The Law and Economics of Shareholder Democracy[*]

Despite nearly a century of research on business organizations, most Law and Economics scholars continue to interpret corporate law primarily as a response to agency costs arising from a complex network of contractual relationships within the firm. While agency-cost theories offer valuable insights into certain principal-agent relationships—particularly those between shareholders and directors—they often fail to capture other internal dynamics, such as relationships among shareholders themselves. In this article, I contend that corporate law must address not only the mitigation of agency costs but also the distinct costs of collective decision making—namely, the horizontal economic frictions among members of a given corporate constituent, most notably shareholders. In contrast to the bilateral context in which agency-cost theories are most salient, a Law and Economics theory of Shareholder Democracy emerges from the difficulties in aggregating preferences in a multilateral environment, especially when shareholders possess heterogeneous interests. Focusing on the pathologies of shareholder voting, I identify four critical frictions associated with collective decision making—free-riding, rent-seeking, holdout, and indeterminacy—and demonstrate how each differs fundamentally from traditional agency-cost paradigms. Given that these frictions are inherent in modern corporations with multiple shareholders, I explore how they manifest in current corporate law regimes and offer normative insights for reform. By highlighting these underexamined dimensions of shareholder governance, my article calls for a broader theoretical framework to more accurately describe and guide contemporary corporate law.

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I: Introduction

Almost 200 years ago, Blackstone described the corporation as a "little republic." Building on this analogy, Gompers et al. suggest that voting shareholders elect director-representatives, who in turn delegate most decisions to bureaucrat-managers.[1] Like republics, the learned authors suggest that corporations lie between two extremes—democracies, where little power is reserved for management and shareholders can easily replace directors; and dictatorships, where management reserves extensive power and strong restrictions are placed on the ability of shareholders to replace directors.[2] However, despite the ostensible analogy between corporate governance and public governance, corporate law's dominant rationale remains focused on ameliorating agency costs arising from a complex web of contractual relationships among corporate constituents. The influence of agency cost theories on corporate law should not be understated. As of the time of writing, the seminal article on agency costs—Jensen and Meckling—has been cited more than 100,000 times.[3] Agency cost theories are dominant in most textbooks of corporate law, and many scholars regard the reduction of agency costs as the essential function of corporate law and of similar fields like securities regulations.[4]

Agency-cost theories rest on the premise that participants in a corporation voluntarily separate ownership and control within the firm.[5] Accordingly, the "owners" of a typical corporation rely on its managers to run the business, granting them pecuniary (and non-pecuniary) benefits in exchange for the collective advantages conferred by this separation. However, as the traditional narrative goes, delegated control entails a cost, since managers possess superior information about the corporation's affairs compared to its shareholders. As long as these managers must share the corporation's profits with shareholders, they remain incentivized to exploit their informational advantage—namely, by engaging in more shirking and opportunism than they would if they were the sole owners.[6] These concepts have intuitive appeal and find some support in the prevailing empirical evidence.[7]

Critics of agency-cost theories have contested what they view as its overemphasis on minimizing agency costs. Many scholars argue that pursuing this goal too aggressively may erode the benefits of separating ownership and control. Drawing on Arrow's earlier work, for instance, Bainbridge suggests that consensus-based decision making could be far more costly than centralizing authority in a board of directors.[8] In a similar vein, Blair and Stout assert that existing corporate law does not fully support reducing agency costs as the primary normative goal.[9] In particular, they argue that modern corporate law features are inconsistent with contractarian interpretations focusing on

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[1] Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q J ECON 107 (Oxford Academic Feb. 2003). In this article, I use the term "managers of the firm" as a synonym for "directors and senior employees of the firm".
[2] *Id.*
[3] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS 305 (Oct. 1976).
[4] Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance Essay*, 117 COLUM. L. REV. 767 (2017).
[5] Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 THE JOURNAL OF LAW AND ECONOMICS 301 (Jun. 1983). See also ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Transaction Publishers Jan. 1932).
[6] Jensen & Meckling, *supra* note 4.
[7] Gompers et al., *supra* note 2. See also James S. Ang et al., *Agency Costs and Ownership Structure*, 55 THE JOURNAL OF FINANCE 81 (2000).
[8] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (W. W. Norton & Company Feb. 1974); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment Response to Increasing Shareholder Power*, 119 HARV. L. REV. 1735 (2005–2006).
[9] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VIRGINIA LAW REVIEW 247 (Virginia Law Review 1999).

the "principal-agent problem"—a cornerstone of agency-cost theories. The authors note that the law grants substantial power to the board, running counter to the agency-cost objective of curbing directorial opportunism.[10] In more recent work, Kraakman et al. point out that although delegating managerial decision-making powers can reduce shareholders' information and coordination costs, balancing those costs against managerial agency costs remains one of the most difficult tasks for corporate policymakers.[11]

While much of this criticism is warranted and not entirely new, most legal scholars continue to gloss over the distinction between agency costs and those tied to collective decision making. As I will explain in more detail later, the key issue is that agency-cost theories are generally conceptualized in a bilateral context. Indeed, Salanié observes that the canonical principal–agent model presupposes a single principal and a single agent, with one party (usually the principal) presenting a "take it or leave it" contract to the other.[12] Although some economic literature deals with multiple agents or principals, most of these models still center on arrangements like multiple principals and a single agent, treating the multilateral dimension in ways that minimize aggregation problems.[13] In contrast, the frictions that accompany collective decision making arise precisely from the need to aggregate diverse preferences amongst multiple individuals. It is therefore surprising that so little attention has been paid to whether and how these preferences can be combined in a satisfactory way, given that heterogeneous shareholder interests are among the most salient features of modern corporations. Recent empirical work by several scholars, for example, shows that even among a single class of investors (mutual funds), ideologies around corporate voting can vary widely—from strongly pro-social to predominantly financially driven.[14] Furthermore, it remains unclear how focusing exclusively on agency-cost theories can illuminate the frictions among multiple shareholders and guide corporate law's response, particularly since conventional efforts to reduce information asymmetry—such as mandatory disclosure regimes—may not effectively address these intra-shareholder tensions.[15]

To appreciate the stark contrast between these two types of economic frictions, consider how the relationship among multiple shareholders is analogous to that of voters in a polity. By contrast, the relationship between shareholders and directors is more akin to that of an employer and employee—a typical principal–agent relationship.[16] In the former context, voting coalitions can shape electoral outcomes, "special-interest" groups may exert disproportionate influence, and participation rates can shift the results of any given vote. None of these considerations typically apply in the latter context. Indeed, across most jurisdictions, shareholders collectively retain the

[10] In a distinct critique, Raz notes that the characterization of agency problems in corporate law in relation to managers and shareholders glosses over the fact that corporate law creates duties between the corporation as a separate legal person and its fiduciaries, not the former pair. See Asaf Raz, *A Purpose-Based Theory of Corporate Law*, 65 VILL. L. REV. 523 (2020).

[11] In this article, the terms "managerial–shareholder" agency costs and "directorial–shareholder" agency costs are used interchangeably. See REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, THE ANATOMY OF CORPORATE LAW (Oxford University Press).

[12] BERNARD SALANIE, THE ECONOMICS OF CONTRACTS, SECOND EDITION: A PRIMER, 2ND EDITION (MIT Press Mar. 2005).

[13] Bernheim and Whinston do not explicitly model failures in aggregating collective preferences; however, they find that once principals can collude, the problem converges to a standard principal–agent framework. See B. Douglas Bernheim & Michael D. Whinston, *Common Agency*, 54 ECONOMETRICA 923 ([Wiley, Econometric Society] 1986).

