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Spring 2007

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Recommended Citation

Stout, Lynn A., "The Mythical Benefits of Shareholder Control" (2007). *Cornell Law Faculty Publications.* Paper 1093.
http://scholarship.law.cornell.edu/facpub/1093

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Given the evidence that board governance benefits investors, why is there call for increased shareholder control of corporations?

The Mythical Benefits of Shareholder Control

By Lynn A. Stout
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In a forthcoming *Virginia Law Review* article, Professor Lucian Bebchuk argues that the notion that shareholders in public corporations have the power to remove directors is a myth. This is perhaps an overstatement, but Bebchuk is correct to suggest that in a public company with widely dispersed share ownership, it is difficult and expensive for shareholders to overcome obstacles to collective action and wage a proxy battle to oust an incumbent board. Nor is success likely when directors can use corporate funds to solicit proxies to stay in place. The end result, as Adolf Berle and Gardiner Means famously observed in their 1932 book *The Modern Corporation and Private Property*, is that shareholders in American public corporations are "subservient" to directors "who can employ the proxy machinery to become a self-perpetuating body."

So not only is shareholder control largely a myth in public companies, it has been recognized to be largely a myth for at least three-quarters of a century. What should we conclude from this?

Bebchuk concludes that the time has come to breath life into the idea of the shareholder-controlled public firm. But there are many myths – vampires, zombies, giant alligators in the sewers of New York City – that we would not want to make real. Would greater shareholder power to oust directors be a similar monster?

An extensive literature on the theory of the corporation suggests that shareholders enjoy net benefits from board governance. Board governance, while worsening agency costs, also promotes efficient and informed decisionmaking, discourages inter-shareholder opportunism, and encourages valuable specific investment in corporate team production. Because board control has both costs and benefits, the wisdom of Bebchuk's proposal to make it easier for shareholders to oust directors must be based on evidence, and the empirical evidence strongly supports the claim that shareholders themselves often prefer firms with strong board control.

Why, then, do so many observers believe shareholders should be given greater influence over boards? Calls for greater "shareholder democracy" have emotional appeal to laymen, the business media, and even many business experts. The emotional appeal of shareholder control can be traced to three sources: a common but misleading metaphor that describes shareholders as the "owners" of corporations; the opportunistic calls of activist shareholders seeking leverage over boards for self-interested reasons; and a strong but unfocused sense that something (anything!) should be done in the wake of recent corporate scandals. The result has been a widespread, and unfortunate, acceptance of yet another myth – the myth that shareholder control of public corporations actually benefits shareholders.

THEORETICAL ADVANTAGES OF BOARDS

I do not attempt to contest the claim that shareholders in public corporations have little power to remove directors. That much is obvious to any informed observer. Instead, I ask why shareholders in public companies have so little power.

