

# A Theory of Shareholder Approval and Proposal Rights

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This paper develops a theory of how shareholder decision rights over policies and directors affect firm value. The model highlights the distinction between the right to approve and the right to propose. The right to approve is weak; the right to propose is impactful but can help as well as hurt shareholders. Managers have an incentive to deter proposals from activist shareholders by adjusting corporate policy; one might conjecture that external pressure leads them to choose policies more appealing to other shareholders in order to reduce the electoral prospects of activist proposals. However, we show that when deterrence occurs, it is always by moving policy toward the position favored by the activist, even if this reduces shareholder wealth. Our analysis stresses the central role of voting uncertainty in determining the value consequences of shareholder rights and proxy access. (*JEL* D72, G34, G38, K22)

## 1. Introduction

Corporate executives view shareholder voting with a certain amount of trepidation. In part this is because most investors lack a deep understanding of the issues brought before them: small shareholders are rationally ignorant because their stakes are too small to justify the cost of becoming informed, and institutional investors hold portfolios that are too diverse to justify a detailed review of each proposal. Proxy advisors have emerged to supply some of the missing information, but their recommendations are viewed with skepticism by some informed observers.

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Despite the concerns of corporate managers, over the last 15 years a series of new regulations, laws, and court rulings have chipped away power from managers and transferred it to the company's shareholders.<sup>1</sup> The reform agenda is driven by a belief that managers cannot be trusted to maximize firm value, and that shareholders need more tools to control managerial agency problems. Yet the benefits that many believe flow from shareholder empowerment have proven surprisingly difficult to detect in the data. Four studies estimating abnormal returns surrounding regulatory changes that altered shareholder power find mixed evidence of the effect of shareholder rights on firm value (negative effect: Larcker et al. 2011; Akyol et al. 2012; Stratmann and Verret 2012; positive effect: Becker et al. 2013; Cohn et al. 2016). This state of affairs led one SEC Commissioner to complain that the case for enhanced proxy access is "unsupported by serious analytical rigor" and the D.C. Circuit Court of Appeals vacated the SEC's new proxy access rules in 2011 because the agency lacked evidence for the benefits it claimed would flow from the new rules.<sup>2</sup>

Our goal in this paper is to provide a theoretical analysis of how giving shareholders the right to propose and approve corporate decisions affects firm performance. Because the debate surrounding shareholder empowerment has focused primarily on the benefits, an important goal of our paper is to highlight potential costs of shareholder empowerment.

Our analysis calls attention to the importance of distinguishing between the power to approve actions and the power to propose actions. In most corporations shareholders already hold the right to approve many actions that managers propose, such as selection of directors, bylaw amendments, and whether to sell the firm, but they lack the power to make proposals of their own. Recently, corporate governance reformers have focused on giving shareholders the power to *propose*—specifically, the power to nominate directors or amend the bylaws so as to facilitate proxy access. The existing theoretical literature abstracts away from this distinction by

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1. The ongoing wave of reforms includes the Sarbanes–Oxley Act of 2002 that set new requirements for auditing and independence of directors; the Delaware Supreme Court's 2008 decision *CA Inc. v. AFSCME* and the Delaware legislature's new Section 112 that gave shareholders the right to propose and adopt proxy access procedures through bylaws; the New York Stock Exchange's 2009 amendment of Rule 452 that limited the ability of brokers to vote shares held in customers' brokerage accounts; the Dodd–Frank Act of 2010 that required nonbinding shareholder votes on executive compensation and authorized the SEC to make rules on proxy access; and the SEC's changes in 2011 to Rule 14a-11 that allowed large shareholders to nominate directors on the firm's proxy statement, and Rule 14a-8 that allowed shareholder amendments to bylaws related to proxy access (although the US District Court of Appeals for D.C. vacated the 14a-11 rule in July 2011). See Gillan and Starks (2007) for an overview of shareholder activism.

2. Quotes are from Casey (2010). See Stratmann and Verret (2012) for a discussion of the current state of benefit–cost evidence (or lack thereof) on proxy access, and the impediment it creates for regulatory agencies. Romano (2001), in a review of earlier evidence, reaches a similar conclusion that shareholder activism has had little effect on firm performance.

assuming that the power to approve and the power to propose are bundled together in a single right to decide (Aghion and Tirole 1997; Harris and Raviv 2010), but we show that approval and proposal rights influence corporate behavior in different ways and should be seen as conceptually different.

We develop a model that incorporates elements that are central to current discussions of corporate governance—including managerial agency problems, activist shareholders with private interests, and uninformed shareholders—and use the model to speak to current policy issues and inform empirical work. In the model, a manager proposes an action (e.g., a level of investment in a new project or nomination of a director with a particular viewpoint on a new project) that impacts the firm's profit. If shareholders have no decision rights, the manager's proposal goes into effect. If approval is required, shareholders vote whether to accept the manager's proposal. If proposals are allowed, a shareholder may propose an alternative action, at a cost, and shareholders vote as a group to adopt either the manager's or shareholder's proposal.

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

The right to propose, on the other hand, is potentially more effective. The right to propose can be used to override recalcitrant managers, and lead to adoption of actions that maximize profit. However, there is second effect, less well recognized, that can make shareholders worse off with the right to propose. When there is some uncertainty about how shareholders will vote, the manager may preemptively adjust corporate policy in order to deter a proposal from an activist shareholder (who accepts the new policy in order to avoid the cost of proposing). One might conjecture that pressure from the activist would induce the manager to make policy more appealing to shareholders in order to reduce the electoral prospects of an activist proposal. However, we show that when deterring an activist, the manager always adjusts policy to make it more appealing *to the activist*. If the activist is aligned with shareholders, this increases firm value, but if the activist is extreme, it reduces firm value. Thus, if the manager responds to an extreme activist with deterrence, shareholders are made worse off than if they did not have the right to propose.

Having shown that the right to propose can be a double-edged sword for shareholders, we then characterize the conditions under which these rights help or harm. We analyze how the likelihood of costly deterrence depends on the configuration of activist preferences, the severity of

managerial agency problems, and we show that uncertainty in shareholder elections increases the likelihood that shareholder rights will be harmful. The finding that deterrence is a potential cost of shareholder rights would seem to be important for empirical research. Because deterred proposals leave no footprints in the data, researchers cannot assess the value of shareholder rights from examination of observed (non-deterred) proposals alone. Attempts to assess the net benefits of shareholders proposals require research designs that can capture the consequences of those proposals that do not occur in equilibrium.

A natural question is whether the impact of deterrence is large enough to be of concern in practice. That is ultimately an empirical question, but we believe there is good circumstantial evidence that warrants taking this possibility seriously. Perhaps most striking, during the period 1997–2015, more than 40% of all shareholder proposals were withdrawn before they went to a vote, usually following negotiations with management (Matsusaka et al. 2016). This suggests that managers regularly accommodate activists in some way. This view is reinforced by several studies that focus on specific cases: Smith (1996) reports that 72% of firms targeted by CalPERS during 1988–1993 made changes as part of a settlement with CalPERS; Buchanan et al. (2012) report that 116 of 133 shareholder proposals to UK firms were withdrawn following negotiations between the firm and proposers; and Fisher-Vanden and Thorburn (2011) find that many firms receiving climate-related shareholder resolutions accommodated activists by participating in a voluntary environmental program, and that these firms experienced a 1% drop in stock price on initial announcement and further losses later.

Proxy access, a prominent policy issue recently, can be seen as lowering the cost of proposing, making the right to propose more accessible. Our model identifies conditions under which proposal power is likely to cause managers to inefficiently accommodate activist shareholders. One condition is uncertainty about how shareholders will vote: if the manager knows that shareholders will not support the activist's agenda, the manager will not seek a middle ground, trusting shareholders to reject the proposal; but with sufficient uncertainty, the manager may preempt the activist rather than risk a vote. Our analysis thus suggests a rationale for current reform efforts to give managers more information about their shareholders. The right to propose can be harmful when the firm has an activist shareholder whose preferences are not aligned with profit maximization: managers have an incentive to accommodate these shareholders with inefficient actions or side payments. For example, if union shareholders seek to advance the interests of union employees rather than their fellow shareholders, as some evidence suggests (Woidtke 2002; Agrawal 2012; Del Guercio and Woidtke 2012; Matsusaka et al. 2016), then proposal rights may be harmful in firms with active union shareholders. Consistent with this idea, Cai and Walkling (2011) find that the market responds negatively to compensation-related proposals from unions, and Cohn et

al. (2016) find that firms with labor-friendly shareholders experienced lower returns around event dates related to the SEC's 2010 proxy access rule.

Our analysis is connected to an emerging literature on how shareholders affect corporate behavior through activism (voice) versus through selling (exit).<sup>3</sup> Theoretically, the mechanisms through which “voice” works for the most part have been treated as a black box (e.g., in Admati et al. (1994), shareholders invest monitoring effort that produces better firm performance). Our study introduces and studies two concrete mechanisms that reflect actual practice, providing a foundation for a more nuanced examination of voice in the corporate context. The analysis suggests that the effectiveness of voice in increasing firm value is constrained by limited agenda control rights and the manager's ability to deter proposals with compromise actions. It also suggests that giving shareholders more powerful tools to exercise their voice can be counterproductive for firm value in some circumstances.

At a formal level, our paper can be seen as an application of the theory of agenda control developed in the political economy literature beginning with Romer and Rosenthal (1979). We build on that literature by incorporating institutional features specific to corporate governance, such as the distinction between activist shareholders and atomistic shareholders. The role of voting uncertainty in generating equilibrium proposals and costly deterrence was explored in Matsusaka and McCarty (2001), again developed in a political economy context. Our analysis differs in its focus on information intermediation by proxy advisors and endogenous treatment of voting uncertainty, which provide a richer, more realistic, and sometimes different set of behaviors; in its emphasis on the distinction between the right to propose and the right to approve; and its more general formulation. More broadly, our paper can be seen as a contribution to the literature on assignment of decision rights in organizations associated with Aghion and Bolton (1992) and Aghion and Tirole (1997), specialized to corporate governance issues (Harris and Raviv 2010). Our paper is part of a strand of that literature emphasizing that decision rights are not absolute, but often fragmented and procedurally circumscribed (Marino and Matsusaka 2005; Alonso and Matouschek 2008).