[14] Patrick Bolton et al., *Investor Ideology*, 137 JOURNAL OF FINANCIAL ECONOMICS 320 (Elsevier 2020); Ryan Bubb & Emiliano M. Catan, *The Party Structure of Mutual Funds*, REV FINANC STUD (2021); Jonathon Zytnick, *Do Mutual Funds Represent Individual Investors?*, No. 3803690 (Oct. 2024).

[15] OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE (Princeton University Press Apr. 2014).

[16] PATRICK BOLTON ET AL., CONTRACT THEORY (MIT Press 2005).

power to remove individual directors—an authority notably absent in shareholder-to-shareholder interactions.[17]

In this article, I abstract from the complexities of corporate law by highlighting the economic frictions that arise among shareholders, which I collectively label "the costs of collective decision-making."[18] Hansmann's seminal work first defined these internal conflicts among owners in organizations, and I build on his analysis to distinguish such conflicts from "agency costs"—those related to monitoring and managerial opportunism even when owners share identical interests.[19] In a related chapter, Kraakman et al. describe these frictions as a "multiple principals" problem involving information and coordination costs, illustrating how they can intersect with agency concerns.[20] While these and other authors have acknowledged these issues, my article contributes a deeper analysis of how collective decision-making costs can lead to economic inefficiencies, explains how corporate law currently responds to these frictions, and proposes a normative framework for improving that response.[21] Although the underlying economic theory—primarily grounded in public choice theory—is not new, applying these principles to both the descriptive and normative dimensions of corporate law is, to the best of my knowledge, a novel undertaking.[22] For tractability, I confine most of the discussion to shareholders. Nonetheless, much of this analysis applies equally to other corporate constituents with multiple participants—such as directors, creditors, and employees.

The insights from my analysis are especially relevant to current debates on how shareholder relationships should be regulated in modern capital markets. While scholars in the 1970s once observed that "the empirically more important conflict [relative to the conflict between shareholders] was that between managers and shareholders",[23] many now emphasize the rising influence of shareholders over corporate affairs.[24] Over the past few decades—particularly in diffuse-ownership jurisdictions such as the United States ("U.S.") and the United Kingdom ("UK")—institutional investors have dramatically transformed the capital market landscape.[25] In 1950, institutional investors held only about 7% of public companies in the U.S.; today, they control almost 70%.[26] Notably, three firms—Vanguard, BlackRock, and State Street—together represent the largest shareholder in 88% of the S&P 500.[27]

My article is organized as follows. Part II examines the structural framework of agency-cost theories, their associated agency problems, and how the costs of collective decision making diverge from agency costs. In Part III, I offer a detailed taxonomy of these collective decision-making

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[17] KRAAKMAN ET AL., *supra* note 12.

[18] The definition of these frictions follows the term first coined by Hansmann. See HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (Harvard University Press 1996).

[19] *Id.*

[20] KRAAKMAN ET AL., *supra* note 12.

[21] Blair & Stout, *supra* note 10; Bainbridge, *supra* note 9; Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2005–2006).

[22] DENNIS C. MUELLER, PUBLIC CHOICE III (Cambridge University Press 2003).

[23] Oliver Hart, *Incomplete Contracts and Control*, 107 AMERICAN ECONOMIC REVIEW 1731 (Jul. 2017).

[24] Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three Symposium: Institutional Investor Activism in the 21st Century: Responses to a Changing Landscape*, 99 B.U. L. REV. 721 (2019).

[25] The costs of collective decision-making tend to be less pronounced in jurisdictions with controlling shareholders, since the controlling shareholder typically holds control rights over both the board of directors and the broader shareholder body (which I term the "general meeting"). Nevertheless, as I will discuss in Parts IV and V, these economic frictions remain relevant even under a controlling-shareholder regime.

[26] José Azar, *Portfolio Diversification, Market Power, and the Theory of the Firm*, No. ID 2811221 (Aug. 2017).

[27] Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUSINESS AND POLITICS 298 (Cambridge University Press 2017); Matthew Backus et al., *Common Ownership in America: 1980–2017*, 13 AMERICAN ECONOMIC JOURNAL: MICROECONOMICS 273 (Aug. 2021).

costs, highlighting their conceptual distinctions from agency-cost problems and explaining how they manifest among shareholders. For instance, indeterminacy problems linked to shareholder voting arise from the intransitivity of collective shareholder preferences—an issue unrelated to asymmetric information among shareholders themselves. Part IV analyzes how existing corporate law seeks to mitigate such costs, while Part V proposes modest reforms to corporate law aimed at further reducing them.[28] Finally, Part VI concludes with some closing observations.

II: Agency Problems and Agency Costs

A. The Agency Problem and Optimal Contracting

"Agency costs" arise from an "agency problem" involving a representative "principal" and a representative "agent."[29] In broad terms, an agency problem arises whenever one party (the principal) relies on the actions of another (the agent) in ways that affect the principal's welfare, typically under conditions where the principal holds an informational advantage over the agent. In corporate law, this framework is often used to classify certain constituents as principals and others as agents. For example, Kraakman et al. identify three generic agency problems in corporations.[30] First, shareholders may be viewed as the principals and managers as the agents; second, non-controlling shareholders can be considered the principals and controlling shareholders the agents; and third, the firm itself and its owners can be treated as principals, while the firm's contracting parties are the agents. Although these dichotomies can seem artificial or even arbitrary—especially in the shareholder–shareholder context[31]—it is crucial to recognize that the principal–agent problem is ultimately a heuristic device, employed to simplify the analysis of bargaining under asymmetric information. [32]

Despite these challenges, the principal–agent framework remains a valuable tool for examining the incentives of both parties in bilateral settings with asymmetric information.[33] In their seminal work, Jensen and Meckling introduced the term "agency costs" to capture these conflicts.[34] Principals can attempt to mitigate them by monitoring the agent's behavior, aligning the agent's incentives with their own (often through bonding mechanisms), or using other contractual measures. However, since the mitigation of these conflicts will be inevitably imperfect, Jensen and Meckling identify the remaining loss to the principal as "residual costs" and define "agency costs" as the sum of monitoring costs, bonding costs, and residual costs.[35]

While the term "agency costs" has since taken on a life of its own, a closer examination of Jensen and Meckling's work reveals an important idiosyncrasy that distinguishes it from much of the contemporary literature employing this concept.[36] In particular, Jensen and Meckling assume that "individuals [have] solve[d] [optimal contracting problems] and given that only stocks and bonds can be issued as claims, [they] investigate the incentives faced by each of the parties… characterizing the relationship between the manager (i.e., agent) of the firm and the [shareholders]

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[28] In this article, my use of the term "corporate law" encompasses not just the traditional body of corporate statutes and case law, but also the broader realm of securities regulations.
[29] BERNARD SALANIÉ, THE ECONOMICS OF CONTRACTS: A PRIMER (MIT press 2005).
[30] KRAAKMAN ET AL., *supra* note 12.
[31] ROBERT C. CLARK, AGENCY COSTS VERSUS FIDUCIARY DUTIES (Division of Research, Harvard Business School 1983).
[32] SALANIÉ, *supra* note 29.
[33] SALANIE, *supra* note 13.
[34] Jensen & Meckling, *supra* note 4.
[35] *Id.*
[36] Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine Essay*, 121 COLUM. L. REV. i (2021).