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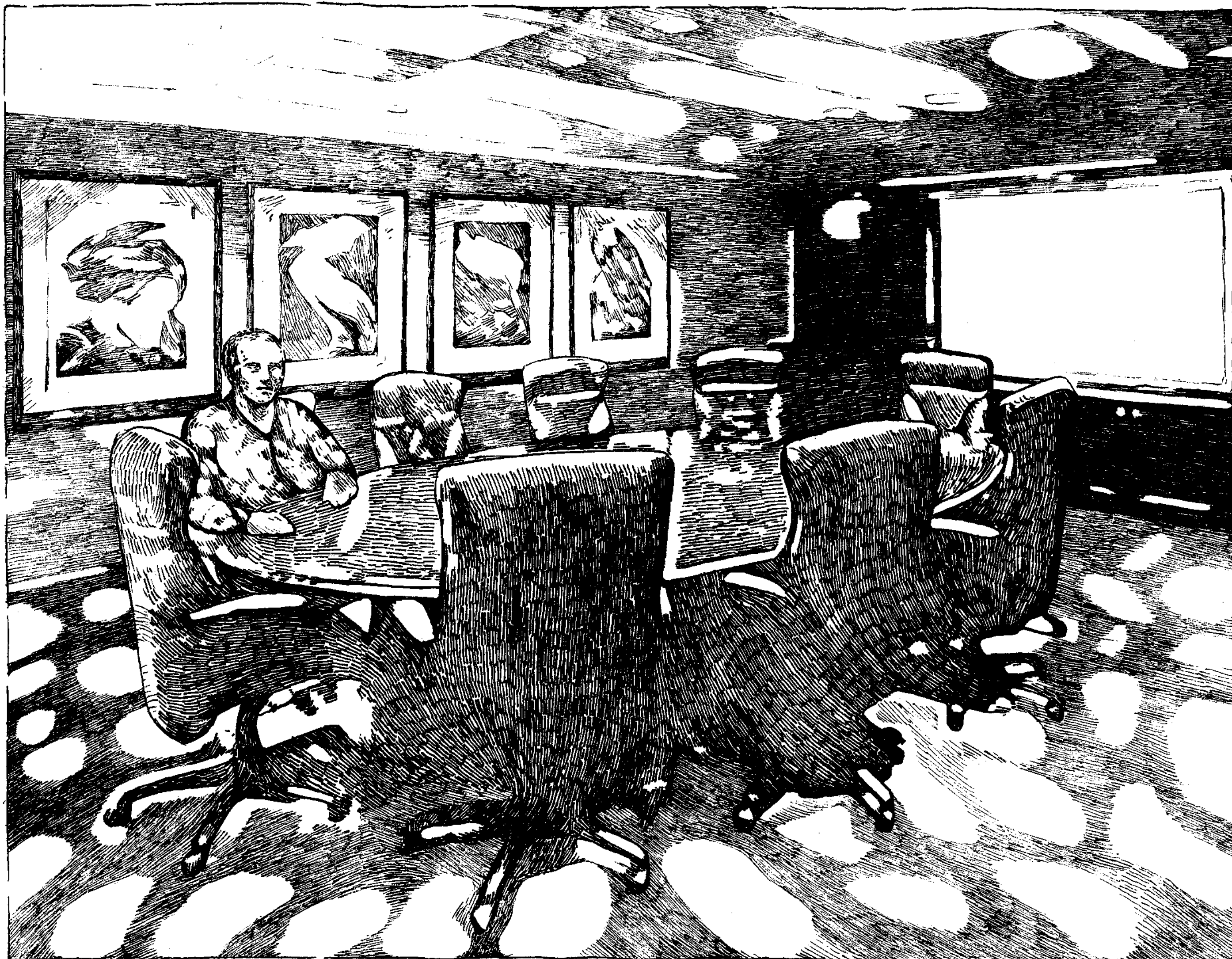
DECISIONMAKING Board governance benefits shareholders by performing not one, but three, important economic functions. Perhaps the most obvious is promoting more efficient and informed business decisionmaking. It is difficult and expensive to arrange for thousands of dispersed shareholders to express their often-differing views on the best way to run the firm. Nor, given the rational apathy most shareholders bring to the table, should we expect shareholder governance to produce particularly good results. Accordingly, most experts agree that board governance offers important advantages in terms of efficient and informed decisionmaking.

But if more efficient and informed decisionmaking were all that director governance provided, it is hard to explain why corporate law limits shareholder voting quite so severely. The default rules of corporate law allow shareholders to vote only to elect directors and to veto "fundamental" corporate changes (e.g., mergers) that the directors must propose. Yet one can imagine many important decisions — for example, whether the CEO should be fired, or shareholders should be paid a special dividend — about which shareholders could easily become informed and efficiently register their views. And if board governance provides only efficient and informed decisionmaking, should we not at least make it easier (as Bebchuk proposes) for shareholders to replace the board? Why does corporate law not only strictly limit the matters on which shareholders may vote, but make it difficult for them to exercise their votes effectively to boot?

A second problem with emphasizing efficient and informed decisionmaking as the primary reason for board governance is that it may be a better explanation for executive governance. After all, if we want decisions to be made by a small number of highly informed individuals who are deeply involved in the firm's day-to-day operations, what better way to accomplish this than by hiring (as virtually all large companies do) a skilled executive team? Why can't shareholders then vote directly to choose or remove the executives? Why add the extra decisionmaking layer of a board — especially one whose members are often not involved in the company and that meets only a few times each year?

Better decisionmaking does a good job of explaining why companies hire executive teams. It does not go nearly as far, however, toward explaining why companies also have powerful boards. Nor does it explain directors' extreme lack of "accountability" to shareholders (a lack that, as we shall see, corporations often magnify through staggered board provisions, dual-class structures, and the like). In addition to pro-



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moting better decisionmaking, board power likely offers shareholders other important advantages.

