the problem" from the board to shareholders, and in fact offering "no solution to the original problem"[680].

The judicial corollary to this "survival of the fittest" story is that it helps to justify why courts take a deferential approach to review the decisions of the board, since courts indeed perceive the Board as the fittest body to perform these decision-making duties. As Kraakman justly notes: "Indeed, the remarkable fact is how little the principal corporate law jurisdictions are willing to bend corporate governance rules to protect minority shareholders, regardless of the modal ownership of public companies"[681].

Second, Increased shareholder power will usually imply **increased decision-making costs**. Shareholder decision-making expands the role of the shareholder in the governance of the firm, which is not necessarily desirable. As we have seen, the Board is a particularly efficient decision-making body, given its better information, deeper expertise and similarity of interests[682]. As Kraakman notes, "shareholder-level protections are often more effective, but also more costly than board-level protections. But the more effective the board is in serving shareholder's interests, the fewer the decisions that should require shareholder action"[683]. Shareholders, if left to their own devices, may also do the wrong thing or be otherwise inefficient[684]. It seems the right balancing act requires careful selection of the types of decisions that merit larger shareholder involvement, considering both the likelihood of Insiders to abuse authority and the ability of shareholders to intervene efficiently in such a decision.

Third, increased shareholder power may create **strategic hold-ups**. A manifestation of increased shareholder power typically is the requirement that key decisions be approved by a higher supermajority threshold vote. This strengthens the veto right of large minority shareholders, who can hold-up efficient transactions in order to capture personal benefits[685]. This issue is also referred to as the "special interest" problem, where one shareholder representative can try to extract private rents in return for co-operation. Bebchuk defines this as the "balkanization" threat[686]. It seems the right balancing act requires the ability for firms to set their own voting thresholds based on the specific composition of their ownership structure, weighing the need to give a voice to minority shareholders and the need to eliminate value-destroying blocking of efficient transactions.

Fourth, increased shareholder power may lead to **excess power, risk-taking and shareholder opportunism**. In essence, it may create a governance dynamic that reflects the short-term capital appreciation goals of shareholders more than the board's long-term strategic plan for the firm. Like Insiders, Outsiders can also exhibit opportunistic behaviour. Stout gives an extreme but interesting example where shareholders (in this case, a hedge fund) use their leverage over the board to pressure directors to acquire a rival company (of which the hedge fund was also a major shareholder of) at a substantial premium over market[687]. We can also question the social impact of shareholder-driven management in general, if shareholders can capture the rewards of risk-taking but society bares its costs (ex: employees lose their jobs in the event of bankruptcy). It seems the right balancing act may require the ability for shareholder representation in management through corporate elections, but having a strong counterbalance of disinterested directors to rein in opportunistic decision-making.

Fifth, the **marginal benefit** argument is often cited by proponents of managerial discretion. They note that the US is *already* very democratic and pro-shareholder and that Canada is *already* "one of the most democratic corporate law regimes of any of the world's major industrial states (in the sense that it is responsive to shareholders voting a majority of voting shares)"[688]. Critics will therefore question the marginal benefit of sliding the equilibrium even more towards shareholder power, given that both US and Canada are already "good enough" or perhaps even "leaders" in matters of corporate governance.

Sixth, proponents of the status quo will also frequently also cite side-arguments relative to the **incertitude of alternatives**, such as the "if ain't broken, don't fix it" and "now is not the time"[689] classics[690], as well as the lack of decisive evidence supporting a better alternative[691].

3.1.3 Power Disequilibria and the Need for Government Intervention

Through our study of the powers of Insiders and Outsiders, it seems clear that shareholders are at a relative disadvantage to managers in the corporation. This situation can be explained by the need for managerial authority to effectively run firms. However, we defend that the power equilibrium is still too largely dominated by managerial discretion.

Of course, the degree to which the pendulum of power swings in favor of management is a corollary of the ownership structure. As we have seen, corporations with more concentrated ownership structures in Canada may confer less discretion to managers, relative to more widely-held US counterparts, and thus reduce the power desequilibrium between shareholders and managers[692].

That said, improving shareholder protections seems warranted to produce better governance outcomes, increase the value of firms and strengthen the liquidity of capital markets.

Free markets, it seems, cannot alone re-establish this equilibrium. As our study in Part 2 reveals, market mechanisms offer important, yet overall incomplete, protections for shareholders. Even the staunchest proponents of free markets, like Adam Smith, concede that market forces alone cannot be relied on to effectively re-distribute power in corporations with a view to value maximization:

> The invisible hand will destroy the possibility of a decent human existence "unless government takes pains to prevent" this outcome, as must be assured in "every improved and civilized society." It will destroy community, the environment and human values generally – and even the masters themselves, which is why the business classes have regularly called for state intervention to protect them from market forces. (...)"[693].

A few centuries later, Kraakman and Black echo this perspective:

> "The market cannot fill the regulatory gaps that American-style enabling corporate law leaves behind"[694].

Government intervention seems a necessary force to re-shape the corporate governance landscape. However, the type of intervention is key. To be clear, we are not proposing increased government intervention in business. We rather propose the opposite: that government step in to give additional powers to agents (especially shareholders), so they can regulate themselves. Auto-regulation can only be effective if agents have sufficient and credible power to defend their rights.

Governments can seek to shape the corporate governance landscape mainly by affecting either (1) internal governance mechanisms or (2) regulatory mechanisms. One on hand, it can seek to modify the basic allocation of power in the corporate triad, so that agents are increasingly capable of resolving conflicts among themselves in a flexible way. On the other hand, it can issue binding mandatory law applying to all corporations, in the hope that stricter law may deter wrongdoing.

In the next section, we argue that reforms to both internal governance and regulatory mechanisms are likely necessary, but posit that the former type may generally more desirable. Giving internal governance powers to agents so they can prevent and resolve conflicts among themselves, with minimal resort to the courts, seems consistent with the role of the corporation to simplify business exchanges and reduce formalism. That said, reforms to regulatory mechanisms may also be desirable in certain areas such as securities law, or when the reforms aim to modify internal governance and the basic allocation of power in the corporation. For example, modifying proxy rules relative to corporate elections would likely require regulatory changes, but the result would be to increase the power allocation to shareholders.