and debt holders (i.e., principals)."[37] As a result, the defining features of how the principal–agent relationship might deviate from the "first-best" counterfactual are essentially assumed away in their article. Instead, Jensen and Meckling focus on "monitoring costs," defined as costs the principal can bear to limit the agent's aberrant activities, and "bonding costs," defined as costs the agent can bear to ensure he does not undertake actions detrimental to the principal.[38]

In Jensen and Meckling's framework, the principal is implicitly assumed to incur an additional (exogenous) cost to "steer" the agent's incentives in alignment with her own—beyond what is provided through their contractual relationship.[39] Intuitively, these monitoring and bonding costs can be viewed as costly measures the principal undertakes to reduce information asymmetry between herself and the agent. Unfortunately, Jensen and Meckling do not specify what "monitoring" precisely entails or how it differs from existing contractual tools available to the principal.[40] For example, although they suggest that monitoring activities may include "auditing, formal control systems and budget restrictions… which serve to more closely identify the manager's interests with [shareholders]," it remains unclear where the boundary lies between contractual and non-contractual means of auditing and restricting budgets.[41] In this context, Tirole provides a more detailed framework of monitoring and bonding techniques, distinguishing—within the realm of monitoring—between "active monitoring" and "speculative monitoring."[42]

B. Agency Costs, Second-Best, and Incomplete Contracting

When Jensen and Meckling introduced their model, the principal–agent framework served as a valuable tool for examining how contracting parties respond to information asymmetry.[43] Consider a stylized setting featuring a single shareholder (principal) and a manager (agent).[44] The shareholder can employ both contractual and non-contractual measures—such as screening and signaling—to mitigate managerial opportunism. This approach enabled economists to observe how contracts formed under these "second-best" conditions deviate from a hypothetical "first-best" scenario in which no information asymmetry exists.[45] In this setting, most allocative inefficiencies stem from the non-contractible nature of managerial actions that benefit the firm.[46] If those actions were fully contractible, the shareholder could simply induce efficient behavior by offering contractual terms that specify the manager's payoff for each relevant action.[47]

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[37] Jensen & Meckling, *supra* note 4.
[38] *Id.*
[39] More formally, we can think of this as an environment where the principal is allowed to remove the non-contractibility of the agent's actions at a fixed cost, M.
[40] Jensen & Meckling, *supra* note 4.
[41] *Id.*
[42] In the corporate governance context, Tirole distinguishes between active and speculative monitoring by shareholders. Under active monitoring, shareholders investigate prospective managerial decisions that could affect the firm's value. For instance, an active monitor might gather information on a new management policy and implicitly threaten to exercise control rights to remove the current management if the policy severely undermines value. By contrast, speculative monitoring involves scrutinizing past managerial actions—such as historical financial benchmarks—and, if the findings are unfavorable, the monitor may exit by selling shares on the secondary market. While questions remain about the institutional mechanisms that enable shareholder oversight, these examples illustrate how monitoring constrains managerial opportunism and highlights the non-contractual nature of shareholder oversight. Similar reasoning applies to bonding costs as well. JEAN TIROLE, THE THEORY OF CORPORATE FINANCE (Princeton university press 2006)..
[43] Jensen & Meckling, *supra* note 4.
[44] In this context, I use the term "manager" interchangeably with "director."
[45] SALANIE, *supra* note 13; BOLTON ET AL., *supra* note 17.
[46] Benjamin E. Hermalin et al., *Contract Law*, 1 HANDBOOK OF LAW AND ECONOMICS 3 (Elsevier 2007).
[47] *Id.*

In many cases, the manager's actions are unobservable to the shareholder or cannot be validated by external mechanisms, making them effectively non-contractible.[48] To address this limitation, the shareholder can rely on observable, verifiable (i.e., "contractible") terms and link them to the manager's compensation or other rewards. This tactic curbs opportunistic behavior by aligning the manager's incentives with the shareholder's interests. For instance, in moral hazard scenarios, the principal may use measurable yet imperfect signals of the manager's actual performance as the basis for a contract.[49] Because these proxies seldom capture genuine performance precisely, contracts remain "second-best," giving rise to efficiency losses tied to the gap between contractible and unobservable actions.

However, these canonical moral hazard problems typically assume that the shareholder can identify and define contractible measures at the outset of their relationship. Under this view, the shareholder is presumed to fully anticipate the manager's opportunism in a deterministic manner, so any efficiency losses from implementing a second-best contract are willingly accepted as part of the cost of separating ownership and control.[50] This assumption becomes especially problematic in corporate law and governance, where—even with a single shareholder and a single manager—parties cannot foresee all contingencies that might arise long after the corporation's charter is established.[51] In particular, a corporation's business may evolve to require additional equity financing that could not have been anticipated when the corporation was first formed.[52]

The inability to describe certain events with precision before they occur—despite recognizing their implications afterward—is a pervasive challenge in real-world contracting.[53] This limitation, known as "incomplete contracting," arises when contracting parties cannot fully specify terms of trade at the outset (i.e., ex-ante). As Bolton and Dewatripont observe, introducing incomplete contracting into the analysis marks both a "substantive and methodological" departure from the traditional principal–agent paradigm.[54] In particular, when contingencies affecting the parties' payoffs are left undefined, one or more parties may exploit the contract to their own advantage ex-post. Williamson refers to this practice as "ex-post opportunism"—often called the "hold-up problem"—and argues that the possibility of such behavior can deter otherwise beneficial ex-ante investments.[55] For instance, a shareholder may scale back her capital contributions to a corporation if she suspects that the manager will later take opportunistic actions that erode the value of these initial investments.

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[48] In other words, a contractual term is "noncontractible" when it is *either* unobservable *or* unverifiable. As Hermalin has noted, the set of observable actions includes the subset of verifiable actions, motivating the extensive literature on how contracting parties may be able to address observable-but-non-verifiable actions. Putting aside these complexities,
[49] Bengt Holmström, *Moral Hazard and Observability*, 10 THE BELL JOURNAL OF ECONOMICS 74 ([RAND Corporation, Wiley] 1979); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 THE AMERICAN ECONOMIC REVIEW 777 (American Economic Association 1972).
[50] Hart observes that in a second-best principal–agent contract, there are no transaction costs in writing the agreement (no thinking, negotiation, or enforcement costs). It follows that the original owners and manager can draft a long-term contract spelling out the manager's obligations in every possible future state. Although such a contract cannot be "perfect"—some actions, like managerial effort, remain unobservable—it can still be "comprehensive." In other words, there is never a need to revise it when new information comes to light, because if a particular action becomes desirable in a future state, the contract can simply include a state-contingent clause dictating that action. See Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 THE UNIVERSITY OF TORONTO LAW JOURNAL 299 (University of Toronto Press 1993).
[51] *Id.*
[52] Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have*, 13 JOURNAL OF FINANCIAL ECONOMICS 187 (Elsevier 1984).
[53] Spamann has suggested that all contracts are invariably incomplete. See Holger Spamann & Jacob Fisher, *Corporate Purpose: Theoretical and Empirical Foundations/Confusions*, No. 4269517 (Nov. 2022).
[54] See BOLTON ET AL., *supra* note 17.
[55] Oliver E. Williamson, *Corporate Finance and Corporate Governance*, 43 THE JOURNAL OF FINANCE 567 (Wiley Online Library 1988).