INTER-SHAREHOLDER OPPORTUNISM Board power does indeed serve shareholder interests in a second way – by protecting shareholders from each other. The risk that a large shareholder might try to influence corporate decisions in a self-serving way that harms other shareholders is well-recognized in closely held firms, where corporate law and practice have evolved numerous strategies to constrain inter-shareholder opportunism. What is less well-understood is that, by making it easier for large shareholders in public firms to threaten directors, a more effective shareholder franchise might increase the risk of inter-shareholder "rent-seeking" in public companies.

According to Iman Anabtawi, shareholders in public firms have conflicts of interest that can give rise to opportunistic behavior. An especially troubling situation involves the investor who takes a position in a stock and uses his voting power to push for business strategies that increase the value of another security the investor also holds. Hedge fund Perry Capital, for example, recently acquired a block of Mylan Laboratories common stock while simultaneously entering a derivatives contract with a brokerage firm that allowed Perry to keep the Mylan votes while hedging away its economic interest in the stock. Perry then used its position as a large Mylan shareholder to pressure Mylan's board to acquire another company, King Pharmaceuticals, at a hefty premium over market price. Why would Perry want Mylan to overpay for King? Because Perry also held a large block of King stock – and had not hedged away its economic interest in King.

The case of Perry Capital illustrates the danger inherent in changing the rules of corporate law in a way that gives opportunistic shareholders in public companies greater leverage over boards. By the same token, corporate law rules that insulate boards from shareholder pressures can discourage predatory shareholder behavior. Board power serves the interests of investors who worry about director "shirking," but fear shareholder "sharking" (opportunistic behavior by shareholders) even more.

TEAM PRODUCTION As we have just seen, shareholders can be exploited not only by corporate officers and directors (the usual suspects in "agency cost" discussions), but also by their fellow shareholders. They face this risk because stock is, counterintuitively, an illiquid investment. Although a single shareholder may be able to sell a small number of shares easily, when exploited shareholders try to sell en masse the result is a predictable loss of value.

The connection between illiquidity and vulnerability explains why shareholders can be exploited. It also provides the foundation for a third theory of director power on which I, Margaret Blair, and others have written: the team production theory. Team production analysis recognizes that shareholders are not the only group to make illiquid, "firm specific" investments in corporations. Executives, customers, creditors, suppliers, employees, and other corporate "stakeholders" also put time, money, and expertise into relationships with companies. These investments have value only if the company survives and thrives and the relationship is preserved. A typical start-up, for example, needs an entrepreneur with an idea, equity investors to fund initial operations, and executives to provide skill and long hours implementing the idea. Each contribution is essential, and each risks being lost if the firm goes under or the investor is forced out of the corporate "team" before the project succeeds.

Economists have long recognized that formal contracts cannot fully protect specific investments in team production. As a result, all "specific investors" – whether they be stockholders, executives, customers, or rank-and-file employees – are vulnerable to the risk that someone given control over the corporation might use that control to threaten the value of their investment or exclude them from the corporate team. If shareholders controlled public corporations, at least some might be tempted to use shareholder control in an opportunistic fashion to "hold up" other team members. This is because shareholders can profit from threatening other stakeholders' interests. For example, they can increase earnings by demanding that long-term employees accept reduced health benefits or risk being fired, or by requiring customers to purchase additional software in order to get continued customer support. When specific investments are large enough, the immediate financial returns from making such opportunistic threats can easily outweigh any longer-term reputational costs. Anticipating this, many important corporate stakeholders would be justifiably reluctant to make specific investments in public companies run by widely dispersed but powerful shareholders, some of whom might be tempted to pump up share price by making opportunistic threats.

Of course, directors can make opportunistic threats, too. The difference is that, unlike shareholders, directors do not benefit financially from making threats, at least not in their positions as directors. To the extent that directors have an interest in the corporate entity, their interest is to keep the entity healthy so they can keep their board positions. (Although it is often asserted without support that corporate directors can use their powers in a self-serving fashion to enrich themselves, this claim ignores the very real constraints imposed by the duty of loyalty.) Board governance as a result attracts specific investors by offering what renowned corporate lawyer Marty Lipton has described as the promise of "business continuity." Stakeholders contemplating making specific investments in relationships with corporations put more faith in firms run by boards than in firms run by powerful and possibly opportunistic shareholders. The result is that board power serves shareholders' collective *ex ante* interest in attracting valuable specific investments even as it frustrates individual shareholders' *ex post* attempts to increase "shareholder value" at other stakeholders' expense.