A final goal of our paper is to offer a rigorous analysis of some ideas that have been offered in the law literature (e.g., Gordon 1991; Bebchuk 2005; Anabtawi 2006; Stratmann and Verret 2012). Our analysis provides a formal structure to evaluate various arguments that have been made concerning opportunistic proposals by activists, the role of information and uncertainty, and the consequences of different proxy access regimes, among other issues.

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3. For a survey, see Bond et al. (2012). For a recent example of the importance of (potential) exit, see Bharath et al. (2013). Admati et al. (1994) are an early theoretical study.

## 2. Model

### 2.1 Actors and Preferences

The model has three actors, a manager, an activist shareholder, and a set of identical atomistic shareholders. The actors together influence the choice of an action  $x$  that generates a profit or loss for the firm as well as private benefits for the manager and activist. If the firm does not make a decision, then  $x = 0$ , called the status quo point. The action can be thought of as investing an amount  $x$  in a new line of business, divesting a fraction  $x$  of assets, selling the company to another firm at a price  $x$ , nominating a director who prefers policy  $x$ , and so on.<sup>4</sup>

An action generates profit for the firm (and shareholders) of  $\pi(x; \theta)$ . The profit function is single-peaked with a maximum at  $x = \theta > 0$ , weakly concave, and derivatives exist at all points. This specification subsumes quadratic preferences, the workhorse model in the literature.

The manager's payoff is  $u(x) = \pi(x; \theta + m)$ . This function embeds the notion that the manager's payoff is linked to the firm's profit and also depends on a noncontractible private benefit that produces a "bias" in the manager's ideal point. The parameter  $m \geq 0$  represents an agency problem that creates a misalignment of incentives.<sup>5</sup> If  $m = 0$ , then the manager cares only about profit and there is no agency problem. The manager's "ideal" action is  $x = \theta + m$ .

The activist shareholder's payoff is  $v(x) = \pi(x; \theta + a)$ . As with the manager, the activist's payoff depends on the firm's profit, but also on a noncontractible private benefit that produces a biased ideal point. The private benefit might be nonpecuniary, for example, the firm engages in "socially" desirable actions favored by the activist; or the benefit might be pecuniary, for example, the firm develops a property near land owned by the activist. One can think of situations in which  $a$  is positive or negative, but we focus on the case of  $a \geq 0$  to streamline the analysis. The activist's ideal action is  $x = \theta + a$  and when  $a = 0$  the activist cares only about maximizing profit. All parameters of the payoff functions are assumed to be known by all actors.

### 2.2 Shareholder Rights and Sequence of Actions

Shareholder rights can take several forms. In the extreme case of no shareholder rights, the manager chooses the action unilaterally. In the case of

4. Given our aims in this paper, we do not include model elements that distinguish director elections from voting directly on bylaws or corporate policies. A richer model of director elections would assume that nominees take positions on an issue designated by  $x$ —one can think of  $x$  as a nominee's platform—and shareholders vote based on a director's stated platform.

5. The manager's payoff function could be constructed from more fundamental considerations. For example, suppose  $\pi(x) = -(x - \theta)^2$ , and suppose the manager's payoff depends on the sum of profit and a noncontractible private benefit of  $2mx$ . Then  $u(x) = \pi(x) + 2mx = -(x - \theta - m)^2 + Y$ , where  $Y = m^2 + 2m\theta$  is a choice-irrelevant constant.

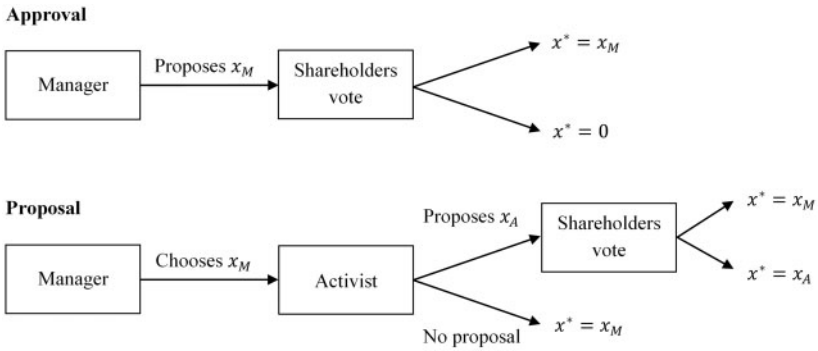


Figure 1. Sequence of Actions.

the right to approve, shareholders vote whether to approve the manager's proposal or reject it in favor of the status quo. In the case of the right to propose, an individual shareholder is permitted to suggest an alternative to the manager's action, and shareholders as a group decide between the two. If shareholders have the right to propose, the activist can make a proposal at a cost  $k > 0$ . The cost represents expenses associated with retaining lawyers, filing fees, information acquisition, and outreach to other shareholders, among other things. In practice, these costs can be nontrivial, as suggested by Buchanan et al. (2012) estimate of \$525,070 for proxy contests in American corporations. We assume that only the activist considers making a proposal; the atomistic shareholders are unwilling to pay the cost.

Figure 1 depicts the sequence of actions. With the right to approve, the game begins with the manager proposing an action. Shareholders then vote whether to accept the manager's proposal. If they reject the proposal, then the action reverts to the status quo.

With the right to propose, in practice typically an activist begins by approaching the manager with a requested policy. Given this request, the manager may alter the company's policies. If the activist is satisfied with the accommodation, then the interaction ends; if the activist is dissatisfied then he or she initiates a proposal. We model this by having the game begin with the manager proposing an action  $x$ , taking into account the existence of a specific activist that is considering a proposal. After the manager's proposal, the activist can offer an alternative action, or under the director interpretation the activist can nominate a competing candidate for director. If a competing proposal is on the table, shareholders vote whether to accept the manager's or activist's proposal. We rule out side payments between the parties initially, turning to that issue after working through the main model.<sup>6</sup>

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

In modeling the proposal process, we assume that the manager's initial proposal cannot be changed after the activist moves. This is important because if the manager could change the policy after the activist withdraws his or her proposal, then a compromise agreement would be impossible given the one-shot nature of the interaction. In practice, managers have an incentive to honor their agreements because of repeated play: if a manager renege on a compromise, the activist would have to wait only until the next annual meeting to make a proposal. We also assume that shareholders do not have the option of choosing the status quo action that may have prevailed prior to the manager's action (i.e., shareholders do not have the option of rejecting both the manager's and activist's proposals). This accords reasonably well with actual practice. For example, proxy statements give shareholders the option to accept or reject the activist's proposal, but do not give them a concurrent option to reject the manager's action; and in director elections, shareholders have to choose between management's slate and the activist's slate, without the option of retaining the current board (if not otherwise nominated).

We begin the analysis by assuming that shareholder voting is predictable, and then introduce uncertainty after some preliminaries. We assume that small shareholders vote as a block. We also assume throughout that the activist's ownership is too small to swing an election, so can be ignored when considering election outcomes. If the activist's stake is large enough to be pivotal, then the activist effectively has control of the firm, and the strategic issues we study do not emerge.

### 3. Preliminaries: Strategic Behavior with No Voting Uncertainty

We begin by considering the situation in which there is no uncertainty about how shareholders will vote. This case illuminates some of the core strategic tradeoffs before we turn to the full model, and it has relevance for situations in which management can accurately forecast voting behavior. The benchmark case is when shareholders have no decision rights and the decision is fully delegated to the manager, in which case the manager chooses  $x^* = \theta + m$ .<sup>7</sup>

#### 3.1 Right to Approve

When shareholders have the right to approve, the manager proposes an action that shareholders can accept or reject: to sell the firm, change the state of incorporation, establish a compensation plan, elect a candidate to the board, etc. If shareholders reject the proposal, then the status quo ( $x = 0$ ) prevails. Because shareholders can achieve a payoff of  $\pi(0)$  by

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



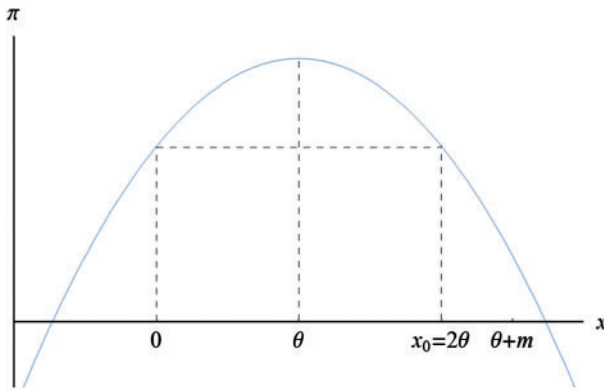


Figure 2. Right to Approve.

rejecting the proposal, they will turn down any proposal that delivers a lower profit than  $\pi(0)$ . Therefore, the maximum proposal  $x_0$  that shareholders will approve satisfies  $\pi(0) = \pi(x_0)$ .

For the case of symmetric preferences illustrated in Figure 2,  $x_0 = 2\theta$ . The manager chooses  $x^* = \min\{\theta + m, x_0\}$ . While shareholders are always (weakly) better off with the right to approve, their benefit from holding the right is limited. The right to approve has no effect on the action chosen when the managerial agency problem is “moderate” ( $m \leq x_0 - \theta$ ) because the manager chooses his or her ideal point; and even when the managerial agency problem is “severe” ( $m > x_0 - \theta$ ), shareholders end up with the same payoff they would have received under the status quo.

The implication that shareholders benefit from the right to approve, but only if managerial agency problems are severe, is consistent with evidence on adoption of say-on-pay regulations that allow shareholders to vote on managerial compensation. Event studies for the United States (Cai and Walking 2011) and United Kingdom (Ferri and Maber 2013) find positive abnormal returns, but only for subsample of firms in which existing compensation is suspect.

