

MANAGER'S JOURNAL/By Lynn A. Stout and Iman Anabtawi

## Sometimes Democracy Isn't Desirable

**M**OM, APPLE PIE and shareholder democracy—they're all good. At least, that's what the SEC seems to believe as it pushes a new "proxy access" rule to give large shareholders more power to oust corporate directors. But investor enthusiasm for Google's IPO suggests the SEC may be wrong about whether investors really want, or need, more shareholder democracy.

American corporate law gives entrepreneurs seeking to sell stock in the companies they create the freedom to draft their corporate charters almost any way they like. This includes freedom to draft charters that either enhance shareholder voting power, or dilute it. If investors valued strong voting rights, you'd think they would pay more for the shares of companies that granted them. Corporate entrepreneurs would respond by supplying charters that give shareholders greater clout.

Yet in the real world, companies almost never "go public" with enhanced shareholder power. Instead, most IPO charters weaken shareholders' rights. Google is a case in point. Its charter gives its founders shares with multiple votes while the public gets shares with only a single vote. Such "dual class" stock is unusual, but milder forms of shareholder disenfranchisement abound. Most IPO charters these days include "staggered board" provisions making it harder for shareholders to replace incumbent directors. Far from avoiding these IPOs, investors, including sophisticated institutions, snap them up like hotcakes.

The SEC's proposed rule accordingly does nothing for the "investor class" its members can't already do for themselves—if they wanted to. Why, if greater

power is such a boon to investors, haven't they already demanded it? Maybe because greater shareholder power isn't so wonderful for investors after all. This argument is being advanced by Google's founders, and it enjoys support from many corporate scholars as well.

The modern corporation is the product of an evolutionary process in which entrepreneurs and investors together select governance structures for new firms, which then compete with each other in the markets for products, employees, and capital. Many firms these days prefer governance structures in which shareholders have weak rights and boards of directors enjoy most of the authority. The model is one of representative, rather than direct, democracy.

Investors might prefer this for several reasons. First, even finance economists increasingly acknowledge what businesspeople have always known: stock prices don't always accurately measure value. (Remember the Internet bubble?) As a result boards can often do a far better job of picking the business strategy best for the firm in the long run than unorganized, uninformed, and price-obsessed stockholders can.

Second, investors don't always share common interests. The SEC's proposed rule would allow only shareholders with large holdings to push their own board candidates. This invites intra-shareholder conflict, allowing large investors—including financial intermediaries, union-sponsored pension plans, and politically-motivated groups—to nominate directors who will represent only their own special interests.

Third, strong boards can mediate not only conflicts among shareholders, but

also conflicts between shareholders and other important corporate constituencies. The "team production" theory of corporate governance teaches that a principal function of board governance is to encourage executives, customers, rank-and-file employees, and others to make long-term commitments to a company by assuring these groups corporate policy will not be set by an anonymous, myopic, return-hungry pack of shareholders. Shareholders go along because, by ceding control to boards, they get greater loyalty and commitment from others. Google's investors may well believe the firm's founders and employees will work harder and better with a dual-class structure that protects them against hostile takeovers or shareholder pressures to raise profits by outsourcing jobs and cutting employee benefits.

Of course, certain shareholder groups might be happy to let the SEC change the rules later on, to give them more power. But this doesn't mean the new rules are better than the original rules the players agreed to.

The SEC should take a lesson from Google. The IPO market already allows entrepreneurs and investors to arrange their business affairs in a fashion that benefits all. The SEC should respect that ability rather than imposing its own bureaucratic view of what is "good corporate governance."

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## Power to PeopleSoft

**DURING THE 1970S** and 1980s, businesses were shaken by a wave of hostile takeovers that ousted management teams, shut down plants and factories, and pink-slipped thousands of rank-and-file employees. Thanks to the invention of the "poison pill" and similar antitakeover defenses that allowed targeted firms to fend off unwanted suitors, the 1990s were a kinder and gentler decade.