Bebchuk calls on government intervention to make what he calls a "constitutional change" (likely a regulatory change) that would reshape powers in the corporate triad. To accomplish this, he appeals to legislators, SEC officials, courts and exchanges[695]. As noted above, he mentions that auto-regulation cannot function effectively with current corporate law, since "existing arrangements fail to provide adequate checks"[696].

3.2 How to Reform: Bring Your Own Governance (B.Y.O.G.)

In this section, we explore in more detail how to think about re-shaping the power equilibrium in the corporation, and how to do so with as little new mandatory requirements for corporations as possible.

3.2.1 Crisis, Politics and Reform

Corporate governance law is too often a product of crisis. The content of corporate governance reforms, for the vast majority, is not dictated by a steady coherent program of government change, but rather by political knee-jerk reactions to scandals when the pendulum of power swings too far in one direction. As Roe notes:

> "Nothing important might happen, except in crisis. Institutions and rules would be comparatively rigid until a shock hits the system: an economic depression or political crisis for us, an asteroid smashing into the earth for biologists. What survives is what is best adapted to persist during the crisis; once the survivors survive the crisis and the maladapted become extinct, nothing much important happens until the next crisis"[697].

Therefore, often the decision of "what to reform" is already made prior to reform.

Crisis-driven reform seems to have been an important trend in both the first and second half of the 20th century. Black cites two colourful illustrations of how shareholder power was dialled down in the US in favour of managerial discretion in regards to proxy rules:

> "One purpose of the [1934] Proxy Rules, a Senate Report explains, was to protect investors from proxy solicitations by "irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials"[698].
>
> "The 1956 expansion of the Proxy Rules, especially in the disclosures required of dissidents, came after a surge in proxy fights in the early 1950s, which led managers to pressure congress and the SEC to act against the evil corporate raiders"[699].

In recent times, reform has also come in reaction to crisis, either at a local or world level. In their paper *Corporate Governance and Control*, Becht et al single out six events that influenced or directly contributed to corporate governance reform: (1) worldwide privatization of the 1980s and 1990s, (2) pension fund reform and the growth of pension fund savings, (3) the takeover wave of the 1980s, (4) deregulation and the integration of capital markets, (5) the 1998 East Asia crisis and (6) corporate scandals and failures in the US at the end of the 20th century[700].

As Clark observes, the "bandwagon effect" that crisis provokes is not only inevitable, but it may also be quite desirable to create sufficient energy to combat the inertia of status quo:

> "It is based on the notion that bandwagons are unavoidable, but their motivating impact can be leveraged and their bad effects alleviated by good statutory design"[701].

However, this energy must be harnessed in such a way that the reform does not become a witch hunt aiming to shame or sterilize a particular market agent at the detriment of others. Speaking of the post-Enron reform movement that resulted in SOX, Clark notes:

> Thoughtful observers found it hard to deny that the reform movement had some aspects of a witch-hunt[702].

Reform efforts in time of crisis are also particularly vulnerable to the influence of special interests. Officials at community, state and federal levels can be swayed by the arguments or the needs of one constituency to enact reform that may not be efficient at a holistic level. Black explains how this push-pull of influence works at every level of government, with a view specifically to past reforms seeking to expand shareholder power:

> "If shareholder proposals begin to win with any frequency, managers will press state lawmakers to change the structural rules in the managers' favor, and the states may well respond. Antitakeover laws show this process at work: shareholders voted with their feet in favor of hostile takeovers; managers, aided by unions worried about jobs and local officials worried about local communities, ran to state lawmakers for protection; the lawmakers limited shareholder power to vote"[703].

A corollary of crisis is the political urgency to react rapidly. In a practical sense, urgency does not allow for careful consideration and review of all issues of the corporate governance landscape, but rather favours dusting off "accumulated policy positions"[704]. In a way, crisis may provide the right impetus for politicians and lawmakers to push bills that were not receiving sufficient attention or support, as long as their aim seems coherent with quickly patching the problem at hand. Again on the post-Enron scandals in the US, Clark notes:

> "Some major reform measures were "taken off the shelf," so to speak, and modified for the occasion"[705].

Rousseau, in his paper on *Canadian Corporate Governance Reform*, recalls an idea from Baillie that lawmaking should always seek to feed off regulatory requirements, rather than being a reaction to either a particular crisis or emerging trends:

> "Perhaps the most serious issue underlying [corporate governance] developments and related proposals is the extent to which changes in […] oversight mechanisms should be driven by legislative or regulatory requirements, rather than developing over time in response to emerging commercial practice and community consensus"[706].

Clark pushes the idea of "good statutory design" further by proposing that lawmakers, even in times of a crisis, commit to a more rigorous lawmaking process that would more deeply root reform efforts in corporate law scholarship. To this effect, he suggests a three-pronged framework to craft and evolve legal reforms:

> In particular, legal reforms in the area of corporate governance should have bite but should also be explicitly structured to authorize and mandate (1) serious empirical study of the effects of particular regulatory changes (or existing rules), (2) periodic reassessment of regulations in light of such evidence (while also considering experience and analytical arguments, of course), and (3) explicit decisions to reaffirm or alter regulations in light of these reassessments[707].

3.2.2 Reform Objectives

Good statutory design should be rooted in the values and objectives our society wishes to develop. Both (1) corporations and (2) the legislator have different goals they aim to achieve. In this section, we seek to understand how reform efforts can best align themselves with the goals of both of these parties.