### 3.2 Right to Propose

When shareholders have the right to propose, the activist shareholder may propose an action, in which case shareholders either select the activist’s proposal or keep the manager’s action. This represents a situation in which shareholders are permitted to nominate directors for the board who compete against the management slate under plurality voting, or propose actions such as disinvestment from Sudan or disclosure of corporate political campaign contributions. The following observation is useful for characterizing the equilibria:

*Observation 1. In any equilibrium, the activist does not make a proposal.*

To prove this, suppose there was an equilibrium in which the activist makes a proposal  $x_A$ . For this to be an equilibrium, it must be the case that shareholders approve the proposal—otherwise the activist would be better off by not proposing and avoiding the cost  $k$ . However, there always exists an alternative action  $x_M$  sufficiently close to  $x_A$  so that the activist would prefer to accept and avoid the proposal cost (i.e., such that  $v(x_A) - k < v(x_M)$ ) and that the manager prefers (i.e., such that  $u(x_M) > u(x_A)$ ). Thus,  $x_A$  cannot be part of an equilibrium. The observation implies that the equilibrium action will maximize the manager's utility subject to deterring the activist from making a proposal.

The activist's ideal action is  $x = \theta + a$ , so the manager can deter an activist proposal by taking action  $x_1$  that satisfies

$$v(x_1) \geq v(\theta + a) - k. \quad (1)$$

At equality, equation (1) has two solutions, one less and one greater than  $\theta + a$ ; denote them  $x_1^-$  and  $x_1^+$ , respectively. Any manager action in  $[x_1^-, x_1^+]$  is sufficiently close to the activist's ideal point to deter a proposal.<sup>8</sup> The manager can also deter an activist proposal by choosing  $x < \theta + a$  because the activist would have to propose an even smaller and less desirable action to defeat the manager's proposal.

Because the activist must not find it optimal to propose in equilibrium, the manager's equilibrium choice maximizes the manager's payoff subject to a deterrence constraint  $x \in [0, x_1^+]$ . Therefore, the manager chooses  $x^* = \min\{\theta + m, x_1^+\}$ . Figure 3 illustrates the case with  $x_1^+ < \theta + m$ , where the right to propose constrains the manager to  $x_1^+$ .

The right to propose can be more effective than the right to approve when  $x_1^+ < x_0$ . As with the right to approve, the right to propose always moves the action closer to profit maximization (or has no effect) than when shareholders have no decision rights. An activist with more extreme preferences than the manager ( $m < a$ ) will be ignored, while a less extreme activist ( $a < m$ ) exerts a moderating influence if  $x_1^+ < \theta + m$ .<sup>9</sup> The effectiveness of the power to propose increases as the cost of making a proposal declines. The feature of complete deterrence—no proposals in equilibrium—is counterfactual; it disappears in the full model with uncertainty about shareholder voting.

We do not provide a full treatment of a proposal process that gives shareholders the right to propose as well as the right to force the status quo (proposal + approval) because it is less descriptive of actual proposals (as discussed in Section 2.2), but we can outline how the equilibrium

8. Equilibrium requires the activist not to make a proposal if indifferent.

9. As an aside, in the case  $a < 0$ , the activist has an even more moderating influence, and for certain parameters can induce the manager to adopt the profit-maximizing action. This implies, somewhat counterintuitively, that shareholders may be better off with a benefit-seeking activist than a value-focused activist if the activist's interests are "opposite" of the manager's interests.

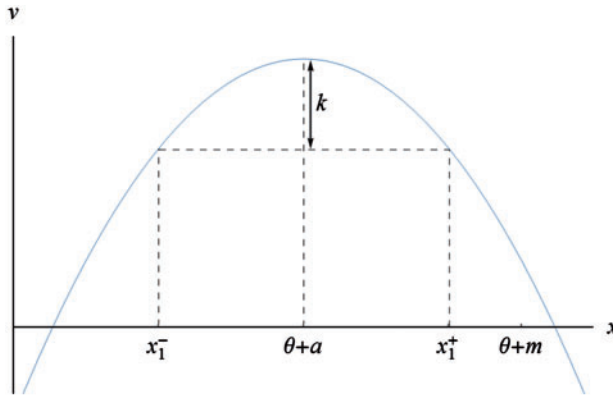


Figure 3. Right to Propose.

changes. Formally, suppose that shareholders can approve either the activist's proposal, the manager's proposal, or the status quo. Both activist and manager proposals must deliver a payoff to shareholders at least equal to the status quo payoff,  $\pi(0)$ ; call it the approval constraint. As with the proposal-only process, an activist with extreme preferences will be ignored. The case of an activist with moderate preferences is more interesting. First, if the activist's ideal point does not satisfy the approval constraint, then the activist's proposal satisfies  $\pi(x_A) = \pi(0)$  with  $x_A < \theta + a$ . The manager cannot deter this proposal with any  $x_M > x_A$  because the deterring proposal would be rejected by shareholders; therefore, the manager does not deter and the activist's proposal goes forward and is approved. If the activist's ideal point does satisfy the approval constraint, then the manager may be able to deter, but the approval constraint limits the deterring proposal, pushing it closer to shareholders' ideal point. This case has one material difference from the "proposal without approval" case—activist proposals can occur in equilibrium—but its welfare implications are the same—"proposal + approval" makes shareholders better off (or no worse off).

### 3.3 Conclusions

The preceding results are collected in the following proposition:

*Proposition 1.* Suppose shareholder voting is fully predictable. If shareholders have no decision rights, then  $x^* = \theta + m$ . If shareholders have the right to approve then  $x^* = \min\{\theta + m, x_0\}$ , where  $\pi(0) = \pi(x_0)$ ; and the manager's proposal is always approved. If shareholders have the right to propose then  $x^* = \min\{\theta + m, x_1^+\}$ , where  $x_1^+$  is the largest solution for  $x_1$  in  $v(x_1) = v(\theta + a) - k$ ; and no shareholder proposal occurs.

With no uncertainty, several conclusions emerge. Increasing the power of shareholders—either by requiring approval or allowing them to make proposals—curtails managerial agency problems and can increase firm value.

The right to approve has no effect on corporate actions except when managerial agency problems are severe, and even then, it only gives shareholders the payoff they would have received under the status quo action. The right to propose, on the other hand, can push the manager toward value maximization. The right to propose is most beneficial to shareholders when there is an activist who receives large private benefits that run in the opposite direction from the manager's private benefits. The power to propose does not change behavior through approval of shareholder proposals, but by inducing a change in the manager's behavior. Although the complete absence of actual proposals is not robust to introducing voting uncertainty into the model, the observation that proposal power influences behavior through a threat is robust, and implies that empirical research focusing on actual shareholder proposals is likely to miss much of the impact of proposal rights [as found by Smith (1996) in his study of CalPERS].

#### 4. Main Results

This section analyzes the full model in which shareholder voting is uncertain. We show that uncertainty has interesting and important effects on the consequences of shareholder rights. In particular, shareholders can be worse off when they have the right to propose.

##### 4.1 Uncertainty about Voting

To model uncertainty, we assume that shareholders are uninformed about the nature of the proposals that come before them for a vote, and have incomplete information about the ideal points of the manager and activist. Because shareholders are uninformed, they rely on a recommendation from a proxy advisory firm.

The proxy advisor is unbiased and attempts to determine the relative value of the two proposals from the perspective of shareholders. Formally, the proxy advisor receives a signal  $r \in \{M, A\}$  about which proposal is best, where

$$Pr(r = M) = p(\pi(x_M; \theta) - \pi(x_A; \theta)),$$

and  $p \in (0, 1)$ ,  $p(0) = 0.5$ , and  $p' > 0$ . This formulation reflects that the proxy advisor has valuable but imperfect information. One interpretation is that while the proxy advisor can read the text of the proposal, there is uncertainty about how its implementation would affect firm performance; or, if the  $x$ s are director candidates, the proxy advisor is uncertain about the skills of the two candidates.

The ideal points of the manager  $m$  and activist  $a$  are drawn from a distribution with probability density function  $g(m, a)$  and cumulative distribution function  $G(m, a)$  defined over  $[0, +\infty) \times [0, +\infty)$ . The manager and the activist know the realized values of  $m$  and  $a$ , but the proxy advisor and shareholders only know the distribution. This formulation implies that both  $m < a$  and  $a < m$  are possible. In using the signal to make a

recommendation, the proxy advisor takes into account the nature of the equilibrium and the prior distribution of manager and activist preferences. Let  $x_M = \chi_M(m, a)$  and  $x_A = \chi_A(m, a)$  be the equilibrium proposal mappings between manager and activist ideal points and proposals, with  $\chi(m, a) = \emptyset$  indicating the absence of proposals in equilibrium and  $\Gamma$  representing the space of manager and activist ideal points such that  $\chi_M(m, a) \neq \emptyset$  and  $\chi_A(m, a) \neq \emptyset$ , and the proxy advisor receives a signal with which to make a recommendation.

Let  $q(m, a|r)$  be the posterior distribution about the type of the manager and activist following the signal  $r$ . Define  $\Delta(m, a) = \pi(\chi_M(m, a); \theta) - \pi(\chi_A(m, a); \theta)$ . Then by Bayes' Rule for  $(m, a) \in \Gamma$ ,

$$q(m, a|r = M) = \frac{p(\Delta)g(m, a)}{\iint_{\Gamma} p(\Delta)g(m, a)dmda},$$

and similarly for  $q(m, a|r = A)$ . The proxy advisor recommends a vote for the manager's proposal if it produces a higher expected shareholder payoff than the activist's proposal. The expected difference in shareholder payoff conditional on the signal is  $E[\Delta|r = M] = \iint_{\Gamma} \Delta(m, a)q(m, a|r = M)dmda$  and similarly for  $E[\Delta|r = A]$ .

Note that  $E[\Delta|r = M]$  and  $E[\Delta|r = A]$  are constants for any distribution  $G$  and associated equilibrium, and importantly, do not depend on the realized ideal points of the manager and activist. The proxy advisor recommends a vote in support of management if  $E[\Delta|r] \geq 0$  and against management if  $E[\Delta|r] < 0$ .