SUMMING UP Since the public corporation first emerged in the nineteenth century, it has proven to have enduring appeal for large, uncertain, long-term business projects, including railroads, canals, automobile and aerospace manufacturing, pharmaceuticals, software, and brand-name consumer products. An important part of this appeal lies in the advantages of board control. Incorporation allows thousands or even hundreds of thousands of diverse corporate participants – share-

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holders, employees, executives, suppliers, customers, and sometimes even the local community – to make illiquid commitments to large, uncertain, long-lived projects, safe in the knowledge that control over the project rests in the hands of a small and informed group of individuals who have a modest personal interest in ensuring the company's success and (perhaps more important) no strong financial interest in trying to expropriate wealth from other participants.

Of course, board power has disadvantages as well. To the extent that directors are "unaccountable" to either shareholders or other stakeholders, they may not always do the best possible job of running the firm. Directors have an enforceable fiduciary duty of loyalty that discourages outright theft. However, for a variety of reasons, the duty of care (famously hamstrung by the business judgment rule) is far less effective at preventing director shirking. As a result, board governance inevitably creates a risk that directors will manage corporations in a fashion that is adequate, but not optimal.

Board power accordingly has benefits but also some costs. This makes it impossible to assume, based on armchair theorizing alone, that shareholders would benefit from stronger voting rights. Before changing longstanding rules of corporate law to give shareholders greater leverage over boards, as Professor Bebchuk suggests, lawmakers should demand compelling evidence that the benefits of changing the rules outweigh the costs.

EMPIRICAL EVIDENCE

The compelling evidence necessary to support Bebchuk's proposal is, however, notably missing. Bebchuk cites five empirical studies of proxy contests in support of his proposal. At least two of the five cut against Bebchuk's thesis, finding negative abnormal returns from proxy contests when dissenting shareholders succeed in gaining board seats. Another two undermine his proposal more indirectly, finding that proxy contests increase shareholder "value" primarily when they trigger a firm's liquidation or sale. (An extensive literature, which Bebchuk does not discuss, addresses why putting a firm up for sale often raises share price for reasons unrelated to improved performance, including bidder overpayment, inefficient market discounting, downward-sloping demand, and shareholder wealth extraction from other stakeholders.)

This weak and mixed evidence on the benefits of proxy contests mirrors a broader pattern in empirical studies of corporate law. Although dozens of papers have tried to find relationships between particular governance practices and corporate performance, most fail to find any strong connection, and the few studies that do (including at least one study cited by Bebchuk) often are not supported by other researchers.

What explains this pattern? Why is it so hard to prove that particular governance measures improve corporate performance? Part of the problem may lie in academics' tendency to equate "corporate performance" with short-term share price performance, a dubious metric at best. Gauging corporate performance by measuring share price changes over weeks or months is a bit like picking your accountant by measuring his or her height. It is easy to do, but unlikely to ensure a good outcome.

STRONG EVIDENCE FOR BOARDS There may be a more fundamental reason, however, why the business world has stubbornly refused to give hungry academics the evidence they crave about how they can improve corporate performance through one or another governance "reform." In brief, business firms enjoy a wide range of choice over the governance rules they adopt and work under. Sensibly enough, they choose the rules that work best for their particular business (and, in the process, for their investors). This means that we should not expect to see a strong connection between any particular governance structure and corporate performance, because different structures work well for different firms. In other words, corporate law is endogenous.

To understand this idea, let us start with an often-overlooked fact of business life: investors are not forced at gunpoint to purchase shares in public corporations. They can invest instead in proprietorships, partnerships, limited partnerships, and closely held companies. And when investors do buy shares in public companies, they can choose which firms' shares they buy.

This last point is important because American corporations can choose which state's laws they will incorporate under. Even more significant, they can choose to modify those laws through customized charter provisions, including charter provisions that strengthen or weaken shareholders' voting rights. Bebchuk's proposal does nothing for shareholders that corporate law does not already allow them to do for themselves. If investors truly believed greater shareholder control meant better corporate performance, they could "vote with their wallets" by preferring shares in firms that give shareholders more control.

If investors often did this, it would be evidence that shareholder control serves shareholder interests, at least in those firms. Yet studies indicate that equity investors generally do not prefer companies that give them stronger rights. This can be seen most clearly in the context of initial public offerings (IPOs). Companies "going public" have every incentive to adopt governance structures that appeal to outside investors (generally sophisticated mutual and pension funds). If greater shareholder control meant better shareholder returns, IPO companies could raise more money by offering shareholders more control. Yet studies find that when IPO firms use customized charter provisions to modify shareholder voting rights, they generally use them to move in the direction opposite of that recommended by Bebchuk, weakening shareholder rights.