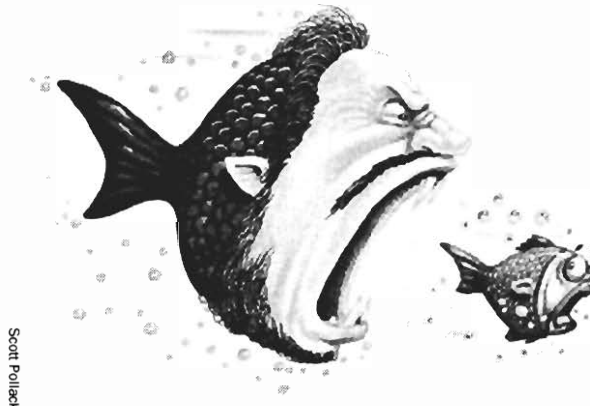
Now, the corporate world, as Yogi Berra would put it, looks like *deja vu* all over again. The hostile takeover is back, in the form of Oracle Corp.'s \$6 billion-plus bid to acquire PeopleSoft.

Should Oracle be allowed to buy PeopleSoft—even though PeopleSoft's board of directors doesn't want to sell the company? Oracle chief Larry Ellison certainly thinks so. And Mr. Ellison has the backing of a number of prominent economists and corporate theorists to give him academic cover for his actions.

These theoreticians worship at the altar of the "shareholder primacy" model of corporations, a cartoonish, two-dimensional view of the business world that treats employees and managers as widgets who can, and should, be discarded at a moment's notice when this means more money for shareholders.

According to the shareholder primacy model, corporations are bundles of assets collectively owned by shareholders who hire directors and managers to manage those assets on their behalf. It follows that each and every penny of the firm's profit should go to the shareholders. Everybody else—employees, managers, suppliers, customers—gets the minimum provided by their contracts (or even the boot).

This is why Oracle is arguing, in a lawsuit filed in Delaware, that the PeopleSoft board is violating its "duty" to PeopleSoft's shareholders by using its poison pill defenses against Oracle's



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premium bid. Have we learned nothing from the Crash of 2000?

It is long past time to broaden our view of what makes value in corporations, and to question the notion that stock price is king. Indeed, a competing model of corporations that challenges the old shareholder primacy view is gaining traction among both academics and corporate people who know how companies really work.

This "team production" model starts from the observation that a pile of cash, sitting alone, does nothing. A successful corporation needs not only financial capital from investors, but also human capital—investments of loyalty, expertise, energy, and imagination by the firm's employees and executives.

Why do these corporate "team members" make such investments? In part, because they are paid to. But salaries and written employment contracts are not the entire answer. Employees and executives also often work harder and longer than they can be required to because they believe they have a stake in the firm and its future. Similarly, customers and creditors develop loyalties that contribute to the bottom line. Such team loyalties can be shaken or destroyed when control of a

firm passes to hostile hands—like those of Larry Ellison.

By selling to Mr. Ellison, PeopleSoft's shareholders might be able to make a few more dollars in 2003. But PeopleSoft was founded in 1987. If the company's executives and employees had believed the firm at any time could be easily taken over by a hostile raider, would they have invested the effort and loyalty that

makes the firm a success today?

The team production model of the corporation recognizes that, without its takeover defenses, PeopleSoft might never have become a valuable—and tempting—takeover target in the first place.

A corollary is that PeopleSoft's directors should have the authority, when approached by a hostile raider, to refuse to sell the company. This director power to "just say no" is important to protect the reasonable expectations of PeopleSoft's customers, executives, employees, and other important corporate team members. But it is also important to protect the interests of PeopleSoft's shareholders, who otherwise might now hold shares in a worthless, failed firm.

This view may not sit well with Larry Ellison, or with theoreticians who argue that greater shareholder wealth today should be a board's only goal. But it recognizes an important business reality. The single-minded pursuit of a higher share price is not always good for business or—in the long run—for investors themselves.

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