Introducing incomplete contracting into bargaining analysis enriches our understanding of corporate governance by formalizing ownership and control rights. In a seminal paper, Grossman and Hart propose that "ownership rights" can be conceptualized as residual rights of control—that is, where contracts fail to specify an alternate use for a firm's assets, the owner retains decision-making authority.[56] Because these rights are determined ex-ante, the owner's—in this case, a shareholder—legal prerogative effectively guards against ex-post opportunism by a non-owner manager. Nevertheless, vesting control in the owner carries its own costs: once empowered to interpret the contract in her favor, she may engage in opportunistic behavior that disadvantages the manager.[57] As Grossman and Hart argue, the optimal arrangement balances these benefits and costs so that control rights reside with the party whose contributions are most critical to the firm's success.[58] Notably, this notion of "gap-filling" applies broadly, extending beyond the ownership of physical assets.[59]

Figure 1

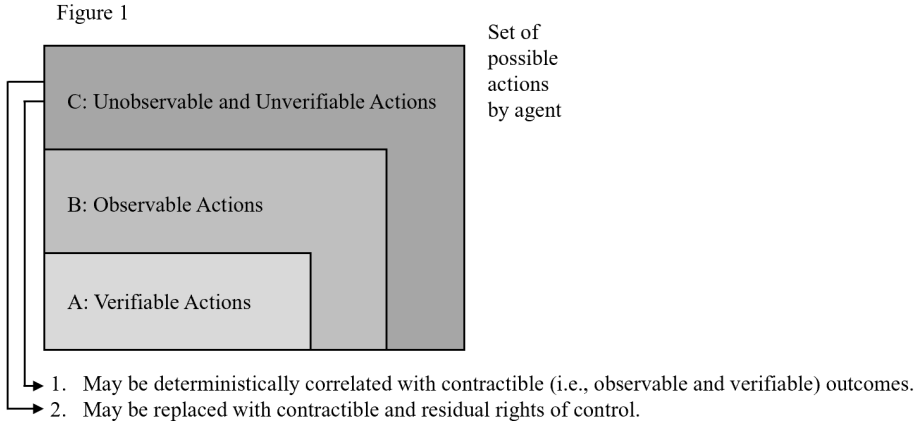

Figure 1 illustrates two possible approaches a shareholder can take regarding non-contractible actions (region C) undertaken by the manager. First, even if the shareholder anticipates potential opportunism, she may rely on contractual incentives that are deterministically correlated with these non-contractible actions. Alternatively, in an incomplete contracting framework, she can invoke control rights that effectively supersede the agent's authority when unforeseen contingencies arise. While each approach has its own trade-offs, it is crucial to recognize that they are complementary rather than mutually exclusive.[60]

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[56] Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 JOURNAL OF POLITICAL ECONOMY 691 (Aug. 1986). See also Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 REV ECON STUD 115 (Oxford Academic Jan. 1999).

[57] A similar situation applies where the manager has control rights and acts opportunistically vis-à-vis the shareholder.

[58] Grossman & Hart, *supra* note 55.

[59] Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q J ECON 387 (Oxford Academic May 1998).

[60] Consider a principal–agent relationship that features both complete and incomplete contracting elements. In the complete realm, the principal can monitor or bond the agent (to mitigate moral hazard and adverse selection), while explicit terms constrain opportunism. Under incomplete contracting, however, the allocation of control is crucial: giving it to the principal lets her decide what the agent should do in an unforeseen contingency; allocating it to the agent grants him discretion over his own actions. This dual framework mirrors modern corporate governance. When contingencies are foreseeable, shareholders might use explicit charter provisions—such as forbidding board implementation of a poison pill—to curb managerial opportunism. For unanticipated events, they can adjust the ex-ante division of control rights between the board and the general meeting of shareholders. For instance, shareholders may reinforce their voting power by prohibiting staggered boards, preserving their right to amend bylaws, or lowering supermajority thresholds for mergers and charter amendments.

Figure 2

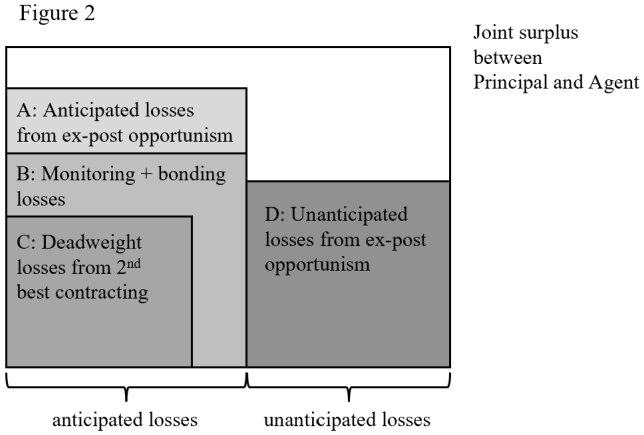

Figure 2 illustrates the efficiency losses that can arise in a principal–agent setting combining elements of both complete and incomplete contracting.[61] As noted earlier, the inefficiencies stemming from incomplete contracting differ from those identified in the principal–agent framework established by Jensen and Meckling.[62] For instance, Region A accounts for the anticipated costs of giving the manager control rights under incomplete contracting—such as the manager's reduced willingness to make relationship-specific investments.[63] In contrast, Region D represents unanticipated losses arising from ex-post opportunism by the manager, which may lead to costly ex-post bargaining and involuntary wealth transfers.[64]

Much of the modern literature using the term "agency costs" reconciles Jensen and Meckling's framework with this broader set of inefficiencies.[65] Even in a simplified context involving a single shareholder (principal) and manager (agent), the shareholder incurs second-best contracting losses (Region C), monitoring and bonding expenses (Region B), and potential ex-post opportunism (Regions A and D). Within this stylized framework, we can integrate Jensen and Meckling's original concepts by classifying the losses in Regions A, C, and D as "residual costs" and those in Region B as "monitoring and bonding" costs.

C. Corporate Law, Agency Costs and the Costs of Collective Decision-Making

The expanded agency-cost theory presented in Part B offers a strong explanation for bilateral relationships. Consider the stylized scenario in which a single shareholder (principal) and a manager (agent) interact as outlined in Part B. In this setup, the shareholder may draw on various "self-help" strategies—both contractual and non-contractual—to counter managerial opportunism. Examples include incentive-based executive compensation (which induces second-best contracting costs), periodic audits (which incur monitoring costs), and appointment or removal rights (which invoke control rights). As proponents of agency-cost essentialism emphasize, corporate and securities laws help reduce information asymmetries between the shareholder and manager, thereby easing the shareholder's need for costly monitoring, bonding,

[61] Note that the area representing the "joint surplus" between the principal and agent includes all benefits arising from the separation of ownership and control within the firm.
[62] Jensen & Meckling, *supra* note 4.
[63] Blair & Stout, *supra* note 10.
[64] One might view these unanticipated losses as an "illegitimate divergence of interests," in which the party holding control rights exploits ill-defined terms of trade through ex-post opportunism. Infra Part III.
[65] Lund & Pollman, *supra* note 36.

or contractual provisions that can undermine allocative efficiency.[66] For instance, mandatory disclosure rules may compel managers to reveal private information that would otherwise remain hidden in the absence of monitoring or incentive contracts. Notably, agency-cost theories are not limited to shareholder–manager dynamics. They also apply to relationships between controlling and non-controlling shareholders, where the non-controlling shareholder effectively becomes the principal and the controlling shareholder the agent.[67] In such cases, the non-controlling shareholder can deploy similar "self-help" measures to mitigate controlling-shareholder opportunism.