3.2.2.1 Corporate Objective (Shareholder Primacy vs. Stakeholder Theory)

Corporations aim to create value and be profitable. In a more formal way, their goal is to provide returns for shareholders. As we recall from Nobel laureates Coase and Williamson, the corporate form exists as a nexus of contracts to minimize information and transaction costs compared with free-market contracting. In other words, they exist because they are the simplest or most efficient way to conduct business. The author Ballantine summarizes well this perspective:

> "The primary purpose of corporation laws is not regulatory. They are enabling acts, to authorize businessmen to organize and to operate their business, large or small, with the advantages of the corporate mechanism. They are drawn with a view to facilitate efficient management of business and adjustment to the needs of change"[708].

However, the goal of the corporation may not be as simple as it appears. Beyond providing returns to shareholders, relatively recent scholarship and jurisprudence has brought to the forefront the need for the corporation to serve the broader interests of other stakeholders, such as but not limited to creditors, employees, customers, suppliers, as well as the environment and society as a whole. According to governance scholars Monks and Minnow, half of the states in the US now have rules that permit or sometimes require the consideration of stakeholder interests[709]. This is the debate of (1) shareholder primacy vs. (2) stakeholder theory. This debate is an old one, but with modern importance.

On one hand, in terms of **shareholder primacy**, one of the earlier cases to establish the norm of maximizing shareholder wealth was the 1919 landmark case of *Dodge vs. Ford Motor Company*[710]. The Dodge brothers alleged that Henry Ford diverted profits to employees and consumers at the expense of shareholders. In fact, Ford seeked to reinvest in the company by providing extra benefits to these agents, rather than distributing profits to shareholders. The Court forced Ford to distribute dividends to shareholders, clearly and unequivocally enforcing for the first time the norm of maximizing shareholder wealth. The Court's conclusion was to the effect that:

> "The business corporation is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed for that end"[711].

Maximizing shareholder wealth is also strongly supported by some of the leading scholarly voices of the 20th century, such as Berle, Coase, Friedman and Jensen.

Among the first academic studies on the topic was a 1932 debate between scholars Berle and Dodd via a series of short articles in the pages of the *Harvard Law Review*, where Berle advocated shareholder primacy and Dodd pushed for the stakeholder model[712]. While the "generally accepted historical picture puts Berle in the position of the original ancestor of today's shareholder primacy position"[713], a recent paper by Bratton and Wachter demonstrates that Berle's position was indeed more nuanced, more balanced and evolved significantly over time – even ultimately recognizing the merits of the stakeholder view[714]. In his article *Corporate Powers as Powers in Trust* (1931)[715], Berle takes a clear position in favor of the shareholder primacy model, arguing that management should work for shareholders. However, in the classic *The Modern Corporation and Private Property* (1932), Berle's views are more complex. The book presents the

problem of the increasingly passive shareholder in contrast to the increasingly powerful managers, due to the separation of ownership and control. Bratton and Wachter argue that:

> "Had the book closed with this appeal for a shareholder trust model, it could stand today as an historical monument to shareholder primacy, however far ranging its discussion of the social and economic problems posed by management power. But Berle himself prevented that result by stating the opposite position in *The Modern Corporation*'s final chapter, six pages entitled ''The New Concept of the Corporation"[716].

Bratton and Wachter note that *The Modern Corporation and Private Property "*captures Berle in the middle of his metamorphosis from friend of shareholders to advocate of the corporation as an instrument for furthering national social welfare policy"[717]. Indeed, in Book IV Chapter 1 of the book, Berle and Means argue that the separation of ownership and control has "destroyed the traditional belief that profit maximization will drive the corporation to most efficiently use its assets"[718], noting that the traditional logic of property and profits do not hold in the large modern corporation. Therefore, Berle's earlier pro-shareholder model is balanced by a more corporatist view that admits that corporations may have a social function and social responsbilities.

Nobel laureate Ronald Coase (1937) also supported shareholder primacy in his famous article *The Nature of the Firm,* but based his support on the argument that the corporation is a nexus of contracts built on top of shareholder capital seeking to minimize transaction costs transaction. Nobel laureate Milton Friedman (1970), one of the most fervent advocates of the norm of maximizing shareholder wealth, famously declared that "the only social responsibility of business is to increase their profits"[719]. The work of Jensen & Meckling (1972), Alchian & Demsetz (1972) and Fama & Jensen (1983) on the principal-agent relationships reaffirmed the primacy of shareholders. By observing that managers had a mandate to manage on behalf of shareholders (the "residual claimants"), they found that maximizing shareholder wealth should be the central objective of the corporation. In a later study, Jensen found further support for the single objective of shareholder wealth maximization, stating that "since it is logically impossible to maximize in more than one dimension, purposeful behavior requires a single value objective function"[720]. Finally, the influential studies of Easterbrook & Fishel (1991) also reaffirmed the notion advocated by Coase that the firm is a nexus of contracts at the service of shareholders.

It seems the idea of shareholder primacy was so widely accepted near the end of the 20th century that Hansmann and Kraakman concluded that it represented the "end of history" for corporate law: "Since the dominant corporate ideology of shareholder primacy is unlikely to be undone, its success represents the end of history for corporate law"[721]. Their anointment of the shareholder model as the "standard model" can also be explained partially by the historical failures of other models, such as the manager-oriented model, the labor-oriented model and the State-oriented model[722]. Their conclusion relative to shareholder primacy was to this effect:

> "Ultimate control over the corporation should rest with the shareholder class; the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders; …and the market value of the publicly traded corporation's shares is the principal measure of the shareholders' interests"[723].

It also seems important to note the more nuanced version of their elevation of shareholder primacy, which states that maximal social welfare is dependent on the maximization of shareholder wealth, but does however recognize some place for the stakeholder model:

> "All thoughtful people believe that corporate enterprise should be organized and operated to serve the interests of society as a whole, and that the interests of shareholders deserve no greater weight in this social calculus than do the interests of any other members of society. The point is simply that now, as a consequence of both logic and experience, there is convergence on a consensus that the best means to this end -- the pursuit of aggregate social welfare -- is to make corporate managers strongly accountable to shareholder interests, and (at least in direct terms) only to those interests"[724].