For example, John Coates has showed that, during the 1990s, between 34 percent and 82 percent of IPO charters included staggered board provisions that made it harder for shareholders to remove directors. An even more dramatic example of this trend can be seen in the recent Google IPO. Google went public with a dual-class charter that left outside investors largely powerless. Far from shunning Google's IPO, investors oversubscribed it. In the language of economics, investors "revealed" a preference for a firm in which they themselves had almost no power.

Are investors stupid? Why do they not avoid IPOs with weak shareholder rights? Is it possible that shareholders, like Ulysses, sometimes see advantage in "tying their own hands"

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and ceding control over the corporation to directors largely insulated from their own influence?

Reformers calling for greater "shareholder democracy" rarely ask such questions. Yet investors' long-standing willingness to buy shares in companies controlled by "unaccountable" boards provides compelling empirical evidence that investors themselves often prefer weak shareholder rights. This raises the question: why do so many observers still support the kind of top-down, one-size-fits-all governance "reform" recommended by Bebchuk, when there is so little evidence that shareholders — or anyone else — would benefit?

EMOTIONAL APPEAL

The myth of the shareholder franchise rests on a larger, deeper myth: the myth that public corporations are run well when they are run according to shareholders' wishes. This larger myth of the benefits of shareholder control has captured hearts and minds not because it is based on evidence, but because it has a tremendous emotional appeal. This emotional appeal can be traced to three sources.

SHAREHOLDER 'OWNERSHIP' The first source is the popular but misleading metaphor that describes shareholders as "owners" of corporations. As a legal matter, the claim that shareholders "own" the corporation is obviously incorrect. Corporations are independent legal entities that own themselves; shareholders own only a security, called "stock," with very limited legal rights. Nevertheless, the ownership metaphor exerts a powerful, if often subconscious, influence on the way many people think about corporate governance. After all, if shareholders "own" corporations, should they not also control them?

Sophisticated observers generally avoid the trap of "ownership" talk. Instead, they fall prey to two other mistaken ideas. The first is the casual assumption, prevalent in the economic literature on "agency costs," that shareholders are the "principals" in public corporations and that directors are shareholders' "agents." But as corporate law experts have pointed out, the agency metaphor misstates the real legal status of shareholders and directors. At law, a principal has a right to control her agent. Directors are not agents but fiduciaries largely insulated from shareholders' control, and they owe duties not just to shareholders but also to the firm as a whole.

The other mistaken idea that often influences experts is the claim that shareholders are the "sole residual claimants" in corporations. Again, as a factual matter, this is patently incorrect. In a public company, the board of directors controls both dividend payouts and corporate expenses (meaning the board controls whether the corporation's books show any "earnings"). This means that shareholders are unlikely to receive, and certainly are not legally entitled to receive, every penny of revenue received by the corporation that is not obligated to be paid out on some formal contract. Rather, while shareholders may share in the wealth when the corporation does well and suffer when the firm does poorly, so may employees, creditors, and other stakeholders. Director discretion means that many different groups are potential residual claimants and residual risk-bearers in public firms.

Thus, none of the three phrases commonly used to describe shareholders' relationship to the public corporation — whether as "owners," "principals," or "sole residual claimants" — is factually correct. Nevertheless, all three give the idea of greater shareholder control an emotional appeal that ignores the realities of business law and practice.

SHAREHOLDER DEMOCRACY? A second reason why many people may find the idea that shareholder control necessarily benefits shareholders to be appealing may be that particular shareholders at particular firms sometimes say they want more control. Activist hedge funds, in particular, often anoint themselves champions of "shareholder value" who ought to be allowed to control the board's actions.

As discussed earlier, however, a major advantage of board control is that, by requiring shareholders and stakeholders alike to give up much of their power over the corporation *ex ante*, board governance protects shareholders' and other stakeholders' illiquid specific investments in corporations from attempts by large shareholders to extract wealth by threatening those investments *ex post*. For this reason, *ex post* shareholder demands for greater control should be viewed with a jaundiced eye for what they often are: opportunistic attempts to increase "shareholder value" by changing the corporate rules in the middle of the game.

