

Fall 9-1-2006

The Separation of Ownership and Control in Modern Corporations: Shareholder Democracy or Shareholder Republic? A Commentary on Dalia Tsuk Mitchell's Shareholders as Proxies. The Contours of Shareholder Democracy

Lucas E. Morel

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>

 Part of the [Business Organizations Law Commons](#), and the [Securities Law Commons](#)

Recommended Citation

Lucas E. Morel, *The Separation of Ownership and Control in Modern Corporations: Shareholder Democracy or Shareholder Republic? A Commentary on Dalia Tsuk Mitchell's Shareholders as Proxies. The Contours of Shareholder Democracy*, 63 Wash. & Lee L. Rev. 1593 (2006), <https://scholarlycommons.law.wlu.edu/wlulr/vol63/iss4/12>

This Article is brought to you for free and open access by the Washington and Lee Law Review at Washington & Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington & Lee University School of Law Scholarly Commons. For more information, please contact lawref@wlu.edu.

The Separation of Ownership and Control in Modern Corporations: Shareholder Democracy or Shareholder Republic?

A Commentary on Dalia Tsuk Mitchell's *Shareholders as Proxies: The Contours of Shareholder Democracy*

Lucas E. Morel*

Professor Tsuk Mitchell has written a clear, informative, and well-organized account of how the adage, "the more things change, the more things stay the same," applies to investing in corporate America. She argues that despite a century's worth of changes in the laws governing the nexus between shareholders and corporate boards, most investors continue to own parts of companies without possessing any meaningful control over their investment—except for selling their shares if they do not like what management is doing with the company. This "love it or leave it" approach to shareholder guidance of the companies in which they invest creates a "myth of shareholder democracy,"¹ the subtitle of her paper. As she put it in her title, it bestows "property without sovereignty," giving investors title to something without any real authority over it except for the right to get rid of it. Here the separation between "ownership and control"² forms the crux of the matter.

This separation raises the question of the investor's true identity or function. Are shareholders strictly investors (i.e., maximizers of profit) or potential participants in the direction of the companies in which they invest? Why can they not be both?³ Why can investors not buy in to companies *and* have a less drastic means of influencing board deliberations and actions than

* Associate Professor of Politics, Washington and Lee University. B.A. *cum laude*, Claremont McKenna College; M.A., The Claremont Graduate School; Ph.D., The Claremont Graduate School.

1. Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503 (2006).

2. *Id.* at 1527.

3. *Id.* at 1504–05.

the silent threat of selling their shares when they are dissatisfied? The short answer is that while investors are free to sell their shares if the company performs poorly and returns are weak, ultimately, to enable the directors and managers to run the company at a profit, investors must agree to limit drastically *their* direction and management of the company. Why? The simple fact is that one invests not to create a company or even run it, but one invests to gain a decent return. To borrow from politics, it is the difference between voting occasionally and actually running for office oneself. Now, voting every two years for one's congressman and then going about one's business does not mean politics are forgotten. In fact, it is what one does between elections that makes the vote so important. But I would suggest that there is a categorical difference between what a citizen does between elections, and what an investor does between buying and selling his shares—and it is this difference that ultimately makes democracy a poor analogy for corporate decision-making.

The problem is that corporations are not polities and shareholders are not citizens. Of course, one can take the metaphor of democracy too far and ask it to carry too much weight as an analogy for how shareholders should relate to the companies they invest in, but the democratic analogy breaks down almost from the outset: Corporations do not deal with their investors' lives, liberties, and property—as civil government does—but instead, corporations deal just with investors' property. Because it is wealth, and not personal rights, that are at stake, one can see why shareholders concede with little protest almost all authority over the company's uses of their investment.

Moreover, one can readily see why a member of a political community would need to give consent to his government in order for that government to exercise authority over that citizen: This authority originates with the individual and thus can only be exercised by his consent. Legitimate government rests on the idea that individual human beings possess natural rights; as the Declaration of Independence states, "they are endowed by their Creator with certain unalienable rights."⁴ Because no one is born the natural ruler of anyone but himself, no one can rule another without that person's permission. Thus is born the social contract, whereby a community of rights-bearing individuals agrees to delegate their natural right to rule themselves to a group of their choosing but only for certain limited purposes.