Although agency-cost theories offer robust insights for bilateral corporate relationships, they struggle to account for the economic frictions that emerge once additional parties join the original pair. For example, starting from the basic scenario of a single shareholder and a single manager introduced in Part B, adding more shareholders introduces new coordination costs among them.[68] The central challenge arises when the shareholders have diverging interests on factors such as investment time horizons (long vs. short term), degrees of diversification, insider status, pro-social preferences (e.g., environmental or social goals), or hedging strategies for firm-specific risk.[69] In such cases, much like in a polity, the various preferences of shareholders must be aggregated to reflect the collective will of all shareholders.[70] Under these circumstances, corporate law's function of reducing information asymmetry may offer little assistance. Although mandatory disclosure can improve the manager–shareholder relationship at the collective level, it does not resolve intra-shareholder conflicts that surface when shareholders must act in unison. Indeed, while information asymmetry can exacerbate the costs of collective decision-making, it is not a necessary condition for such costs to exist.[71]

Building on this need to unify divergent interests, these "costs of collective decision-making" are typically addressed through a voting rule, which consolidates individual shareholder preferences into one outcome that ostensibly represents the collective will.[72] Crucially, however, such a rule need not require unanimous consent and thus may not fully capture the preferences of all shareholders. Indeed, the most common voting rule in corporations—the majority rule—effectively subjects those who lose the vote to the majority's decision on the matter at hand.

One might ask whether these differences among shareholders could be resolved ex-ante. As Rauterberg observes, "shareholder agreements"—a form of ex-ante contracting among shareholders—are routinely employed in private corporations and continue to play a role in public corporations, impacting up to 15% of them in recent years.[73] Among other functions, such agreements can determine votes for directorial positions, assign certain control rights (e.g., vetoes over major corporate actions), restrict share transfers to third parties, and waive aspects of the duty of loyalty.[74] Similarly, one might argue that shareholders "voluntarily" accept the terms of the charter (or the corporate constitution/articles of association, outside the U.S.).[75] However, while

[66] Goshen & Squire, *supra* note 5.
[67] KRAAKMAN ET AL., *supra* note 12.
[68] In this context, I am referring to the "coordination costs" as the "costs of collective decision-making". See *Id.*
[69] Anabtawi, *supra* note 22.
[70] ARROW, *supra* note 9.
[71] Infra Part II.
[72] Infra Part II.
[73] Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 YALE J. ON REG. 1124 (2021).
[74] *Id.*
[75] Henceforth, I will use the term "charter" to refer to the articles of association or the corporate constitution for non-U.S. jurisdictions.

multilateral contracts within corporations certainly occur, they typically require unanimous assent under contract law, limiting the scope of purely ex-ante solutions.[76]

Accordingly, incomplete contracting becomes central in explaining the costs of collective decision-making. Take, for instance, shareholder voting: Easterbrook and Fischel suggest that "voting exists in corporations because someone must have the residual power to act (or delegate) when contracts are not complete." [77] In this view, voting functions as a mechanism for settling issues unaddressed at the outset of the parties' relationship. Put differently, shareholders collectively wield control rights over certain corporate decisions and must decide ex-post how the firm should proceed—effectively "gap-filling" the incomplete (corporate) contract whenever unanticipated contingencies arise. However, unlike the simpler dyadic situation in which a single shareholder can exercise control based on her own preferences, the presence of multiple shareholders introduces an aggregation process that can create additional distortions. This reality calls for a paradigm shift in how corporate law should approach such conflicts. Furthermore, although shareholder voting might appear irrelevant in jurisdictions where a single controlling shareholder effectively dominates both the board of directors and the general shareholder meeting, many jurisdictions impose a "majority-of-the-minority" approval requirement on transactions involving controlling shareholders and the corporation.[78]

In the next Part, I propose a framework for examining the "microfoundations" of collective decision-making, emphasizing the economic frictions that emerge and showing how they diverge from a "first-best" counterfactual.[79] I then present a granular taxonomy of these collective decision-making costs, which lays the groundwork for a descriptive and normative account of corporate law that is not well explained by agency-cost theories.

III: The Costs of Collective Decision-Making

A. Shareholders and their Issue/Preference Space

As discussed in Section II, the costs of collective decision-making stem from the challenge of aggregating individual shareholder preferences into a single outcome that ostensibly reflects the group's will. However, unlike agency-cost theories—where one can typically envision a "first-best" contract for a bilateral relationship—the appropriate counterfactual for collective choice is far more elusive.[80] Indeed, Arrow's celebrated "impossibility theorem" demonstrates that no preference-aggregation method can define a social ordering while satisfying five fairness-related axioms: "unanimity, non-dictatorship, transitivity, range, and the independence of irrelevant alternatives".[81] In light of this, I propose a more modest counterfactual, analogous to the agency-cost paradigm, which aims to maximize the ex-ante joint surplus of corporate constituents who

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[76] Giuseppe Dari-Mattiacci, *The Theory of Business Organizations*, No. ID 3296232 (Dec. 2018).

[77] Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 THE JOURNAL OF LAW AND ECONOMICS 395 (The University of Chicago Press Jun. 1983); Hart, *supra* note 49.

[78] This measure ensures that minority shareholders retain a meaningful voice, thereby highlighting the continued importance of voting mechanisms in controlling-shareholder regimes. In the U.S. context, see *Kahn v. M & F Worldwide Corp.*, 88 A. 3d 635 (Supreme Court 2013). In the UK context, see *Smith v Croft (No 2)* [1987] 3 All E.R. 909 Ch D. More generally, see KRAAKMAN ET AL., *supra* note 12.

[79] By "microfoundations", I am referring to the individual-level behaviors and choices that, taken together, explain broader economic outcomes.

[80] A common counterfactual is the "Arrow–Debreu" scenario, in which contracting parties can identify and define all possible future events that might affect an individual's utility. They also contract on "state-contingent commodities"—goods treated as distinct commodities in each conceivable state of nature. See Kenneth J. Arrow & Gerard Debreu, *Existence of an Equilibrium for a Competitive Economy*, 22 ECONOMETRICA 265 ([Wiley, Econometric Society] 1954).

[81] Kenneth J. Arrow, *A Difficulty in the Concept of Social Welfare*, 58 JOURNAL OF POLITICAL ECONOMY 328 (The University of Chicago Press Aug. 1950).

choose to participate in a corporation under a given legal regime. Before turning to a taxonomy of collective decision-making costs, I introduce two conceptual tools—an "issue space" and a "preference space"—that will help capture the nature of shareholder disagreements.

a. Issue Space

To characterize the "differences in opinion" that can arise among shareholders of a corporation, we must first identify the subject matter of disagreement. In the literature, the topic of contention is often referred to as an "issue."[82] As in a polity, shareholders who hold heterogeneous preferences regarding a particular issue may vote differently, even if they share the same information and beliefs.[83] A voting rule then determines the "winners" of each vote, empowering them to represent the shareholders' collective decision on that issue.[84] Two aspects are particularly important in defining the "issue space," or the total set of possible issues: the number of potential issues and the scope of any given issue.

The number of potential issues in a corporation's day-to-day affairs can be immense, corresponding to unforeseen contingencies that were not prescribed at the outset. Where contracting is highly incomplete, a multitude of unanticipated situations may require ex-post "gap-filling" of the corporate contract. For example, disagreements might arise over whether a corporation should undertake additional equity financing—something not foreseen when the corporation was formed. Traditionally, managers hold control rights over such matters, enabling them to perform this gap-filling role.[85] Consequently, the extent of managerial control circumscribes the portion of the issue space in which shareholders may intervene.