Most of our analysis focuses on parameter configurations in which the signal is informative in equilibrium:

*Informative signal condition.*  $E[\Delta|r = M] \geq 0 > E[\Delta|r = A]$ .

If the informative signal condition holds, the proxy advisor's recommendation varies with the signal received; otherwise, the proxy advisor's recommendation is independent of the signal and based entirely on knowledge of the underlying structure of the game. We will show below the existence of configurations in which the informative signal condition does and does not hold. When the signal is informative, the proxy advisor recommends the manager's proposal if  $r = M$  and recommends the activist's proposal if  $r = A$ . Then the (post-proposal and pre-signal) probability that the proxy advisor recommends the manager's proposal is  $p(\pi(x_M) - \pi(x_A))$ .

#### 4.2 Motivation

This formulation of uncertainty was selected because it embeds prominent real-world features of the voting process.<sup>10</sup> One assumption is that

10. We believe that the main implications of the model are robust to plausible alternative assumptions about the source of uncertainty. In previous versions of the paper, we considered a model in which shareholders received a noisy signal from the proxy advisor, and a model in which the manager is uncertain about shareholder preferences.

investors on their own are unable to understand completely the consequences of the options before them. While the names of director candidates and the text of shareholder proposals are available to voters, that information on its own may not reveal how a given candidate or proposal will affect firm performance. Some investors are well-informed about the firms they own, especially activist investors, but many others, such as institutional investors, hold large, diversified portfolios that can contain hundreds of different stocks, and it is not rational for such investors to invest much effort in acquiring information about specific proposals for each firm. Even large funds have limited capacity to evaluate voting options. A recent industry study (Bew and Fields 2012) notes that in 2009, there were more than 20,000 proposals at Russell 3000 companies, and most funds had only three to five full-time employees devoted to proxy oversight. We believe that the main implications of the model are robust to alternative assumptions about the source of uncertainty.

Another assumption of our formulation is that because of their limited information, investors rely on external advice when deciding how to vote. Much advice today is provided by two proxy advisory firms, Institutional Shareholder Services (ISS) and Glass, Lewis, & Co. The growing reliance on proxy advisory services is a well-known feature of shareholder voting, and the influence of recommendations from advisory services is well documented (e.g., Cai et al. 2009; Malenko and Shen 2016). As noted by the UK's Financial Reporting Council (2012) that sponsors the UK Corporate Governance Code, "the increasing internationalization of the equity market . . . results in more shareholders being remote from the companies they own which may make them more reliant on proxy agency's advice."

The final assumption is that proxy advisors may make mistakes, and their recommendations are to some extent unpredictable from the viewpoint of managers. The quality of advice from proxy advisory firms is a much-discussed concern of corporate officers and regulators. Some companies complain that advisory firms use incorrect or inappropriate data in reaching their conclusions, while others complain that the basis for recommendations is not clear or is excessively subjective (e.g., Larcker et al. 2013). The subjective element in recommendations concludes one consulting firm (Kroll and Edwards 2012), "allow[s] proxy advisors to consider unique company circumstances to a company's advantage, while at the same time bring[s] uncertainty about the ultimate recommendation." The US Chamber of Commerce (Center for Capital Market Competitiveness 2013) notes that one advisory firm employs a total of 180 analysts to evaluate 250,000 issues spread over thousands of companies in a 6-month period, which highlights the challenges facing advisory firms in reaching correct conclusions. More systematically, Daines et al. (2010: 460) study the corporate governance recommendations of ISS, and find that the company's governance ratings "have either limited or no success

in predicting firm performance or other outcomes of interest to shareholders.”

#### 4.3 Right to Approve

Because  $m \geq 0$ , the manager would never propose  $x_M < 0$ . So shareholders are concerned only with how the manager’s proposal compares to  $x_0$ , defined above as  $\pi(0) = \pi(x_0)$ . The proxy advisor recommends  $x_M$  with probability  $p(\pi(x_M) - \pi(x_0))$ . The manager then chooses  $x_M$  to solve:

$$\max p \cdot u(x_M) + (1 - p) \cdot u(0).$$

The first-order condition is  $p'\pi'(x_M)(u(x_M) - u(0)) + pu'(x_M) = 0$ . Because  $u'(\theta + m) = 0$  and  $\pi'(\theta) = 0$ , it follows that  $\theta \leq x_M \leq \theta + m$ : proposing an action greater than the manager’s ideal point reduces the proposal’s chance of passing and delivers a lower payoff conditional on passage, compared with simply proposing the manager’s ideal point; proposing an action less than the shareholders’ ideal point reduces the proposal’s chance of passing and delivers a lower payoff conditional on passage, compared with simply proposing the shareholders’ ideal point. Thus, with uncertainty, the right to approve continues to constrain the manager. However, uncertainty creates the possibility that the shareholders might not approve the manager’s proposal even if it is better than the status quo ( $\theta$  large enough so that  $\theta < x_M < x_0$ ). Therefore, with voting mistakes, it is possible that the shareholders are worse off with the right to approve than without it.

#### 4.4 Right to Propose

Unlike the case with no uncertainty where proposal power is always beneficial, here we show that under some conditions the manager might accommodate the activist in order to deter a proposal, leading to a lower profit action than if shareholders did not have the right to propose.

4.4.1 Statement of Solution. The equilibrium is characterized by four conditions. Working backward, if not deterred the activist chooses  $x_A$  to maximize the expected value of an election between the manager’s and the activist’s proposals:

$$\max p \cdot v(x_M) + (1 - p) \cdot v(x_A). \quad (2)$$

The optimal proposal reflects a tradeoff between choosing an action that produces a high payoff for the activist if it is approved and an action that gives the activist a good chance of winning. Denote the solution, representing the activist’s best-response function, as  $x_A(x_M)$ .

The activist makes a proposal if the expected payoff from a lottery over the two proposals, less the cost of making a proposal, exceeds the payoff from simply accepting the manager’s proposal:

$$p \cdot v(x_M) + (1 - p) \cdot v(x_A(x_M)) - k - v(x_M) \equiv \varphi(x_M) > 0. \quad (3)$$

The manager’s proposal deters the activist if  $\varphi(x_M) \leq 0$ . At equality, there are two solutions, one on each side of  $\theta + a$ . The manager prefers the solution closer to the manager’s ideal point; let  $x_1$  denote the solution to  $\varphi(x_1)$  that is closest to the manager’s ideal point. The manager’s equilibrium deterring proposal is denoted as  $x_1^*$ . Note that  $x_1^*$  may be different from  $x_1$  if the manager’s ideal point itself can deter.

If the manager does not deter the activist, then the manager chooses a proposal to solve

$$\max p \cdot u(x_M) + (1 - p) \cdot u(x_A(x_M)). \tag{4}$$

Denote the solution as  $x_M^*$ . As with the activist, in choosing a proposal the manager trades off selection of an action that provides a high payoff if it is approved against selection of an action with a good chance to be approved. The activist’s best response to  $x_M^*$  is denoted as  $x_A^*$  ( $= x_A(x_M^*)$ ).

Finally, the manager chooses to deter if

$$p \cdot u(x_M^*) + (1 - p) \cdot u(x_A^*) - u(x_1^*) \equiv \gamma \leq 0. \tag{5}$$

The rest of this section characterizes equilibrium behavior. There are two main “types” of equilibria, one in which the activist proposes and one with no activist proposal. We describe in some detail the behavior of the actors in each equilibrium. Then we discuss the conditions under which each equilibrium prevails.

4.4.2 Characterization of Equilibrium with Moderate Manager, Extreme Activist:  $0 < m < a$ . Consider first the case where the activist is more extreme than the manager. This could represent an activist that stands to personally benefit from an action, such as a union or a government pension fund that would like an inefficient plant to continue in operation rather than be shut down.

*Proposition 2.* Suppose  $0 < m < a$  and the informative signal condition holds. (i) If the manager allows an activist proposal, then  $x_M^* < x_A^* < \theta + a$  and  $\theta < x_A^*$ . (ii) If the manager deters, then  $\theta + m \leq x_1^* < \theta + a$ .

*Proof.* (i) Suppose there was an equilibrium with competing proposals in which  $x_A \leq x_M$ . Because it would not be optimal for the activist to propose if  $x_M \leq \theta + a$  and it would not be optimal for the manager to propose if  $\theta + a \leq x_M$ , such an equilibrium cannot exist. Therefore,  $x_M^* < x_A^*$ . Given this, equation (2) implies that  $\theta < x_A^* < \theta + a$ .

(ii) The first-order condition for the activist’s problem (2) is  $-p'\pi'(x_A)(v(x_M) - v(x_A)) + (1 - p)v'(x_A) = 0$ , which defines  $x_A$  as a function of  $x_M$ . Differentiating  $\varphi$  as defined in equation (3) with respect to  $x_M$  where  $x_M < \theta + a$  and applying the envelope condition gives

$$\begin{aligned} \frac{\partial \varphi}{\partial x_M} &= -p'\pi'(x_M)(v(x_A) - v(x_M)) - (1 - p)v'(x_M) \\ &< -p'\pi'(x_A)(v(x_A) - v(x_M)) - (1 - p)v'(x_A) = 0, \end{aligned}$$



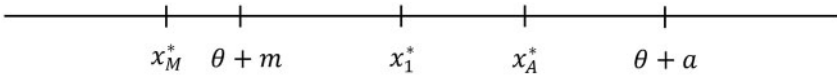


Figure 4. Equilibrium Proposals.

where the inequality follows from  $x_M < x_A < \theta + a$  and  $\theta < x_A$ , implying that  $v(x_M) < v(x_A)$ ,  $0 < v'(x_A) < v'(x_M)$ , and  $\pi'(x_A) < \pi'(x_M)$ ; and the last equality follows from the first-order condition. This result implies that there is a unique deterring proposal  $x_1 < \theta + a$  such that  $\varphi(x_1) = 0$ , and that all proposals  $x \in (x_1, \theta + a]$  also deter, while proposals less than  $x_1$  do not deter. Then if  $x_1 < \theta + m$ , the manager can deter by choosing the manager's ideal point, which yields the activist a higher payoff than  $x_1$ . Therefore, the optimal deterring proposal must satisfy  $\theta + m \leq x_1^*$ .  $\square$

Proposition 2, illustrated in Figure 4, characterizes the equilibrium strategies, and leads to a key implication: if the manager chooses to deter, the manager does so with a more extreme proposal than if the right to propose was not available. (Below we show by example the existence of parameter values that cause deterrence to be optimal for the manager.) As a result, when deterrence occurs, shareholders are worse off by virtue of having the right to propose. Intuitively, the presence of an extreme activist leads the manager to move policy in a more extreme direction in order to avoid the risk that shareholders might approve a proposal from the activist. This result holds under fairly general conditions and is not self-evident: one might conjecture that the manager would try to deter the activist by moving policy toward shareholders, making the activist's alternative less appealing, in which case shareholders would be better off. This does not happen because appealing to shareholders with a moderate proposal makes the manager's policy increasingly distasteful to the activist, driving up the activist's return from proposing even with the lower probability of success.