On the other hand, in terms of **stakeholder theory**, the influential work of Freeman and McVea (1984) stressed the concept of multi-objectivity and defined the norm of consideration of stakeholder interests as follows:

> The stakeholder framework does not rely on a single overriding management objective for all decisions. As such it provides no rival to the traditional aim of "maximizing shareholder wealth." To the contrary, a stakeholder approach rejects the very idea of maximizing a single-objective function as a useful way of thinking about management strategy. Rather, stakeholder management is a neverending task of balancing and integrating multiple relationships and multiple objectives"[725].

Rohrlich also points out that, as we have seen, many of the first corporations formed under the special act of the legislature in the early 20th century generally had a public vocation[726]. The first corporations were cities, towns, universities, hospitals or other institutions with a similar social mission. Millon also recalls the social roots of corporations:

> During the first part of the nineteenth century, each instance of incorporation required a special act of the state legislature, and only stakeholders mattered. As a creation of the state, the corporation was viewed as a socially useful instrument for the state to carry out its public policy goals and as an entity whose powers must be kept in check. The legal norm was the ultra vires doctrine, which limited the ability of a corporation to pursue activities beyond its original charter or state of incorporation"[727].

Lynn Stout and Margaret Blair, two staunch advocates of the stakeholder model, find recognition of the stakeholder model in what they term the "team production theory", where "equity investors are not the only group whose resources can be converted into firm specific assets"[728]. They also cite evidence that state corporate law recognizes today specific situations where stakeholder interests should or must be considered by directors and officers:

> "As I have pointed out in writings with Margaret Blair, courts consistently permit directors "to use corporate funds for charitable purposes; to reject business strategies that would increase profits at the expense of the local community; to avoid risky undertakings that would benefit shareholders' at creditors' expense; and to fend off a hostile takeover at a premium price in order to protect employees or the community"[729].

Some jurisprudence also seems to back up the stakeholder theory. The Delaware Supreme Court recognized in *Paramount vs. Time* that, as long as the firm was not in a takeover context (*Revlon* mode), the "board of directors […] is not under any duty to maximize shareholder value"[730].

Similarly, in Canada, the landmark Supreme Court decision of *Peoples vs. Wise* stated that:

> "It is clear that the phrase 'the best interests of the corporation' should be read not simply as the 'best interests of the shareholders'. From an economic perspective, the 'best interests of the corporation' means the maximization of the value of the corporation"[731].

Obviously, the corporate objective of the firm has important implications in corporate law, such as the interpretation of the duty of loyalty and the liability of directors for corporate decision-making in specific contexts like takeovers or bankruptcies[732].

In his analysis *Peoples Department Stores vs. Wise and the Best Interests of the Corporation*, Lee however fails to find in the court's decision sufficiently convincing reasoning to overturn the norm of shareholder primacy:

> "In light of the legal position prior to Peoples, the court's legal analysis is unsatisfying. Teck is not, contrary to the court's suggestion, exemplary of a position "long recognized" by the courts. It is a solitary judicial endorsement, likely obiter, of a controversial legal proposition. Equally questionable is the court's reliance on Olympia & York". […]
>
> "It is disappointing, however, that the Supreme Court did not deal with the normative issues underlying the legal debate about shareholder primacy. The court's silence on these issues would be unproblematic if, as the court's opinion implies, the legal position were clear. But in light of the inconclusiveness of the prior case law, the court's invocation of "long-recognized" principle is unpersuasive as a justification of the court's choice"[733].

That said, the *BCE* case, another recent controversial decision by the Supreme Court of Canada, also seems to support stakeholder theory in a similar way to *Peoples vs. Wise*:

> "The corporation and shareholders are entitled to maximize profit and share value, to be sure, but not by treating individual stakeholders unfairly. Fair treatment – the central theme running through the oppression jurisprudence – is most fundamentally what stakeholders are entitled to 'reasonably expect'"[734].

In one analysis of the *BCE* decision, the commentators note that the court seems once again to have rejected shareholder maximization as the sole motive that officers and directors should follow, even in the *Revlon*-mode context of a takeover:

> "Although the Court's decision to allow the BCE transaction to proceed (which was announced in June 2008, shortly after the case was argued) was the expected result, the recently released reasons reject the duty to maximize shareholder value in the context of change-of-control transactions (the so-called Revlon duty derived from Delaware jurisprudence) in favour of a nebulous duty to treat all affected stakeholders fairly, commensurate with "the corporation's duties as a responsible citizen." By requiring the directors to consider the interests of all stakeholders, the effect of the Court's decision may be that the directors become legally accountable to no one – immunizing directors' substantive decisions from legal attack provided that they get their process right and can make a plausible business case on the basis of their view of the best interests of the corporation. As a result of the *BCE* decision, stakeholders seeking to challenge a directors' decision in the courts will need to focus on the process whereby the decision was made, rather than on the substance of the decision"[735].

In these decisions, we note a clear willingness of the courts to force managers to consider a broader stakeholder approach of corporate law, which clashes with the traditional shareholder-centric approach of securities law in both US and Canada. Therefore, a slight disconnect seems to exist between corporate and securities law on the vision and definition of a corporation's objective.

In any case, one recurring challenge to stakeholder theory lays in how to determine which groups of agents should be considered or preferred in the strategic management of the firm. Some commentators argue that stakeholder interests should simply be considered as part of the management style of the organization, while others take the stronger stance that management has the legal obligation to consider stakeholder interests (and that the courts should consider this a normative standard in their review of board decisions). For this reason, many observers have attacked stakeholder theory, especially its lack of a clear mathematical way for managers to perform the trade-offs between various stakeholders. Jensen in particular is critical of the stakeholder approach:

> "Because the advocates of stakeholder theory refuse to specify how to make the necessary tradeoffs among these competing interests they leave managers with a theory that makes it impossible for them to make purposeful decisions. With no way to keep score, stakeholder theory makes managers unaccountable for their actions. It seems clear that such a theory can be attractive to the self interest of managers and directors"[736].