As it can be difficult to delineate precisely where one issue ends and another begins, it is also important to recognize that any given issue can vary considerably in scope—and that altering its scope may, in turn, shift voting behavior. For example, consider a corporation's decision to fund environmentally friendly initiatives. Some shareholders, motivated by long-term brand reputation or pro-social commitments, may support these measures even if they reduce immediate shareholder returns.[86] Others, especially those with shorter investment horizons or more narrowly financial objectives, could oppose them.[87] Narrowing the issue (e.g., focusing on a specific waste-reduction practice that also benefits the corporation's short-term profits) might attract greater consensus, whereas a broader mandate for general emission reductions might alienate financially driven shareholders.[88] Similarly, expanding the scope of an issue can change how different shareholders weigh the potential costs and benefits. One shareholder might initially object to certain stances held by a prospective board candidate, yet still vote in favor of that candidate if other appealing positions are bundled into the same proposal.

As I will explain later, corporate and securities laws significantly shape both the number and scope of issues delegated to shareholders. Intuitively, when the costs of collective decision-making become substantial, narrowing the "issue space" can yield efficiency gains.

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[82] 100 JAMES M. BUCHANAN ET AL., THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (University of Michigan press 1965).

[83] Note that my framework presupposes the failure of the Fisher separation theorem. See IRVING FISHER, THEORY OF INTEREST: AS DETERMINED BY IMPATIENCE TO SPEND INCOME AND OPPORTUNITY TO INVEST IT (Augustusm Kelly Publishers, Clifton 1930).

[84] MUELLER, *supra* note 23.

[85] Infra Part IV.

[86] Bolton et al., *supra* note 15.

[87] *Id.*

[88] Roberto Tallarita, *Stockholder Politics*, 73 HASTINGS LAW JOURNAL 1697 (Aug. 2022).

b. Preference Space

For a given issue and a particular information set, each shareholder holds specific preferences regarding the collective decision.[89] To illustrate the potential scope of disagreement, scholars often use a spatial framework.[90] Imagine, for instance, that shareholders must decide how much the corporation should spend on climate reduction policies—hereafter, "green expenditures." In a simplified model, every shareholder is assigned an ideal point on a continuum of possible spending levels. A shareholder's utility then decreases the farther the corporation's final decision deviates from that ideal point, and increases the closer it aligns. Put differently, the more ideologically "similar" the collective decision is to a shareholder's preferred level of green expenditures, the greater utility she derives from it.[91]

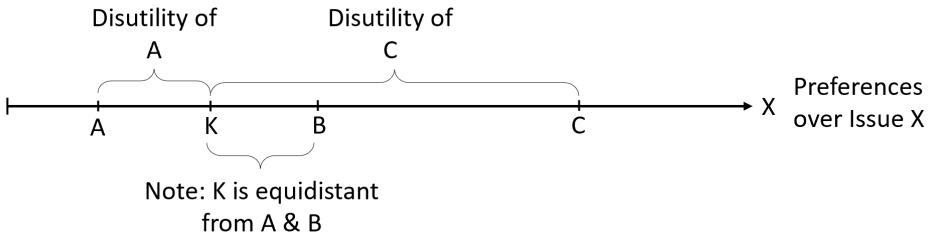


Figure 3

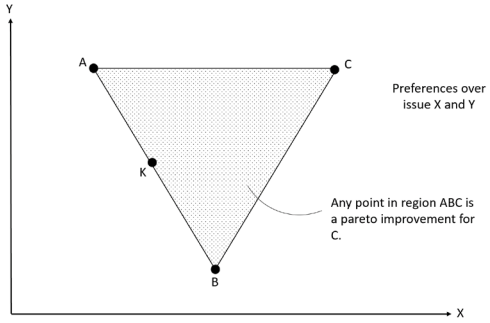
Figure 3 illustrates how majority rule can shape outcomes in a single-dimensional setting. Three shareholders—A, B, and C—must decide the corporation's green expenditures along a one-dimensional issue space. Under a majority vote, Shareholders A and B select point K, which is equidistant from each of their ideal points; as a result, they obtain the same level of utility. By contrast, C's ideal point lies much farther from K, leaving C with a considerably lower utility. This outcome demonstrates how majority rule can impose involuntary transfers that contribute to the costs of collective decision-making.[92] Meanwhile, Figure 4 shows a plausible preference space over two issues, X and Y, illustrating how these dynamics become more complex when decisions span multiple dimensions. [93]

[89] These preferences are exogenously given. The set of all relevant preferences over all possible issues is known as the "preference space".

[90] Anthony Downs, *An Economic Theory of Political Action in a Democracy*, 65 JOURNAL OF POLITICAL ECONOMY 135 (Apr. 1957).

[91] Keith T. Poole & Howard Rosenthal, *A Spatial Model for Legislative Roll Call Analysis*, 29 AMERICAN JOURNAL OF POLITICAL SCIENCE 357 ([Midwest Political Science Association, Wiley] 1985).

[92] Infra Part III, Section D.



[93]Figure 4:

While we have focused on how shareholders form preferences over a single issue, it is important to recognize that they often hold joint preferences across multiple issues.[94] Including more than one issue in a vote can alter voting behavior relative to a single-issue scenario. This phenomenon—commonly referred to as the problem of "multidimensionality"—can introduce intransitivity in collective preferences.[95] Returning to the earlier example of voting on green expenditures, consider adding another dimension, such as the corporation's spending on employee benefits. The possibility of tradeoffs between these two issues might lead a shareholder to choose a markedly different level of green expenditures than if that issue were decided in isolation.

B. A Taxonomy of the Costs of Collective Decision-Making

The costs of collective decision-making arise whenever individual shareholder preferences must be combined into a single outcome that ostensibly represents the group's will. Any distortions introduced by the aggregation mechanism—such as a voting rule—can reduce the shareholders' joint surplus and thus contribute to these costs. Building on this insight, I explore four critical frictions linked to collective decision-making: free-riding, rent-seeking, holdout, and indeterminacy.

a. Free-Riding Problems

One of the most salient contributors to the costs of collective decision-making is the free-rider problem—often referred to as a collective action problem. In the corporate context, free-riding arises because each shareholder personally bears the expense of governance activities (such as researching issues, monitoring managers, and voting), yet the resulting benefits are shared by all shareholders. As a result, no single shareholder has a sufficient incentive to invest optimally in such efforts, leading to systematic underinvestment in governance.[96] This phenomenon can be especially pronounced in diffusely held corporations, where scholars often describe shareholders as being "rationally apathetic."[97]

From a preference-aggregation perspective, free-riding distorts both voting behavior and governance outcomes in two main ways. First, in a voluntary voting system where absent shareholders are excluded, a "one share, one vote" rule may incentivize only larger shareholders to vote on issues, while smaller shareholders abstain because their individual stakes—and hence their benefits—are too small to justify the cost of voting. Second, when information is costly to obtain, many shareholders who do participate choose to vote uninformed or follow default recommendations (such as those from management or proxy advisory firms) instead of conducting their own research.[98] These search costs—the time and effort needed to clarify one's own preferences or investigate the proposals on the ballot—can themselves become a source of free-riding if other shareholders choose to rely on the informed votes of a few rather than invest in their own research.[99] Beyond voting itself, such "passive" shareholders are also unlikely to engage with managers or actively monitor the firm, assuming others will shoulder those costs. As a result,