Bebchuk (2005: 885) argues that shareholders cannot be hurt by having the right to propose because the manager would ignore extreme activists: “[M]anagement would not be particularly worried about a threat to bring a proposal for a change that would likely be value-decreasing [because such a proposal] would be highly unlikely to obtain majority support. Accordingly, a threat to bring such a proposal would not enable a shareholder to blackmail management.” Proposition 2 shows that this intuition is incomplete. As long as there is some uncertainty about the voting outcome, the manager has an incentive to respond to a threat even if the proposal is unlikely to receive majority support. The manager may choose to offer some accommodation to the activist in order to remove

the *risk* of the activist's proposal being approved<sup>11</sup>; and the accommodation could make shareholders worse off than if proposals were not allowed.

Courts and business interests have expressed concern that union shareholders may use the proposal process to induce management to adopt corporate policies that benefit union members but hurt firm value.<sup>12</sup> Thomas and Martin (1998) attempt to assess this argument by comparing shareholder votes on union proposals with votes on other proposals, concluding that because the approval rate on union proposals is similar to that on other proposals, unions are not using the process in a harmful way. Proposition 2 casts doubt on tests of this nature because the damage, if any, from an activist shareholder might come from the manager's deterring response, not the proposals that actually go to a vote. Harmful deterring responses would not appear in databases of shareholder proposals.

The cost of the right to propose arises from uncertainty about how shareholders will vote. Uncertainty is present in the model because shareholders can mistakenly vote for a proposal that is not in their interest if they receive faulty advice from a proxy advisor. The feature that shareholders might mistakenly vote against their own interests is not essential; what is critical is that the manager faces some uncertainty about the voting outcome. Below we show this by developing an alternative microfoundation for uncertainty in which shareholders do not make mistakes. Put differently, our point is not that shareholders can be worse off if they fail to vote in their own interest—which is obvious—but that shareholders can be hurt because of the manager's incentive to deter proposals. The costs associated with deterrence have not been assessed by existing research that focuses on actual proposals, and thus are akin to the unseen part of an iceberg. The implication is that scholarly and regulatory benefit-cost studies that wish to quantify the costs of shareholder proposals should not focus only on the oft-mentioned possibility of shareholders harming themselves with unwise votes, but should also attempt to measure the indirect costs arising from deterrence.

The right to propose also has an interesting effect when the manager allows a competing proposal. Casual intuition suggests that shareholders would be better off having two choices instead of only one option imposed by the manager. Consistent with this, shareholders can be better off if the manager's competing proposal is closer to value maximization than the manager's unilateral or monopoly proposal, that is, if  $x_M < \theta + m$ .

11. In 2013, PepsiCo agreed to disclose its lobbying activities so that the New York State's public pension fund would withdraw a shareholder proposal to that effect, despite the fact that a similar proposal in 2012 was rejected by 93% of shareholders voting (O'Keefe 2013).

12. For example, in its decision vacating the SEC's new proxy access rules, the D.C. Circuit Court of Appeals worried that "union and state pension funds might use [proxy access] as leverage to gain concessions, such as additional benefits for unionized employees, unrelated to shareholder value." See *Business Roundtable and Chamber of Commerce of the USA v. Securities Exchange Commission*, 2010.

However, even in that case, if the activist's proposal is very harmful or very likely to be approved, the lottery over the two proposals can be worse ex ante for shareholders than the manager's monopoly proposal. Even less obvious, it is possible for shareholders to be worse off regardless of the voting outcome. This can happen if  $\theta + m < x_M < x_A$ , in which case the manager competes with the activist by moving away from shareholders, forcing shareholders to choose between two proposals, both of which are worse than the manager's monopoly choice. Although the manager dislikes moving policy in this direction, it may be optimal for the manager to do so if it induces the activist to move to an even more extreme proposal, reducing the activist's probability of election success.

4.4.3 Characterization of Equilibrium with Extreme Manager, Moderate Activist:  $0 < a < m$ . We next consider the case where the activist is more closely aligned with shareholder interests than the manager. Equilibrium behavior can be characterized as follows:

*Proposition 3.* Suppose  $0 < a < m$  and the informative signal condition holds. (i) If the manager allows an activist proposal, then  $\theta < x_A^* < \theta + a < x_M^*$ . (ii) If the manager deters, then  $\theta + a < x_1^* \leq \theta + m$ .

*Proof.* The proof is analogous to that of Proposition 2, so it is presented in an abbreviated form.

(i) Suppose there was an equilibrium with competing proposals in which  $x_M \leq x_A$ . Because it would not be optimal for the activist to propose if  $\theta + a \leq x_M$  and it would not be optimal for the manager to propose if  $x_M \leq \theta + a$ , such an equilibrium cannot exist. Therefore,  $x_A^* < x_M^*$ . Given this, equations (2) and (4) imply that  $\theta < x_A^* < \theta + a < x_M^*$ .

(ii) The first-order condition for the activist's problem (2) implies  $v(x_M) < v(x_A)$ . Using similar arguments as in the proof of Proposition 2 gives  $\frac{\partial \varphi}{\partial x_M} > 0$ , implying the existence of a unique deterring proposal  $\theta + a < x_1$  such that  $\varphi(x_1) = 0$ , and that all proposals  $x \in [\theta + a, x_1)$  also deter, while proposals greater than  $x_1$  do not deter. If  $\theta + m < x_1$ , the manager can deter by choosing the manager's ideal point, which yields the activist a higher payoff than  $x_1$ . Therefore, the optimal deterring proposal must satisfy  $x_1^* \leq \theta + m$ .  $\square$

This case is similar to the previous case, except that here shareholder wealth is higher if the right to propose leads to deterrence.

4.4.4 Equilibrium and the Informative Signal Condition. Propositions 2 and 3 characterize equilibrium behavior assuming that the informative signal condition holds. Next, we show that the informative signal condition can hold given the equilibrium strategies described in Propositions 2 and 3.

Define the expected difference in payoff between the two proposals before receiving the signal (conditional on proposals occurring) as

$E_0[\Delta] = \iint_{\Gamma} \Delta(m, a)g(m, a)dmda$ . Note that if  $E_0[\Delta] = 0$ , then the informative signal condition holds, and by extension it will hold in a neighborhood of  $E_0[\Delta] = 0$ . By Proposition 3,  $\Delta(m, a) < 0$  for  $m > a$ , when proposals occur in equilibrium. We show by example below that it is possible for  $\Delta(m, a) > 0$  when  $m < a$ . One can then select distributions  $G$  to make  $E_0[\Delta]$  arbitrarily close to zero.

When the informative signal condition does not hold, the proxy advisor's recommendation does not depend on the signal. This causes an unraveling in which no proposals occur in equilibrium, and the character of the equilibrium depends entirely on out-of-equilibrium beliefs.

*Proposition 4.* Suppose the informative signal condition does not hold. Then the activist does not propose, and: (i) if out-of-equilibrium beliefs are such that  $E[\Delta|r] < 0$  for all  $r$ , then the manager chooses  $x_M = \max\{\theta + m, x_1^-\}$  when  $m < a$ , and  $x_M = \min\{\theta + m, x_1^+\}$  when  $a < m$ ; (ii) if out-of-equilibrium beliefs are such that  $E[\Delta|r] > 0$  for all  $r$ , then the manager adopts  $x_M = \theta + m$ .

*Proof.* (i) If  $E[\Delta|r] < 0$  for all  $r$  then the expected profit from the manager's proposal is less than the activist's proposal regardless of the signal. In this case, any activist proposal will win. The manager prefers to deter rather than accept a policy at the activist's ideal point. The deterring action  $x_M$  solves:  $x_M = \max\{\theta + m, x_1^-\}$  when  $m < a$  and  $x_M = \min\{\theta + m, x_1^+\}$  when  $a < m$ .

(ii) If  $E[\Delta|r] > 0$  for all  $r$  then the expected profit from the manager's proposal is greater than the activist's proposal. The manager can propose his or her ideal point, and the activist will not challenge the proposal.  $\square$

Proposition 4 shows another potential cost of the right to propose. In case (i), when the out-of-equilibrium beliefs are in favor of the activist's proposal, the manager always chooses an action that is ideal for the activist (less the cost of proposing,  $k$ ), and the activist does not propose. If the manager is induced to accommodate an extreme activist, shareholders are worse off than if they did not have the right to propose. In case (ii), when out-of-equilibrium beliefs favor the manager, the manager chooses his or her ideal point, and the activist does not offer a proposal.

Note that when the informative signal condition does not hold, the out-of-equilibrium beliefs  $E[\Delta|r]$  are arbitrary, in the sense they are not determined by priors or Bayes' Rule because no proposals occur in equilibrium, and thus the nature of the equilibrium is indeterminate. One could attempt to select from among the possible equilibria by applying some sort of equilibrium refinement; we do not go down that path because it takes us some distance from our primary substantive concerns. As a technical point, we note that for every equilibrium in which the informative signal condition holds, there are also equilibria in which the condition does not hold and no proposals occur in equilibrium.