If we really want to gauge shareholders' true preferences, the best way to do this is not to listen to what some shareholders say but instead to look at what shareholders collectively do at the investment stage, when they must "put their money where their mouths are." As we have already seen, at the investment stage, shareholders seem perfectly happy to buy shares in companies controlled by boards (or, at least, unwilling to pay the price of keeping control themselves). This observation highlights the danger of giving too much credence to shareholders' after-the-fact calls for greater control. Like Ulysses, shareholders chose to bind themselves to boards *ex ante* for good reasons.

'ENRON EFFECT' Finally, let us turn to the third and perhaps most powerful source of the emotional appeal of shareholder governance. This is the sense of imminent crisis that has been sparked by recent large-scale corporate frauds and failures at Enron, Worldcom, Tyco, Adelphia, Healthsouth, etc. Faced with what seem obvious cases of executive malfeasance and director negligence (as well as the lesser outrage of apparently runaway executive pay at firms like Disney and General Electric), many observers have concluded that *something must be done.* When this sense of crisis is combined with misleading descriptions of shareholders as "owners," "principals," or "sole residual claimants" (not to mention activist shareholders' *ex post* calls for greater leverage), it is easy to jump to the conclusion that the "something" that "must be done" is to give shareholders in public firms a louder voice and a stronger hand.

This response — we might call it the "Enron effect" — fails to appreciate both the causes of corporate fraud and the lessons of business history. Enron did not collapse because its

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shareholders did not have enough power. In fact, to outside observers, the firm seemed to be a model of "good corporate governance," with a large majority of supposedly independent directors, an independent audit committee, no staggered board provision, and stock option compensation to tie both director and executive pay to performance. More generally, Enron's collapse – and other scandals at other firms – occurred at a time in history when shareholders enjoyed more influence over boards than ever before.

In the earlier times, shareholders in public companies were far more powerless and more handicapped by collective action problems than they are today. Most were private individuals with very small stakes, no ready means of communicating with each other, and no access to corporate funds or the corporate ballot. Today, shareholders have much greater ability to act in concert and to influence boards as a result of a variety of developments that include the increasing clout of institutional investors like pension funds and mutual funds; the rise of "activist" investment funds; the creation of shareholder advisory services like Institutional Shareholder Services; the development of new information technologies that make inter-shareholder communication quicker, cheaper, and easier; and the Securities and Exchange Commission's adoption of rules designed to give shareholders greater voice.

These developments make the suggestion that we can avoid future Enrons by giving shareholders in public firms more control seem a bizarre non sequitur. Greater shareholder power in the 1970s and 1980s did not prevent corporate scandals in the 1990s. If the medicine did not work the first time, why should taking more work now?

CONCLUSION

In fact, the medicine may hurt. Lack of shareholder power did not contribute to Enron's fall. One thing that did contribute, however – and contributed to problems at many other firms as well – was Enron's willing embrace of the favorite governance "reform" fad of the 1990s: stock options. Just as shareholder power is hailed as the obvious solution to corporate America's problems today, stock options were hailed as the ideal way to ensure "good corporate governance" a decade ago. Congress found this notion so compelling that, in 1993, it prohibited corporations from deducting as a business expense any executive compensation in excess of $1 million unless the compensation were somehow tied to "performance." The result was an explosion in the use of stock options that has since been linked to similar explosions in executive pay, earnings "restatements," and large-scale frauds.

The case of stock options offers a cautionary tale on the unintended consequences of top-down corporate governance "reforms" that are not based on compelling evidence. By adopting a solution without fully understanding the problem, Congress likely did far more harm than good.

Bebchuk's proposal presents the same danger. For generations, American investors have voluntarily ceded control over their investments in public companies to boards of directors largely insulated from their own influence. Economic theory teaches that investors do this because board control serves their self-interest in at least three ways: by promoting efficient and informed decisionmaking; by discouraging inter-shareholder opportunism; and by encouraging specific investment in corporations by executives, employees, customers, creditors, and other corporate stakeholders. Business history and practice support this view. Given this background, we should demand strong empirical evidence indeed before concluding that giving shareholders greater control over corporate directors would be a good idea.

That evidence is missing. Rather than being driven by data, calls for greater shareholder control over public corporations seem driven by sentiment and the unspoken assumption that shareholder democracy, like Mom and apple pie, must be good a thing. In other words, the proposal laid out by Professor Bebchuk in his forthcoming *Virginia Law Review* article itself rests on a myth: the myth that greater shareholder control in public firms benefits shareholders. Unless and until we can make this fable a reality, a strong shareholder franchise should also remain a fiction. R

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