For the needs of this paper, we should simply understand that the goal of the corporation does in fact matter when reforming corporate law. In a shareholder primacy model, lawmakers can vest increased power directly to shareholders, knowing this will increase their likelihood of getting an appropriate return on their investment. In a broader stakeholder model, it appears more debatable whether vesting additional powers in the board (who in theory has an informed 360 degree view) or with shareholders (who are likely more self-interested) is the more appropriate method to create better stakeholder outcomes.

3.2.2.2 Legislator Objective (Permissive vs. Imperative framework)

The legislator's objective, contrary to the corporation, is obviously not to directly to make money, but rather to create the welfare-maximizing regulatory framework for long-term economic and social development of the country.

To achieve this, the legislator may also wish to promote specific values, such as democracy and capitalism, that it believes are core to this development. As for **democracy**, the legislator may wish to promote a framework with equal opportunity for participants, where shareholders can use their voting right to enact change and choose leaders, and where sufficient checks and balances exist so that the powerful minority in control does not oppress the majority. As for **capitalism**, the legislator may wish to promote a framework where individuals can let their self-interest reign to create value for society, where there are little hassles and red tape, and where good projects have easy access to capital. At the same-time, this value creation must be accomplished in a responsible way. Therefore, the legislator must also seek to minimize opportunistic risks associated with capitalism and free markets, notably by reducing externalities on poorly protected agents or by empowering them so they can better protect themselves[737].

Moreover, Kraakman and Black, having themselves participated in reforming the corporate law system of Russia, note a more measurable way to assess the legislator's goal.

> "Corporate law, we believe, should have the same principal goal in developed and emerging economies -- succinctly stated, to provide governance rules that maximize the value of corporate enterprises to investors"[738].

The goal of the legislator with regards to corporate law could therefore be simplified to: maximizing the value of firms.

In practice, to maximize the value of firms, the lawmaker must consider a number of trade-offs and strike the right balance between authority and accountability, and between shareholder and manager power. Kraakman offers what is perhaps the best description of this exercise:

> "Nonetheless, it is possible to design a law that works tolerably well – that vests substantial decisionmaking power in large outside shareholders, who have incentives to make good decisions; that reduces, though it cannot eliminate, fraud and self-dealing by corporate insiders; that minimizes, though it cannot altogether avoid, the need for official enforcement through courts; that gives managers and controlling shareholders incentives to obey the rules even when they could often get away with ignoring them; that reinforces desirable cultural attitudes about proper managerial behavior; and that still leaves managers with the flexibility they need to take risks and make quick decisions"[739].

In regards to how to reform, perhaps the most salient question for government thus becomes what type of legislative approach it should promote. It can favour (1) a permissive or (2) an imperative approach to lawmaking, or some combination of both.

While US and Canada have been strong proponents of the permissive "enabling" approach, recent reform in reaction to corporate scandals has clearly been of a more imperative "mandatory" nature. As we have seen, crisis too often triggers the perception for the need for strong black letter law to ensure that abuses will not be repeated in the future. However, is such mandatory rulemaking really warranted, or even efficient?

Leading scholars contend that while generally the "enabling" approach tends to create better governance outcomes and a healthier governance culture long-term than the "mandatory" alternative, this should not be taken to mean than government should adopt a "laissez-faire" strategy. On the contrary, the role of government should be to shape the balance of powers of the corporation, so that corporate agents may themselves set the governance arrangements that they perceive as value-maximizing:

> "While acknowledging that market instruments may not play an effective role in deterring self-interested behaviour in such a setting, leading commentators tend to avoid proposing an expanded regulatory role for corporate law. Thus, after noting that legal mechanisms such as the oppression remedy and securities legislation requirements protect minority shareholders to some extent, they tend to argue that further concerns about concentrated ownership problems need not lead to the enactment of new mandatory rules. Instead, government policy should seek to enhance the effectiveness of markets in the governance system, for instance, by fostering the disclosure of information, in order to lead them to exert better control of the agency problem associated with concentrated ownership"[740].

Next, we will seek to better understand how government policy can help to shape this "governance system" by actively redistributing powers to corporate agents.

3.2.3 The "Bring Your Own Governance" Model

The "bring your own governance" model, in essence, lets shareholders themselves set some of the rules in the corporation. It gives increased power to shareholders to create the contours of the governance framework they wish directors and officers to operate in. We find that such a model has two key interlaced components: (1) shareholder choice and (2) a self-enforcing nature.

3.2.3.1 Shareholder Choice

> "I think that I am better than the people who are trying to reform me".
>
> - Johann Wolfgang von Goethe

Shareholder choice, in its most basic definition proposed by Bebchuk, is basically a choice to have a choice. Given a choice by the legislator, shareholders could choose to escape binding state corporate law that currently gives wide discretion to directors to govern the firm.

As we have seen, the fundamental idea of choice is usually preferable than one-size fits all arrangements (like the ones which are currently baked into state corporate laws):

> "Companies are heterogeneous and the preferences of company participants vary. Correspondingly, a legal standard is unlikely to suit all parties in all instances. If a law is mandatory, parties which are ill-served by it either simply have to endure the consequences or may incur substantial costs restructuring matters[741].

Again, shareholder choice ties in nicely to the "enabling" role of the corporation (to simplify business exchanges between businessmen) as well as to the "enabling" role of corporate law (to reduce the formalism to a minimum while ensuring the rights of agents are protected). As Rousseau notes:

> When discussing the role of public regulation in the enforcement of corporate governance principles, it appears important not to lose sight of the theoretical justifications which support an enabling approach in this matter. As discussed previously, they caution that regulation should not seek to enforce compliance with a definite set of governance principles and should as much as possible leave it to corporate members to choose the applicable principles. […] In such a context, it seems preferable that the choice of governance structure remains a decision taken by the corporation rather than by regulators"[742].