4.4.5 Voting Uncertainty versus Shareholder Error. Our model assumes that shareholders might mistakenly vote in favor of a proposal that makes them worse off. This assumption captures a longstanding concern in the law (Bainbridge 2012)—that shareholders lack the information necessary to participate constructively in corporate decisions—but its primary theoretical purpose is to introduce uncertainty over the voting outcome. While it might seem at first glance that our finding that shareholders can be worse off with proposal rights follows in some sense trivially from the assumption that shareholders might vote against their interests, this is not correct. Our finding that proposal rights can be costly because of the incentives they give the manager to deter an extreme activist is best seen as a consequence of uncertainty over the voting outcome, not shareholder voting mistakes. To illustrate this point, we next sketch an alternative version of the model in which there is uncertainty about the voting outcome yet shareholders never make voting mistakes.

This alternative model is the same as the main model in the text, except for the changes indicated in this paragraph. We assume that the manager's ideal point is  $m$ , the activist's ideal point is  $a$ , the shareholder's ideal point is distributed uniformly over  $[0, 1]$ , and  $0 < m < a < 1$ . The distribution is known to all; the actual value is realized just before the vote, that is, after the manager and activist have made their proposals. When voting, the shareholder observes the proposals with no error, and always supports the proposal that provides the highest payoff. There is no need for a proxy advisor because the shareholder votes without error. The only source of uncertainty in this version of the model concerns the manager's and activist's expectation about shareholder preferences. Then if  $x_M < x_A$ , the probability that the manager's proposal wins is  $\frac{(x_M + x_A)}{2} \equiv p$  (assuming the payoff function of the shareholder is symmetric). This  $p$  function satisfies the properties needed to prove the main propositions above.

This setup can be motivated by considering a "social" issue such as a company's practice of using animals for product testing, or establishment of manufacturing facilities in countries with regimes that violate human rights. In this case, managers and activists could be uncertain about shareholder preferences: shareholders could care only about the company's bottom line but on the other hand they might be willing to trade off some profit in pursuit of ethical business practices.

We emphasize that in this case shareholders never make mistakes; they always vote their interests. However, they can be made worse off by managerial deterrence. As before, let  $x_1^*$  be the manager's optimal deterring proposal, and for simplicity, assume  $\pi(x; \theta) = -(x - \theta)^2$ .

*Proposition 5.* Shareholders are worse off with than without proposal rights if  $|m - 0.5| < |x_1^* - 0.5|$ .

*Proof.* Without shareholder rights, the manager chooses  $x_M = m$  and the shareholder's expected payoff is  $E[\pi(m; \theta)]$  where the expectation is over the distribution of  $\theta$ . Then,  $E[\pi(m; \theta)] = -E[(m - \theta)^2] = m - \frac{1}{3} - m^2$ .

The shareholder's utility is maximized with  $m = 0.5$ . Suppose instead the manager deters with  $x_1^*$  then  $E[\pi(x_1^*; \theta)] = x_1^* - \frac{1}{3} - (x_1^*)^2$ . The shareholder is worse off with deterrence (having proposal rights) if  $|m - 0.5| < |x_1^* - 0.5|$ . Such a configuration is plainly possible. For example,  $m = 0.5$ , and a value of  $k$  small enough so that deterrence becomes necessary and is optimal for the manager.  $\square$

The point of this example is that deterrence hurts shareholders even though shareholders never vote against their interests. It is the exercise of deterrence that can drive the manager to accommodate the activist in a way that hurts shareholders. If the manager were to behave "naively" and not attempt to deter, then proposal rights would be (weakly) better for shareholders due to the benefit from being able to choose between competing options.

#### 4.4.6 When Does the Right to Propose Help versus Harm Firm Value?

We have shown above that the right to propose makes shareholders worse off in some circumstances. We next summarize when the right to propose is beneficial versus harmful to shareholders.

Propositions 2 and 3 point out the role of manager and activist preferences in determining the value of proposal rights. When the activist is extreme ( $m < a$ ), shareholders can be hurt by managerial deterrence of the activist (our numerical analysis also shows shareholders are hurt when there are competing proposals, but we have not been able to prove this analytically); while when the activist is moderate, deterrence makes shareholders better off (and our numerical analysis suggests they benefit from competing proposals as well). This highlights the central role of the activist's objectives in determining the value of shareholder rights. Arguments for empowering shareholders sometimes implicitly assume that shareholder rights would be used only by shareholders that seek to maximize firm value. However, some shareholders may have interests beyond value maximization: Shareholders aligned with unions might wish to enhance wages and benefits of union members; public employee pensions might wish to preserve jobs in their region; "socially responsible" investor groups might want the company to pursue an array of goals such as use of green technology, disinvestment in countries with questionable human rights records, ethical treatment of animals, disclosure of political contributions, and so forth. For evidence unions do in fact use the shareholder proposal process opportunistically to advance the interests of their members, see Matsusaka et al. (2016) that show union shareholders appear to make proposals to influence collective bargaining outcomes. Cai and Walkling (2011) find that investors respond negatively to compensation-related proposals from unions, but not from other shareholders. More generally, based on a comprehensive survey of research on shareholder proposals, Denes et al. (forthcoming) argue that proposal rights are most effective and beneficial when wielded by activists with a significant equity stake; the

interests of such activists are likely to be aligned with value maximization. We next consider uncertainty, a central variable in our analysis. Uncertainty arises in the model from noise in the proxy advisor's signal  $r$ . To analyze variation in uncertainty, we introduce an "uncertainty" parameter  $\sigma$  into the signal function so that

$$Pr(r = M) = p \left( \frac{\pi(x_M; \theta) - \pi(x_A; \theta)}{\sigma} \right).$$

This formulation implies that as  $\sigma$  increases, the probability of receiving either signal becomes closer to 0.5, that is, the signal becomes less informative. As  $\sigma \rightarrow +\infty$ ,  $p \rightarrow 0.5$ .

With the fairly general functional forms for uncertainty and payoffs that we have been using, equilibrium behavior does not necessarily move smoothly or monotonically with uncertainty. So we begin by characterizing what happens in the limit.

*Observation 2.* (i) *With sufficiently low uncertainty, the right to propose increases shareholder wealth (or has no effect).* (ii) *With sufficiently high uncertainty, the right to propose (a) reduces shareholder wealth when  $E[\Delta|r] < 0$  for all  $r$  and  $m < a$ , (b) increases shareholder wealth when  $E[\Delta|r] < 0$  for all  $r$  and  $a < m$ , and (c) has no effect on shareholder wealth when  $E[\Delta|r] \geq 0$  for all  $r$ .*

The observation for low uncertainty follows from the fact that when uncertainty is sufficiently low, the proposal most preferred by shareholders is almost certain to win, and behavior is characterized by the "no uncertainty" case described in Proposition 1. The manager always deters the activist, either by implementing the manager's ideal action (when  $m < a$ ) or by moving policy toward the activist (when  $a < m$ ). The observation for high uncertainty follows by observing that as  $\sigma \rightarrow +\infty$ ,  $p \rightarrow 0.5$ : the proxy advisor's probability of receiving either signal goes to 0.5. Because the signal carries no information, the informative signal condition fails. In that case, the activist does not propose, the proxy advisor's recommendation depends entirely on the out-of-equilibrium beliefs,  $E[\Delta|r]$ , and the outcomes are as described in Proposition 4. One implication is that low uncertainty is desirable from the perspective of shareholder wealth maximization. With low levels of uncertainty, the right to propose can only help. The existence of uncertainty gives rise to the possibility of value-destroying deterrence. From a policy perspective, this suggests that increases in shareholder rights should be coupled with efforts to reduce uncertainty. For example, increased disclosure would be desirable to the extent that it is likely to reduce uncertainty.

We next discuss how uncertainty affects behavior in the non-limit situation:

*Proposition 6.*  $\frac{\partial x_1}{\partial \sigma} > 0$ .

*Proof.* The deterring cutoff value is defined as  $\varphi(x_1) = 0$  where  $\varphi$  is defined in equation (3). Differentiating the cutoff condition with respect to  $\sigma$  gives

$$\frac{\partial x_1}{\partial \sigma} = \frac{p'(\pi(x_A) - \pi(x_1))(v(x_A) - v(x_1))/\sigma^2}{p'\pi'(x_1)(v(x_1) - v(x_A))/\sigma - (1-p)v'(x_1)}.$$

For the case  $0 < m < a$ , the numerator is negative because  $\theta + m < x_1 < x_A < \theta + a$ . Using the first-order condition of equation (2) to solve for  $1 - p$ , the denominator can be expressed as

$$p'(v(x_1) - v(x_A))\left(\frac{1}{\sigma}\right)\left(\pi'(x_1) - \pi'(x_A)\frac{v'(x_1)}{v'(x_A)}\right) < 0.$$

This establishes the result. The case of  $0 < a < m$  is analogous.  $\square$

Uncertainty makes the deterring proposal more extreme. Intuitively, as uncertainty rises, the proxy advisor becomes less likely to correctly detect an extreme proposal. As a result, in order to deter an extreme activist, the manager must offer a more accommodating proposal. Conversely, it is now easier to deter a moderate activist because the manager's extreme proposal is more likely to be approved. In short, Proposition 6 implies that as uncertainty increases, deterrence of an extreme activist is increasingly harmful for shareholders whereas deterrence of a moderate activist is decreasingly helpful for shareholders.

Finally, the manager's willingness to make a deterring proposal increases as the activist's proposal cost increases. Intuitively, as the activist's cost rises, the manager's deterring proposal no longer needs to be as appealing to the activist, which makes it more appealing to the manager. With a sufficiently high proposal cost, deterrence is automatic, effectively reverting to the case of no proposal rights. From a policy design perspective, this analysis suggests that as long as proposal rights are restricted to shareholders whose interests are aligned with value maximization, some attempt should be made to minimize the cost of proposing.