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[94] William H. Riker, *Voting and the Summation of Preferences: An Interpretive Bibliographical Review of Selected Developments during the Last Decade*, 55 AMERICAN POLITICAL SCIENCE REVIEW 900 (Cambridge University Press 1961).
[95] Infra Part III, Section B.
[96] Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019).
[97] BERLE & MEANS, *supra* note 6.
[98] Mike Burkart & Samuel Lee, *One Share - One Vote: The Theory*, 12 REVIEW OF FINANCE 1 (Jan. 2008).
[99] Gilson & Gordon, *supra* note 95; Bebchuk & Hirst, *supra* note 95.

a smaller group of "activist" shareholders ultimately decides key governance matters on behalf of the entire shareholder base, undermining the goal of a genuinely representative collective choice.[100]

Crucially, the free-riding problem in governance stems from the fact that monitoring and similar activities function like public goods: they are non-rivalrous (one shareholder's monitoring efforts do not reduce the benefits available to others) and non-excludable (it is difficult, if not impossible, to prevent others from enjoying the improved governance that results).[101] Because these activities are both unobservable and unverifiable by third parties in many cases, shareholders cannot easily enter contracts that compel one another to invest in governance to a collectively optimal level. [102] Similarly, the process of information search—whether it involves revealing one's own ideal points or learning about other shareholders' preferences—can exhibit public-good aspects if shared, yet shareholders typically lack incentives to publicize costly findings.[103] Although the corporation's charter could, in theory, allocate monitoring duties or require specific levels of engagement, the real-world difficulty of measuring each shareholder's effort means such activities remain effectively non-contractible. [104]

Overcoming free-riding is sometimes possible if shareholders repeatedly interact over the long term, creating opportunities for cooperative behavior. One shareholder could "punish" others for shirking by withholding cooperation (e.g., by withdrawing shareholder support on other issues) in subsequent periods, which may, in principle, encourage higher levels of monitoring or engagement.[105] However, as Olson observes, this solution is more likely in smaller or more cohesive shareholder groups; in large, widely held corporations—where shareholder interests may also diverge—sustained cooperation is harder to achieve. [106]

b. Rent-Seeking Problems

Rent-seeking occurs when shareholders devote socially wasteful resources to secure or maintain their spot in a winning coalition. In a corporate context, these "rents" arise because certain voting rules can impose involuntary ex-post transfers of wealth or control. Under the majority rule, for instance, minority shareholders are susceptible to ex-post opportunism by the majority, which wields residual control rights over the issue at stake.[107] While involuntary transfers alone do not necessarily diminish efficiency, they do so when shareholders forgo relationship-specific investments—investments that cannot be fully recouped if repurposed elsewhere—out of fear that a future majority will capture much of the value created.[108] As Blair and Stout have noted, specialized infrastructure, machinery, or processes can be crucial to a firm's success; yet if dissenting shareholders anticipate having their returns expropriated, they will naturally scale back such investments.[109]

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[100] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2007–2008).
[101] MUELLER, *supra* note 23.
[102] Bengt Holmstrom, *Moral Hazard in Teams*, 13 THE BELL JOURNAL OF ECONOMICS 324 ([RAND Corporation, Wiley] 1982).
[103] Bebchuk & Hirst, *supra* note 95.
[104] Holmstrom, *supra* note 101.
[105] 124 MANCUR OLSON JR, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS, WITH A NEW PREFACE AND APPENDIX (Harvard University Press 1971).
[106] *Id.*
[107] Duncan Black, *On the Rationale of Group Decision-Making*, 56 JOURNAL OF POLITICAL ECONOMY 23 (Feb. 1948).Note also that I refer to such ex-post opportunism as "hold-up" costs. See Williamson, *supra* note 54.
[108] Blair & Stout, *supra* note 10.
[109] *Id.*

A key form of rent-seeking in this setting relates to "coalition-formation", which may involve side-deals, vote trading, or extensive negotiations that do nothing to enhance the firm's productive output. Instead, they represent an unproductive contest for private spoils. Drawing from public choice theory, Buchanan explains how groups vying for exclusive benefits often expend time and resources simply to capture rents, rather than generating new economic value.[110] In a corporate voting scenario, this results in a misallocation of resources: effort and capital that could be channeled into improving the company's products or strengthening long-term strategy are instead wasted on jockeying for control.

Rent-seeking distorts preference aggregation by encouraging strategic rather than sincere voting.[111] Some shareholders may vote for measures they do not genuinely support if doing so secures them a position in the winning coalition. Others might withhold legitimate objections if they stand to gain side-benefits from cooperating. Consequently, the collective decision can deviate significantly from the preferences of the average or median shareholder, reflecting instead a patchwork of concessions and side payments negotiated out of view.[112]

The example in Figure 3 illustrates this dynamic, where shareholders A, B, and C vote on the corporation's "green expenditures" under a majority rule. By adopting point K, which lies between A's and B's ideal points, A and B effectively force an involuntary transfer of ex-post economic wealth from C to themselves. Neither A nor B finds K completely satisfactory, yet both accept it to ensure that C's interests are marginalized. Either shareholder could still strive for an even more favorable outcome, but that effort would entail further bargaining costs and coalition reshuffling—further hallmarks of rent-seeking behavior that detract from overall efficiency.

c. Holdout Problems

Beyond the efficiency losses tied to involuntary wealth transfers under certain voting rules, another significant category of costs in collective decision-making involves holdout problems. Unlike rent-seeking—which typically arises when a majority exploits minority shareholders—holdout problems can surface even when all shareholders would otherwise gain from a proposed decision. In these scenarios, a shareholder with pivotal voting power refuses to grant consent until she secures a larger share of the ex-post surplus, leveraging the threat that, without her vote, the proposal (and the benefits it would provide) fails entirely.

Much like rent-seeking, holdout behavior reflects strategic rather than sincere voting—thereby distorting preference aggregation.[113] A holdout shareholder might even oppose her own ideological stance if doing so enhances her ultimate payoff. On the one hand, this strategy may yield outsized gains for the holdout at the expense of other shareholders. On the other, pushing too far risks derailing negotiations, thereby nullifying any prospective gains for everyone involved (including the holdout). For holdout problems to arise, certain economic frictions must increase the expected return from withholding consent above the expected losses from a failed agreement. Scholars such as Miceli and Kathleen, Shavell, and Menezes and Pitchford have identified factors—ranging from

[110] James M. Buchanan, *Rent Seeking, Noncompensated Transfers, and Laws of Succession*, 26 THE JOURNAL OF LAW AND ECONOMICS 71 (Apr. 1983).
[111] David P. Myatt, *On the Theory of Strategic Voting*, 74 THE REVIEW OF ECONOMIC STUDIES 255 (Jan. 2007).
[112] MUELLER, *supra* note 23.
[113] Scott Duke Kominers & E. Glen Weyl, *Holdout in the Assembly of Complements: A Problem for Market Design*, 102 AMERICAN ECONOMIC REVIEW 360 (American Economic Association 2012).

information asymmetries to the complementarity of votes and the time costs of bargaining—that can tip the balance in favor of holdout tactics.[114]

Because the holdout problem can block beneficial decisions, it helps explain why most corporations avoid unanimity rules. While unanimity would in theory guarantee Pareto-efficient outcomes (protecting each shareholder from ex-post expropriation), it also vastly increases the power of any single dissenter to stall or veto projects that might otherwise enjoy wide support.[115] Consequently, corporations frequently opt for lower voting thresholds—such as majority or supermajority rules—even though these carry the risk of rent-seeking problems which threaten minority shareholder interests. This trade-off illustrates the tension between safeguarding individual shareholders from opportunism and mitigating the danger that a solitary participant could hold the enterprise hostage.

d. Indeterminacy Problems

Indeterminacy problems arise when the preferences of shareholders, taken as a whole, cannot be coherently expressed as a single collective will. Unlike free-riding, rent-seeking, or hold-out problems which generally assume that a stable collective preference ordering exists, indeterminacy recognizes that no such ordering may be achievable.[116] A central reason for this is the possibility of intransitive collective preferences: under certain configurations, a group may cyclically prefer option X to Y, Y to Z, and Z to X, making it impossible to select a winner without resorting to an arbitrary tiebreaker or an external agenda.