That said, increasing shareholder choice has not been so far a priority in the reform initiatives. Perhaps the government fears relinquishing some of its substantive powers by allowing shareholders to change defaults offered in state corporate laws. Perhaps it is simply easier to issue mandatory laws, especially in the context of the urgency of a crisis, than it is to consider revising the invisible structure underlying how firms are governed. Rousseau shares this puzzling result that not more attention has been given to how shareholders can be empowered to make their own choices:

> Indeed, one of the most puzzling aspects of the work undertaken by reform committees is the absence of any initiative aimed at ensuring the involvement of the shareholders meeting in the establishment of corporations' governance norms. Under the existing framework, shareholder intervention is expected to proceed primarily from the evaluation of corporate shares rather than from the exercise of their voting rights[743].

While recognizing the role of the board as the default decision-making authority, Bebchuk strongly favours a system where shareholders can intervene to make rules-of-the-game decisions (general governance issues) and even significant or game-ending decisions (particular transactions). He summarized his position on shareholder choice:

> "Letting [shareholders] overrule management might well be the best approach to maximize expected shareholder value. Given that it is their money on the line, shareholders naturally would have incentives to make the decision that would best serve their interests"[744].

More concretely, Bebchuk reminds us that the default setting of board authority would not change, but simply that shareholders would have the power to adopt corporate charter provisions that would "allow them in the future to intervene regarding specific business decisions in the manner and subject to the limitations specified in these provisions"[745]. Procedural requirements would be designed to circumscribe this power of intervention.

Perhaps the most appealing aspect of shareholder choice is the relative ease by which it can be accomplished, which Bebchuk refers to as the "one rule to change them all" or "constitutional change" scenario[746]. This constitutional change implies letting shareholders initiate rules-of-the-game changes, notably in matters of corporate charter amendments and of re-incorporation in other states. Corporations can therefore amend their charters or choose another jurisdiction with more suitable corporate law. Thus, this one rule basically installs "private ordering" as the new default[747]. In other words, firms can select value-maximizing governance arrangements on their own, based on their particular needs.

Through this change, corporate shareholders could thus have a greater deal to say about the governance rules that affect them, and could in effect opt-out of corporate law provisions that do not serve their interests. Currently, only the board can propose to opt-out of state corporate laws through charter amendments, and only for some laws in some states. Shareholders are powerless to initiate such modifications. As Bebchuk notes, this change would produce important impacts on corporate governance with minimal need for government intervention or expensive reform efforts:

> "Making this one basic change in existing corporate governance arrangements would improve the whole set of corporate governance arrangements over time"[748].

Once government makes this "constitutional change", we can expect that "shareholders will have self-help tools to address corporate governance flaws, and public officials will have less need to intervene"[749]. They can then proceed to organically make governance changes to their firms.

3.2.3.2 Self-Enforcing Model

> "The peak efficiency of knowledge and strategy is to make conflict unnecessary."
>
> - Sun Tzu

A natural corollary to shareholder choice is the need for procedural safeguards that ensure that shareholder power is used for rightful purposes. The self-enforcing model seeks to create a process that allows for checks and balances in the corporation between corporate agents. Kraakman defines the self-enforcing model this way:

> "The self-enforcing model structures corporate decision-making processes to allow large outside shareholders to protect themselves from insider opportunism with minimal resort to legal authority, including the courts. […] Shareholders […] protect themselves by their own voting decisions and by exercising transactional rights[750].

Kraakman suggests that there are 5 central features of the self-enforcing model:

> (1) Enforcement, as much as possible, through actions by direct participants in the corporate enterprise (shareholders, directors, and managers), rather than indirect participants (judges, regulators, legal and accounting professionals, and the financial press).
>
> (2) Greater protection of outside shareholders than is common in developed economies, to respond to a high incidence of insider-controlled companies, the weakness of other constraints on self-dealing by managers and controlling shareholders, and the need to control self-dealing to strengthen the political credibility of a market economy.
>
> (3) Reliance on procedural protections -- such as transaction approval by independent directors, independent shareholders, or both -- rather than on flat prohibitions of suspect categories of transactions. The use of procedural devices balances the need for shareholder protection against the need for business flexibility.
>
> (4) Whenever possible, use of bright-line rules, rather than standards, to define proper and improper behavior. Bright-line rules can be understood by those who must comply with them and have a better chance of being enforced. […]
>
> (5) Strong legal remedies *on paper*, to compensate for the low probability that the sanctions will be applied *in fact*[751].

The self-enforcing model proposed by Kraakman is particularly interesting, since it cannot be qualified either of a "permissive" or "prohibitive" model, but rather sits somewhere in the middle. Self-enforcement in this context must also be distinguished from its weaker meaning of "voluntary compliance" that is often to describe how agents might want to voluntarily adhere to a law (for example, how directors may want to follow an NLERS proposed by stock-exchanges). Self-enforcement here relates more to how agents can self-enforce through voting rights and transaction rights, and without resort to the courts[752].

To make this more concrete, let's look at an example relating to how the self-enforcing model could apply in the context of approval of particular transactions:

> For self-interested transactions between the company and its directors, officers, or large shareholders, a self-enforcing statute replaces the permissiveness of the enabling approach (loosely policed by courts) and the ban of the prohibitory model with approval by independent directors, a majority of non-interested shareholders, or both[753].

One of the best aspects of the self-enforcing model is that it is very context-informed. In a way, it builds on top of the legal, market and financial institutions in a given context, as well as its norms of behaviour and its ownership structure distribution[754]. Kraakman and Black initially conceived of the model as particularly efficient for developing or restructuring economies, like Russia, since it is "robust when resources are weak"[755]. However, the main features of the self-enforcing model also seem desirable in a more developed economy with more sophisticated institutions. Settings of the self-enforced model can furthermore be tweaked to modulate the frequency of the need for judicial authority.

While Kraakman and Black use the self-enforcing model to design an end-to-end corporate law framework, we perceive its usefulness more as a model to reinforce how internal governance mechanisms should be able to prevent and resolve conflicts mostly through the direct actions of Insiders and Outsiders, through strong procedural steps safeguarding their capacity to intervene in key decision-making.