4.4.7 Determinants of Equilibrium Type and Implications for Occurrence of Shareholder Proposals. To this point, we have characterized equilibrium behavior holding constant the "type" of the equilibrium, whether deterrence occurs or not. Here, we explore the factors that determine whether or not deterrence occurs. This produces implications about the occurrence of proposals because a proposal occurs if and only if deterrence does not happen.

It is straightforward to show that proposals are more common (a deterrence equilibrium is less likely) when proposal costs are low, as one would



expect. From equation (5),  $\frac{\partial \gamma}{\partial k} = -u'(x_1) \left( \frac{\partial x_1}{\partial k} \right)$ . If  $m < a$ , then  $\partial x_1 / \partial k < 0$  and  $u' < 0$ . If  $a < m$ , then  $\partial x_1 / \partial k > 0$  and  $u' > 0$ . In both cases,  $\partial \gamma / \partial k < 0$ .

Because we have not imposed strong assumptions on the functional forms, the relations between the type of equilibria and other model parameters are not simple to characterize. To gain intuition on how uncertainty and manager and activist preferences influence the type of equilibrium, we report results from a numerical analysis that assume quadratic preferences and a uniform probability distribution.<sup>13</sup> Panel A of Figure 5 presents numerical estimates of the relation between the equilibrium outcome and the ideal points of the manager and activist. Panel B maintains the same assumptions except with higher uncertainty. The automatic deterrence region is the band around the 45° line, and the strategic deterrence regions are the two gray regions around this.

In terms of preferences, Figure 5 shows that deterrence is more likely when the manager and activist have similar preferences, and competing proposals are more likely when their preferences are far apart. Then the likelihood of a proposal is increasing in the distance between the activist's and manager's ideal points.

Intuition might suggest that a firm with a severe agency problem is more likely to attract a proposal. While such a firm is likely to attract the ire of shareholders, the manager of such a firm can also be more likely to take an accommodating action to deter a proposal. Whether the end result is more or fewer proposals depends on the relative position of the manager and activist. In our model, the occurrence of a proposal is not so much a symptom of an agency problem but the result of the failure to deter. When preferences diverge by a large amount, accommodation is too costly for the manager, and the manager chooses to allow a proposal to

13. Specifically, these estimates assume quadratic preferences  $u(x) = -(x - \theta - m)^2$  and  $v(x) = -(x - \theta - a)^2$  with  $\theta = 1$  and  $k = 0.25$ , and a uniform probability distribution with range  $[-L, L]$ , where  $L = 50$  in Panel A and  $L = 500$  in Panel B. We compute equilibria numerically for each combination of  $m$  and  $a$  with values from 0 to 5 at 0.01 increments. Although we report results for only two specific cases, we have not found any examples that are qualitatively different. An interesting feature of Figure 5 Panel A is that the deterrence band below the 45° line ( $a < m$ ) is wider than the band above the line ( $m < a$ ). From the manager's perspective, an equilibrium with competing proposals above the 45° line has the benefit of pulling the activist toward the manager's ideal point, reducing the manager's willingness to deter. In an equilibrium below the line, the activist moves away from the manager's ideal point, increasing the manager's willingness to deter. This interesting feature is absent in Panel B with increased uncertainty because both the manager and the activist compete from positions fairly close to their respective ideal points. Another interesting feature is the curvature in Panel A. For large values of  $m$  and  $a$ , the proxy advisor's signal picks up increasing differences in profits of competing proposals away from  $\theta$ . Above the 45° line ( $m < a$ ), the gray region shrinks because the manager is more confident of prevailing, and as a result, the manager is less willing to accommodate the extreme activist. Below the 45° line ( $a < m$ ), the opposite happens. The gray region expands because the manager is less confident of prevailing, and as a result, the manager is more willing to accommodate the moderate activist. This interesting feature is absent in Panel B with increased noise in the proxy advisor's signal. Finally,  $\Delta(m, a) > 0$  when  $m < a$  as mentioned in Section 4.4.4.

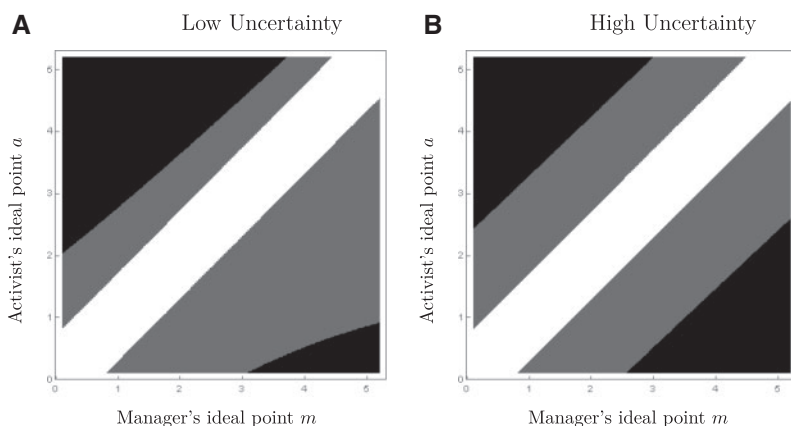


Figure 5. Equilibrium Regions.

*Notes:* Equilibrium regions in  $m - a$  space. Automatic deterrence (white), strategic deterrence (gray), and competing proposals (black). The  $45^\circ$  line separates moderate-manager-extreme-activist cases above the line ( $m < a$ ) from extreme-manager-moderate-activist cases below the line ( $a < m$ ). Equilibria are computed numerically for each combination of  $m$  and  $a$  with values from 0 to 5 at 0.01 increments.

occur. This suggests that one cannot make inferences about the severity of agency problems from the frequency of proposals; a severe agency problem would not result in a proposal if the activist is equally extreme, and a nonexistent agency problem could attract a proposal if the activist is extreme. When it comes to empirical research, an implication is that regressions attempting to explain the number of proposals should control not only for activist and manager preferences, but also for the distance between them that drives the failure to compromise.

Denes et al. (forthcoming; Table 3) report that many (but not all) studies find that low-performing firms attract more proposals than high-performing firms. In terms of our model, a high-performing firm can be represented by a profit-maximizing manager,  $m \approx 0$ . Figure 5 shows that such firms are unlikely to be targeted by activists with  $a \approx 0$ , which might represent hedge funds. In plain English, because managers are already doing what hedge funds want (maximizing profit), there is little opportunity for activism to improve profit. The same argument implies that profit-oriented activists will target poorly performing firms.

The effect of uncertainty is nonmonotonic. In the limit, Observation 2 indicates that deterrence occurs when uncertainty is sufficiently low or sufficiently high. Thus, proposals occur only for an “intermediate” range of uncertainty. The effect of uncertainty in this intermediate range can be seen by comparing the figures in Panels A and B of Figure 5. Uncertainty increases the deterrence region when  $m < a$ , and decreases the deterrence region when  $a < m$ .

The empirical literature estimating stock returns associated with the announcement of shareholder proposals has not found a robust pattern (Denes et al. forthcoming). Our model can produce positive or negative returns from a proposal announcement, depending on what model parameter is revealed by the announcement. For example, if the announcement reveals a managerial agency problem that is bigger than previously believed, the proposal would be bad news; if the announcement revealed the existence of a value-motivated activist that was not previously known, the proposal would be good news. Our analysis provides a framework that can be used to ground future event studies in formal theory, and suggests the importance of being explicit about what information is conveyed by the announcement.<sup>14</sup>

#### 4.5 Side Payments

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

We now assume the manager can transfer cash  $t$  to the activist. Because the transfer payment links the two payoff functions, it is useful to add parameters indicating the intensity of preferences concerning the action compared with their value of cash. The manager’s new payoff function is  $\alpha u(x) - t$  and the activist’s new payoff function is  $\beta v(x) + t$ , where  $\alpha$  and  $\beta$  are the action intensity parameters.

The sequence of the game is modified so that the manager and the activist can negotiate an action and transfer package  $N = \{t, x\}$  before either party takes any other action. If they agree, the settlement is binding on both parties, and the transfer payment is not subject to shareholder approval. If they do not agree, then the game proceeds as before.

We examine behavior when proposals are permitted and the activist is extreme ( $0 \leq m < a$ ). Formally, suppose the manager can make a take-it-or-leave-it offer to the activist. Let  $\bar{u}$  and  $\bar{v}$  be the manager’s and activist’s reservation utility, respectively, if a deal is not reached. The activist accepts the manager’s proposal  $N = \{t, x\}$  if

$$\beta v(x) + t \geq \bar{v}. \quad (6)$$

14. Our analysis assumes that proposals are binding if approved by shareholders, while much of the empirical literature examines nonbinding proposals. One could extend our analysis to include nonbinding proposals by assuming that management feels pressure to adopt a shareholder proposal if it receives majority support, even if nonbinding. There is evidence that managers do respond to nonbinding proposals if they receive substantial votes (Ertimur et al. 2010).

The manager's optimization problem is  $\max_{\{t,x\}}\{\alpha u(x) - t\}$  subject to equation (6). The action choice solves

$$\alpha u'(x) = -\beta v'(x) \quad (7)$$

and  $t$  is determined by equation (6). The manager's payoff from the deal must also satisfy  $\alpha u(x) - t \geq \bar{u}$ .

The manager's participation constraint is never binding, or put differently, there always exists a negotiated deal that both players (weakly) prefer to playing the game without negotiation. To see this, note that if the equilibrium play involves competing proposals, both players would prefer the expected value of the two proposals,  $E[x] = px_M^* + (1-p)x_A^*$ , compared with a lottery over the two proposals because the utility functions are concave; and the activist would avoid the cost of making a proposal. If the equilibrium play involves deterrence, then a negotiated agreement that involves the deterring proposal and no transfer is by definition acceptable to both parties.

Condition (7) implies that the negotiated action lies somewhere between the ideal points of the two parties. More interestingly, it suggests that side payments will be larger when  $\alpha$  is large and  $\beta$  is small. Intuitively, with such a configuration, the manager cares a lot more than the activist about the action. As a result, the negotiated settlement involves an action that is appealing to the manager; to appease the activist then requires a larger side payment. An example of high  $\alpha$  and low  $\beta$  would be a decision concerning managerial compensation, which is likely to be very important to the manager but not so important to an activist. Such a situation is ripe for the activist to threaten an action that reduces managerial compensation in order to extract a side payment of some sort from the manager.