Now, what does this have to do with corporate governance? How much can we expect the political analogy of democratic ideals and practices to carry over into the world of investments? At first, there appears to be no problem with this cross-over application of consent to shareholder participation in the

4. THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776).

companies he owns. However, the most intriguing aspect of Professor Tsuk Mitchell's article was the premise of several of the authorities she cited who proposed greater control by investors of the companies they owned; this premise is fundamental to the Progressive Era critique of the old notion of the individual as the bearer of rights and the government as the protector of the rights that one already possessed. This premise of Progressivism states that rights were not natural or in any sense God-given, but rather the product of a historical process, whereby what one was owed by government evolved over time and hence required the special discernment by the powers that be. Bureaucratic expertise was to replace old-fashioned democratic oversight and accountability because individual investors were presumed to have insufficient knowledge and initiative to protect their investment.⁵

Professor Tsuk Mitchell laments the loss of Progressive and New Deal Era hopes that shareholders be more than mere investors, and instead "channel corporate actions to achieve socially beneficial goals" and fight "hierarchy within corporations" by "constrain[ing] management."⁶ Although I was unsure which of these took greater precedence as the argumentative arc of her paper, empowering shareholders to direct companies "to achieve socially beneficial goals"⁷ appears to be the heart of her project, but most of her examples addressed problems of corporate hierarchy and control over management. Distinguishing these twin objectives in terms of twenty-first century priorities, or connecting them through historical examples of what was meant by "socially beneficial goals" would tie them together better.

She also notes one early scholar's interest in making "passive, widely dispersed owners interested in corporate affairs" through shareholder organizations, which would represent their interests by acting as a "supervisory council" for corporate boards.⁸ This recommendation, based upon the decreasing role that investors were playing in the direction of the companies in which they invested, does not rely upon shareholders themselves to keep these companies honest.⁹ A third party is expected to protect them. Here one might say that the cure might liken to the disease in its detrimental impact on civic

5. See RONALD J. PESTRITTO, *WOODROW WILSON AND THE ROOTS OF MODERN LIBERALISM* (2005) (examining Wilson's progressivism as a direct critique of the principles and practices of the American founding).

6. Tsuk Mitchell, *supra* note 1, at 1514.

7. *Id.*

8. *Id.* at 1530.

9. See *id.* at 1533 ("Fearing that minority shareholders might not be willing or able to protect themselves, they [Berle and Ripley] wanted to establish intermediary organizations to help make corporations self regulating.").

engagement, where third-party, supervisory institutions designed to act as liaisons between shareholders and boards result in a citizenry less, not more, involved in the caretaking of their investments. It should not be a surprise that "the idea of shareholder empowerment through organization had disappeared" because the Progressives believed that experts could do a better job of protecting individuals from those who would prey upon their "vulnerable position in the corporate hierarchy."¹⁰

The emphasis upon the shareholder's lack of agency continues into the section discussing Depression Era attempts to reform the market for securities.¹¹ Again, the responsibility must be placed elsewhere, and not on individual investors. But this emphasis becomes even more explicit when Mitchell considers William Douglas's approach to the problem, concluding, "Shareholders were simply too passive."¹² Government, it appears, must protect citizens against their own inaction on behalf of their own investments.

More information about the problem of investor control in various points in American history would be useful. For example, what percentage of Americans were shareholders in the early decades of the twentieth century, and how many are now?¹³ Here I am thinking of the section subtitled "The Problem of Control" (in Part I of the paper). If a hundred years ago investing in the stock market was a game only rich people played, but today even the barber talks about asset allocation and the merits of index funds over actively managed funds, then perhaps this helps explain why not enough momentum built up early in the last century to change how shareholders relate to corporate boards. In addition, if the problem of shareholder control was so great, why did they continue to invest? Presumably they did so because their primary reason for being a shareholder, to gain a decent return on their investment, still held true. If a reinvigoration of board discretion and the introduction of proxy voting were such detrimental innovations in the early 1900s,¹⁴ why did small, individual investors continue to jump into the market and stay there? The liquidity afforded by stock exchanges makes the right to exit (i.e., sell one's shares) quite palpable as a check on corporate management. The increasing percentage of

10. *Id.* at 1535.

11. *See* Tsuk Mitchell, *supra* note 1, at 1516–17 (discussing various legislative attempts to introduce federal licensing law from 1900 to 1914).

12. *Id.* at 1543.

13. In 1935, 11% of Americans owned stocks; in 2005, 52 % owned stocks. Press Release, Americans for Tax Reform, Social Security Fact of the Day (July 5, 2005), *available at* <http://www.ATR.org/content/pdf/2005/jul/070805pr-ssfact.pdf> (last visited Sept. 6, 2006).