3.3 What to Reform: Exploring Less Traveled Paths

This last section will take a bird's eye view of significant recent corporate reforms, in search of some of the lesser-traveled roads of corporate governance that may hold promise for the future.

3.3.1 Recent Reform Paths

Both scandals and reforms have been numerous in the past decade. Perhaps the most central piece of reform has been the *Sarbanes-Oxley Act* of 2002 (SOX), which has had important repercussions for corporate governance not only in the US, but also in Canada[756].

In a first step, we will seek to understand what this reform entailed and how effective it is thought to have been. SOX was an imposing reform, with many changes to statutory corporate law as well as federal listing requirements. In his analysis of SOX titled *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*[757], Harvard professor Robert Clark deconstructs the reform into three broad categories of changes: (1) audit, (2) board, and (3) disclosure changes.

First, **audit changes** focused on the presentation of financial data by accountants to investors and aimed to simplify "obscure, confusing, incomplete and misleading" statements[758]. The audit changes included: (1) limits on the multiple roles and services of auditors[759], (2) shift in power to hire and compensate external auditors[760] (through the audit committee only, rather than management or the board), (3) reduction of bonding between auditors and the corporation[761] (limiting personnel flow between entities), (4) new internal control processes[762] (attestations about internal reporting), (5) certification of financial reports[763] (executives must personally attest they have reviewed the reports and find them "fair and complete in all material respects"[764]), and (6) financial literacy for audit committee members[765].

Second, **board changes** focused on reducing conflicts of interest and making it more likely that "directors will act as judgemental monitors of management rather than as reciprocating colleagues"[766]. The board changes included: (1) a majority of independent directors (accompanied by a stricter notion of independence), (2) mandatory presence of key audit, compensation and nominating committees (strengthened by the requirement that all directors on key committees be independent) and (3) active board management (regular executive sessions, periodic self-assessments and adherence to new ethical guidelines)[767].

Third, **disclosure changes** focused on providing better information to shareholders, which will increase the quality of their decision-making. The disclosure changes included new requirements relating to: (1) off-balance sheet transactions, (2) key accounting policies, (3) related-party transactions and (4) stock option plans[768].

Although it still may be early to understand the full extent of SOX, it does seems fair to ask whether SOX has generally been a success relative to its goals. In short, there is not much evidence of a homerun success. Clark seems to divide his assessment roughly into three parts: (1) cost, (2) impact on managers, and (3) substantive content.

First, in terms of **cost**, Clark notes that the SOX reforms were extremely costly, which poses the question of whether sufficient benefits would ever be generated to make the reforms worthwhile. As an example, compliance costs for the Fortune 1000 companies was on average $7.8 million, or in aggregate around $35 Billion overall for American companies[769]. Not only did these numbers blow away by at least 40X the SEC's predicted compliance estimate, their regressive nature also imposed a particularly high compliance burden on smaller companies[770].

Second, in terms of **impact on managers**, Clark does note that SOX has had the positive effect of "focusing the mind" of directors on their responsibility to shareholders, especially through the management certification of financial and governance statements. However, he also notes that most managers were already well-aware and acting in accordance to their duty to shareholders, so the reform may have overshot to achieve its goals. Of course, as we have seen, crisis-driven reform can have the tendency to "witch-hunt" particular agents. In the case of SOX, it was corporate managers who cried foul the loudest, under the burden of additional personal liabilities and heavy new corporate reporting obligations:

> "There was a great deal of complaining by corporate managers and others about the high cost and the irrationality of the sweeping reforms that were enacted"[771.]

Finally, as pertains to **substantive content** of the reforms, Clark notes that while targeting problem areas, like audit and board responsibility, was important in reaction to Enron and other corporate scandals, other reforms might have proved more efficient and less costly. To this point, Clark frequently mentions shareholder empowerment reforms, which are only "atmospherically supported" in SOX[772]. More specifically, he believes that the changes to proxy rules and to reform corporate elections (which was abandoned by SOX reform despite significant academic support), as well as the changes to de-stagger boards, might have proven more impactful:

> "Studies about the impacts of the most costly reforms, those concerning audit practices and board independence, are fairly inconclusive or negative, while studies about proposals for shareholder empowerment and reduction of managerial entrenchment indicate that changes in these areas – which in general are only atmospherically supported by the SOX-related changes – could have significant positive impacts"[773].

In Canada, SOX has been a main driver influencing reform projects. That said, as detailed earlier, other ambitious corporate and securities laws reforms have considerably changed the governance landscape in the past decade, in many ways making it even more shareholder-friendly.

3.3.2 A Few "Untouched Paths"

After providing us with a better understanding of recent SOX reforms, Clark turns our attention to what he calls a few "untouched paths" in corporate law, which corresponds to a "vast territory of unchanged laws"[774].

We will use a slightly-adapted version of Clark's framework to explore interesting corporate governance ideas, stemming from both Clark's analysis and from other scholars as well. We will categorize these ideas in the 3 following broad areas: (1) Basic allocation of power in the corporate triad, (2) Particular transaction rules, and (3) Private enforcement mechanisms[775].

First, the **basic allocation of powers among the triad** could be revised to accommodate a larger place for shareholders. To this point, Bebchuk strongly encourages reform in corporate elections. In an important series of articles including *The Case for Shareholder Access to the Ballot*[776], *The Myth of the Shareholder Franchise*[777], *Designing a Shareholder Access Rule*[778], *Placing Election By-Laws on the Corporate Ballot*[779] and *Symposium on Corporate Elections*[780], he articulates a clear vision for shareholder access to a universal ballot, where both Insiders and Outsiders can nominate directors[781]. Bebchuk, in the two key articles *The Case for Increasing Shareholder Power*[782] and *Letting Shareholders Set the Rules*[783], also proposes allowing shareholders to initiate rules-of-the-game decisions, like amending the corporate charter and re-incorporation. As Bebchuk notes, the goal is not a radical re-distribution of power in the triad, but rather marginal increases in shareholder powers that will allow shareholders to meaningfully govern themselves in a self-enforced way (using voting rights, not courts).