Side payments can take a variety of forms. Evelyn Y. Davis, a notorious "corporate gadfly" who brought more than 20 proposals per year from 1959 to 2014, encouraged companies to buy numerous copies of her annual newsletter for \$600 each. The newsletter was about 20 pages and mostly discussed herself, but she earned up to \$600,000 per year from its sales. One year, Ford gave her a new Jaguar. Our analysis suggests how "mischief" proposals can be a problem—even if the activist does not particularly care about the action, the activist may be able to extract a payment from the manager if the manager does not want to deal with a proposal.<sup>15</sup>

Perhaps more important are side payments to unions. Buchanan et al. (2012) find that unions are the main sponsors of proposals to limit managerial compensation, with 43% of compensation-related proposals coming from unions in their sample. Matsusaka et al. (2016) show that unions are more likely to launch proposals during contract negotiations, and the proposals are more likely to target managerial compensation. Our

15. This example is taken from Solomon (2014).

analysis suggests that managers may respond to such proposals by making side payments to the union, such as concessions on worker compensation and benefits, employment levels, and working conditions.

## 5. Policy Implications

### 5.1 Conditions for Proxy Access

In the United States, recent reform activity has focused on strengthening proposal rights by making it easier for shareholders to access the proxy statement, either to nominate directors or make proposals. Delaware Code and the Model Business Corporation Act grant shareholders the right to propose and approve bylaw changes, but reserve for the board the right to propose charter amendments, and only the board can propose a change in the state of incorporation. In the United Kingdom, in contrast, shareholders have the right to propose changes in the corporation's fundamental governance documents, called the memorandum and articles of association. Shareholders in the United States seem to have more limited proposal rights than shareholders in other countries.<sup>16</sup>

Our analysis provides food for thought on two important issues regarding proxy access: minimum ownership and holding period requirements. The implication that proposal rights are most likely to be damaging when activists have interests unrelated to firm value suggests a possible value from limiting the right to propose to value-focused shareholders. One way to bring this about would be to require significant stock ownership in order to make a proposal—assuming that high equity ownership makes a shareholder more interested in firm value. Recent policy proposals that require ownership of 1–3% of a company in order to access the proxy statement might be beneficial from this perspective. Holding period requirements are also likely to screen the type of activists making proposals. A requirement to hold shares for, say, 3 years before making a proposal would empower individuals and groups that are inherently inclined to hold stock for long periods of time, such as pensions and labor unions (and indeed, these organizations have tended to favor holding period requirements). If these groups stand to reap substantial private benefits from the company (such as employment, wages, and benefits), then empowering them can cause managers to accommodate them in value-destroying ways. Similar observations have been made in the law literature, for example, Sharfman (2012).

### 5.2 Reducing Voting Uncertainty

One lesson from our analysis is that shareholder rights are most likely to be harmful when management is uncertain about shareholder votes. Voting uncertainty can lead the manager to accommodate an extreme

16. See Bebchuk (2005; Section II) and Buchanan et al. (2012) for a description and comparison of shareholder rights in the United States and United Kingdom.

activist, even if the manager doubts the activist's ability to attract majority support. Regulatory changes that provide managers with better information about the identity of their shareholders make shareholder elections more predictable. Thus, our analysis suggests a potential benefit from proposals to end the so-called OBO/NOBO system that classifies shareholders into "objecting beneficial owners" whose identity is shielded from management and "non-objecting beneficial owners" whose identity is not shielded. Similarly, our analysis suggests a potential value from creating a data aggregator to obtain owner contact information, allowing companies to select proxy services on a competitive basis, and generally opening up communication between companies and shareholders. The United States is something of an outlier in terms of ownership disclosure: in the United Kingdom, public companies have the right to learn the identity of investors with voting rights through a written process; in Australia, public companies keep a register of names and addresses of all shareholders; and in Canada, public companies are permitted to communicate directly with their beneficial owners.<sup>17</sup>

Our model also identifies unanticipated consequences that might flow from the New York Stock Exchange's amended Rule 452 that limits discretionary voting by brokers in director elections. Prior to amendment, brokers were permitted by default to vote shares they held on behalf of customers who did not provide specific instructions; after amendment, brokers could not vote these shares without explicit instruction from their customers. Because brokers tended to vote in support of management nominees, removing these "automatic" votes for management nominees reduces the predictability of shareholder elections.

### 5.3 Pay-for-Performance Contracts and the Right to Propose

The main argument for shareholder rights is that managers may pursue actions that dissipate shareholder value, and in those situations, shareholders need a tool to counteract managers. Another tool for solving managerial agency problems is compensation contracts that tie managers' pay to firm value. Our analysis suggests that incentive contracts and shareholder rights are to some extent substitutes. The parameter  $m$  can be thought of as an (inverse) index of the strength of managerial pay-for-performance incentives, with  $m=0$  representing a contract that fully aligns manager and shareholder interests by tightly linking pay to performance. Because proposal rights are most likely to be harmful when activists are more extreme than managers, the right to propose poses the greatest danger in the presence of high pay-for-performance contracts. Conversely, there are many reasons why it may not be optimal to offer managers a high-powered incentive contract, such as managerial risk

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

aversion; in such cases, shareholder rights seem a promising avenue to push the firm toward value maximization. It is particularly difficult to tie executive compensation tightly to firm performance in large corporations because it would expose managers to too much risk. This suggests a rationale for making proposal rights more accessible in large than small corporations.

## 6. Conclusion

After two decades of policy innovation, shareholders have acquired more rights to participate in corporate decisions, and activists are pressing for even more shareholder empowerment. Yet the regulation of shareholder rights is now well in advance of the science. The empirical literature is to a large degree descriptive, much evidence to date finds that shareholder rights reduce firm value (Larcker et al. 2011; Akyol et al. 2012; Stratmann and Verret 2012), and the theoretical literature is small.

The purpose of our paper is not to argue that shareholder empowerment is bad, or that enhanced proxy access will necessarily hurt shareholders. Rather we seek to take seriously the call for a more rigorous analysis of the benefits and costs of shareholder empowerment. Recent comments by regulators and judges cite the lack of rigorous analysis of the value consequences of shareholder rights as a critical obstacle to further reform. Because the scholarly literature is largely supportive of enhanced shareholder rights, with scant theoretical work pointing to potential costs, it is difficult to know where to begin a benefit–cost analysis. By identifying both potential costs and benefits, our paper is intended to provide a theoretical foundation for future efforts to quantify the tradeoffs. The analysis provides a formal structure to assess conjectures that have been offered in the law literature, and identifies some tradeoffs that do not appear to have been previously recognized.

One novelty of our analysis is its emphasis on distinct rights to approve and propose, rather than consideration of a general “right to decide.” We show that approval rights are of limited effectiveness when managers can threaten shareholders with an unpalatable fallback choice. Proposal rights are more potent than approval rights, but can make shareholders worse off in some circumstances. One might guess that pressure from an activist to bring a proposal would cause the manager to move corporate policy toward the favored position of shareholders in order to make the manager’s position more appealing in a contested election, that is, external pressure might induce the manager to focus more on profitability. However, we show that when the manager seeks to deter the activist from making a proposal, the manager always moves toward the activist. External pressure from an extreme activist then reduces firm value.

The analysis undercuts the argument that activists would be unable to extract concessions from management with proposals that are unlikely to be approved (Bebchuk 2005). We show that as long as there is a possibility

of approval, managers may choose to accommodate the activist in order to have the proposal withdrawn and avoid the risk of an election. If managers also suffer a direct disutility from the existence of a proposal (something we do not consider)—for example, if they dislike having to discuss their compensation in a public forum—the forces for accommodation would be even stronger.

American law has long recognized the principle that shareholders might not know best about a corporation's business decisions, and the principle is incorporated in a long line of court rulings that the business judgment rule gives managers wide discretion.<sup>18</sup> At the same time there is extensive evidence that managers can be susceptible to agency problems and take non-value-maximizing actions. Our analysis traces out in some detail how the rights of approval and proposal affect firm value in an environment with limited shareholder information and agency problems. Our conclusions arrive somewhere in the middle between the positions of advocates of manager-only decision making and those favoring unlimited shareholder rights. We find that even with uninformed shareholders, giving shareholders decision rights can mitigate agency problems as long as proxy advice is reasonably reliable and there is an informed activist seeking to increase firm value. However, if proxy advisors are prone to error, and critically, if there are activists that seek to extract private benefits from the company, enhanced shareholder rights can be counterproductive. Our model suggests that the key issue is not whether to freeze out shareholders entirely from corporate decisions versus giving them extensive rights, but rather how to structure those rights to prevent their use in counterproductive ways.

As an attempt to provide an initial framework for studying approval and proposal rights, our analysis is necessarily incomplete. Among the possibilities we have omitted is the presence of multiple activists. Intuitively, the analysis would be fairly similar in the presence of multiple activists that shared similar preferences, but the case of competing activists (with ideal actions on opposite sides of the manager's ideal action) is less obvious. We also do not consider coalitions of activists. Shareholders may agree to act in concert, creating blocks that allow more proposals and possibly can swing elections, leading to some new strategic issues. We also do not explore the information gathering and transmission process. In part this is deliberate because other studies in the decision rights literature have gone down that path, in particular, Harris and Raviv (2010). In the traditional literature, the fundamental tradeoff is between allocating decision rights to the party with the best information versus the party whose interests are best aligned with the principal's interests. One of our contributions is to call attention to a completely different set of factors—agenda

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18. A well-known example is the Delaware Supreme Court's decision in *Paramount Communications, Inc. v. Time, Inc.* (1989). See Gordon (1991) and Bainbridge (2006) for discussions.



control and the possibility of strategically deterring the exercise of decision rights—that appear to be important in practice when it comes to proxy access.

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