14. *See* Tsuk Mitchell, *supra* note 1, at 1514–15 (discussing the loss of shareholder voting power in the early 1900's).

Americans who own stocks—through IRAs, mutual funds, 401(k) plans, and the like—would suggest that we are discussing a system of ownership that remains attractive as a means of securing one's future. If the risk of owning "property without sovereignty" were so great because of insufficient shareholder control, few would jump at the chance to be a pseudo- or quasi-owner. But given that mutual funds now outnumber individual stocks, it appears that the prospect of owning companies without expecting to direct them remains an alluring one.

Professor Tsuk Mitchell also lists "a variety of legal devices" that further diminished minority shareholders' influence on the direction of corporations: legalizing mergers, holding companies, and subsidiaries, the issuance of bonds, non-voting preferred stock, and conditional or contingent voting stock, and allowing voting trusts.¹⁵ Again, if these legal obstacles placed before minority shareholders were so detrimental to their interests, why would they continue to invest?¹⁶

To return to the notion of shareholder "democracy," I would suggest an alternative that more accurately describes what Professor Tsuk Mitchell and other advocates of shareholder democracy may be working toward: Why not "shareholder *republic*" rather than "shareholder *democracy*"? After all, as Professor Tsuk Mitchell's paper makes clear, shareholders are partial owners of companies but without much say, if any, in their operation or direction. To become a co-owner of these companies is to put money into them (with the hope of a return) but to leave their management in better hands—which is to say, more informed, experienced, trained, and devoted individuals. As a recent *Economist* article on this debate stated, in a summary of UCLA Professor Stephen Bainbridge's argument: "Managers need the space and discretion to be able to go about the business of wealth creation. The law is designed to help them make good-faith business decisions with the speed and efficiency that modern commerce demands and free up managers to manage."¹⁷ Ironically, there is a chance that too *much* concern for wealth creation on the part of *investors* who did have greater control over the decisions of corporate boards could lead to short-term decisions that would hamper the long-term

15. *Id.* (discussing the methods used by corporations to limit the power of minority shareholders).

16. I briefly mention a small but important point: I would like to have seen more of the current debate over the pros and cons of shareholder democracy. This would give greater credence to the problem of its mythic existence in America.

17. *Battling for Corporate America*, *ECONOMIST*, Mar. 9, 2006 at 69–71. For more detail about Bainbridge's argument in favor of "director primacy" over "shareholder empowerment," see Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 *HARV. L. REV.* 1735 (2006).

performance and viability of these companies. So perhaps the operative descriptor should be "shareholder *republic*" to suggest the *ultimate* sovereignty of the shareholder—he can always sell his partial ownership—while acknowledging that the business will be run almost entirely at the discretion of the *representatives* of the shareholders. "Shareholder *democracy*," in this sense, appears to be a misnomer, and perhaps a carryover from the days of townhall governance, which of course was only possible while the town remained small. A desire for shareholder democracy might very well be a longing impossible to satisfy in the age of the modern corporation, which by definition was a company or business enterprise too large to direct by a consensus of all interested parties.

On a final note, it seems that the legitimate concern that an individual investor be able to monitor his investment beyond a stock ticker faces the same problem that the individual citizen does in exercising his sovereignty as a co-equal member of the political community: namely, the problem of casting an effective vote for the proper managers, if you will, of the political enterprise. Interestingly enough, this problem was solved politically by the very institution that most of the founding fathers thought anathema to the new federal union—political parties. Given their proneness to division, faction, even violence, parties had their work cut out for them: namely, to connect the people to their government. What individual citizens could not do on their own they were able to do as part of a coherent, coordinated effort to shape the political process.¹⁸ Parties found a way to convince Americans they could do the job citizens needed most: to facilitate deliberation about the salient issues of the day, to recruit and support candidates for office who united around common principles and policies, and to keep the public informed about the decisions and activities of their rulers in between elections. What exactly this would look like in the investment world remains for the reader to ponder.

18. Charles R. Kesler, *Political Parties, The Constitution, and the Future of American Politics*, in AMERICAN POLITICAL PARTIES AND CONSTITUTIONAL POLITICS 229, 229–48 (Peter W. Schramm & Bradford P. Wilson eds., 1993) (discussing the impact of political parties on the political process).

NOTES