Second, **particular transaction rules** could be revised in a number of helpful ways.

For related-party transactions, reform should most likely center around executive compensation. In *Pay Without Performance*, Bebchuk and Fried outline two types of reforms to curb excess pay, especially related to the camouflage and decoupling problems we discussed earlier. The two types of pay reforms aim to (1) improve transparency and (2) improve pay arrangements. On the one hand, transparency could be improved by: (1) placing a dollar value on all forms of compensation, (2) disclosing all non-deductible compensation, (3) expensing options, (4) reporting the relationship between pay and performance, (5) disclosing option and share unloading[784]. On the other hand, pay arrangements could be improved by: (1) reducing windfalls in equity-based compensation, (2) reducing windfalls in bonus plans, (3) limiting the unwinding of equity incentives, (4) tying bonuses to long-term performance, (5) being wary of paying for expansion, (6) restoring dividend-neutrality, (7) rethinking executive pensions and (8) avoiding soft-landing arrangements[785]. These are all sensible proposals that do not aim to limit the absolute compensation of directors and officers, but rather make it more a reflection of managerial performance. In the recent publication *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations*, the IIF suggests a very similar list of best practices for re-designing compensation policies[786].

For major transactions, we could see reforms around the key areas of (1) approval, (2) takeover defences and resistance, and (3) remedies. First, in terms of approval, corporate state law could provide new defaults for certain transactions to better protect shareholders, such as "majority of minority voting" or "unanimous board approval" for significant transactions (like sale and purchase of assets that do not meet the criteria of a major transaction usually requiring a full shareholder vote)[787]. Second, takeovers are a particularly challenging area of reform. While they are rare, they are complex and evolve rapidly. As Bainbridge notes: "Making corporate law requires careful balancing of these competing values. Nowhere has this proven more challenging than with respect to corporate takeover defences"[788]. One common proposal is that shareholders approve the adoption of poison pills by supermajority, instead of by simple majority. Bebchuk, Coates and

Subramanian also propose the disactivation of "just say no" defences (ESB-poison pill combo) "after [managers] lose one election conducted over an acquisition offer"[789]. Easterbrook and Fischel advocate the somewhat radical idea of "no resistance", which pleads for the passivity of the incumbent board of the target in the context of a tender offer, in order to reduce conflicts of interest[790]. Although Bainbridge (who usually fiercely advocates board authority) does find merit in the idea, he also points to the "rare and sporadic" nature of takeovers to disclaim the potential overall benefits of the no resistance position[791]. Third, remedies could also be developed to better protect shareholders. Remedies could be enhanced through corporate law (developing a more expansive oppression remedy in the US) or through additional transaction rights (including takeout rights where minority shareholders can sell their shares to the acquirer of a controlling stake in a firm at a fair price[792]). Finally, Bebchuk suggests that takeover efficiency specifically could also be greatly improved by letting shareholders amend corporate charters to opt-out of state corporate law provisions or by re-incorporating in other states[793].

Third, **private enforcement mechanisms** could also enhance shareholder access to governance reform. Two interesting ideas stand out here. On the one hand, Black suggests in passing the idea of a "lighter regime"[794], which would reduce the cost of action for shareholders. For example, proxy rules and mandatory disclosure rules could be simplified or relaxed. Black notes: "Under a less obstructive, more facilitating legal regime, institutions might do much more"[795]. On the other hand, Rousseau proposes that boards of public corporations should have the "obligation to adopt their governance principles in a by-law and submit it to the approval of shareholders at every annual meeting"[796]. This proposal seems to have a number of benefits, including (1) increased shareholder participation, (2) better transparency into corporate governance principles and decisions followed by the firm, and (3) new incentives for management to adopt good corporate governance practices and co-operate with shareholders, or risk a just-say no vote that could damage their reputation[797]. Rousseau's proposal would thus put governance practices front and center on the menu, which could foster healthy discussions about how agents of the corporate triad can best work together to achieve better governance of the firm.

CONCLUSION

Due to agency costs and to the separation of ownership and control in the modern corporation, a divergence of interests exists between Insiders and Outsiders.

These conflicts can pertain to general governance issues or to particular transactions. Some examples of these conflicts include self-dealing, misappropriation, insider trading, executive compensation, corporate elections and major transactions.

These conflicts, as we have seen, are not unavoidable.

The same mechanisms (internal governance, regulatory and market) that Insiders and Outsiders use to draw power can also be structured to minimize friction and align interests between Insiders and Outsiders.

We argue that current power dynamics in the corporation frequently allow for opportunistic behavior from Insiders, notably due to flaws in a few critical governance mechanisms (such as the missing safety valve in corporate elections, or the ability for managers and directors to collude to set their own compensation).

We posit that a corporate power equilibrium that gives a larger flexibility to shareholders to set some governance rules on their own would likely be beneficial. Government intervention to increase shareholder power would inititially be needed to set the framework for increased shareholder activism, yet would eventually make way for more organic rule-setting inside the corporation itself.

This proposition never considers excluding mandatory rules to govern corporations. Corporations need mandatory law to police their external behavior in the larger context of society, even in free market economies.

Rather, in the more limited context of conflicts between agents inside the corporation, we believe that conferring additional power to corporate agents themselves (especially shareholders) should allow value-maximizing setting of rules, better protection of the interests of Outsiders and improved conflict resolution (or ideally proactive *prevention* of conflicts) between Insiders and Outsiders.

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- *Quebec Companies Act* (R.S.Q., chapter C-38) (“QCA”)
- *Revised Model Business Coporations Act* (“RMBCA”)
- *Sarbanes–Oxley Act of 2002* (Pub.L. 107-204, 116 Stat. 745) (“SOX”)
- *Securities and Exchange Act of 1934*
- *Delaware General Corporate Law* (“DGCL”)
- *Williams Act of 1968.*

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