Consider three shareholders—A, B, and C—choosing among three CEO candidates, X, Y, and Z. As shown in Table 1, Shareholder A prefers X to Y, Y to Z, and thus X to Z; Shareholder B prefers X to Y but Z to both X and Y; and Shareholder C prefers Y to X, Y to Z, and thus Y over both alternatives. Under a majority-vote system with pairwise comparisons, this configuration produces a cycle. In a head-to-head vote between X and Y, A and B favor X; between X and Z, B and C favor Z; and between Z and Y, A and C favor Y. Because each new matchup yields a different "winner," no single candidate can be chosen in a non-arbitrary manner under the majority rule.

Voters	Issues			
	X	Y	Z	X
1	>		>	<
2	>		<	>
3	<		>	>
Collective	>		>	>

Table 1

Table 1 captures these preferences in a concise form, revealing that the group "prefers" X to Y, Y to Z, and Z to X. Such a cycle is an example of intransitive collective preferences, meaning there is no stable outcome. In practice, this can lead to "endless cycling," preventing the shareholders from making a definitive selection.

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[114] Thomas J. Miceli & Kathleen Segerson, *Land Assembly and the Holdout Problem Under Sequential Bargaining*, 14 AM LAW ECON REV 372 (Oxford Academic Dec. 2012); Steven Shavell, *Eminent Domain versus Government Purchase of Land given Imperfect Information about Owners' Valuations*, 53 THE JOURNAL OF LAW AND ECONOMICS 1 (The University of Chicago Press 2010); Flavio Menezes & Rohan Pitchford, *A Model of Seller Holdout*, 24 ECONOMIC THEORY 231 (Springer 2004).
[115] Infra Part IV. See Milton Harris & Artur Raviv, *Corporate Governance: Voting Rights and Majority Rules*, 20 JOURNAL OF FINANCIAL ECONOMICS 203 (Jan. 1988).
[116] Alan D. Miller, *Voting in Corporations*, 16 THEORETICAL ECONOMICS 101 (Wiley Online Library 2021).

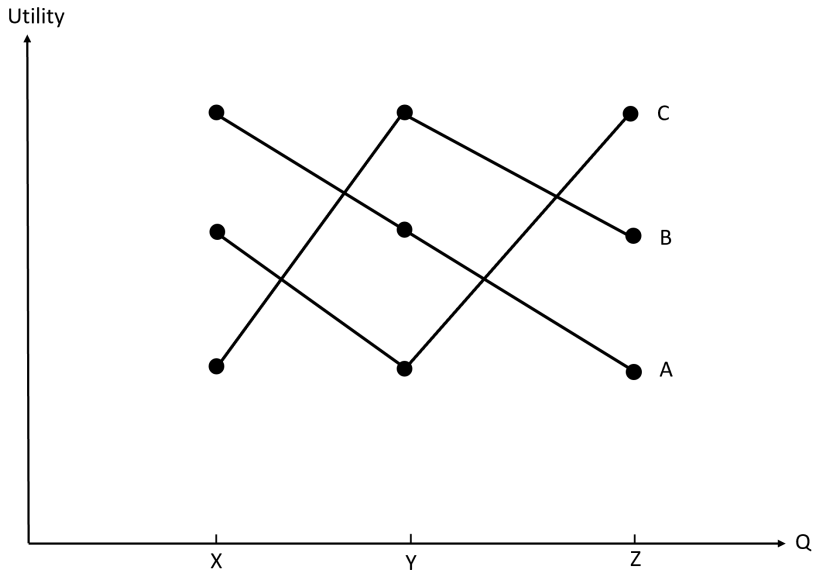

Figure 5

While Table 1 deals with three distinct options, the same principles apply to scenarios involving levels of corporate expenditures, such as the "green expenditures" example depicted in Figure 5. Suppose X, Y, and Z represent increasing amounts of spending (Z > Y > X) on green expenditures. In that case, Shareholder A's ideal point is the lowest level, X, and Shareholder C's ideal point is the middle level, Y. Both shareholders thus hold single-peaked preferences. By contrast, Shareholder B prefers X to Y and Z to Y, meaning B's least-preferred option is the median level, Y—an example of multi-peaked preferences. Multi-peaked preferences can arise in contexts such as "winner-takes-all" patent races, where a shareholder might favor either a large-scale R&D investment or none at all, rather than a middle path.

From a theoretical standpoint, single-peaked preferences eliminate voting cycles for a single issue, as shown in Black's classic result: under majority rule, the collective choice converges on the median voter's ideal point.[117] Unfortunately, this condition does not suffice when shareholders hold preferences over multiple issues or when the scope of an issue expands. Even if each individual issue inspires single-peaked preferences, combining issues can reintroduce cycles. Plott, for instance, demonstrates that a majority-rule equilibrium which eliminates cycles often requires extremely restrictive conditions—such as when satisfying one voter's interest invariably harms another.[118]

These constraints on voter preferences have led many commentators to call cycles "surprising and disconcerting."[119] Yet research also shows that cycling becomes less likely if enough voters share similar preferences. Niemi, for example, observes that the probability of cycling declines as single-peaked preferences become more common, and Gehrlein and Fishburn similarly find that the incidence of cycles falls when voters hold more homogeneous interests.[120] Weber's analysis, meanwhile, indicates that limiting the number of alternatives on the ballot further reduces the risk

[117] Black, *supra* note 106.
[118] Charles R. Plott, *A Notion of Equilibrium and Its Possibility Under Majority Rule*, 57 THE AMERICAN ECONOMIC REVIEW 787 (American Economic Association 1967).
[119] MUELLER, *supra* note 23.
[120] Richard G. Niemi, *Majority Decision-Making with Partial Unidimensionality**, 63 AMERICAN POLITICAL SCIENCE REVIEW 488 (Cambridge University Press Jun. 1969); William V. Gehrlein & Peter C. Fishburn, *Condorcet's Paradox and Anonymous Preference Profiles*, 26 PUBLIC CHOICE 1 (Springer 1976).

of cycling.[121] Still, corporate law and governance literature has paid relatively little attention to the real-world implications of intransitive preferences in firms, though it has long recognized the theoretical potential for cycles.[122]

Where intransitive preferences do arise, it is not immediately clear that "cycling" *per se* must produce direct inefficiencies—especially when the corporation simply alternates among winning candidates or policies. However, in many settings, stable long-term decisions yield distinct advantages that endless switching cannot capture. One example is a corporation's commitment to a particular supplier, where ongoing relationships generate tangible benefits.[123] If shareholders persistently cycle among different suppliers, any advantages of establishing a reliable partnership disappear. Here, the cost of cycling takes the form of forgone efficiencies from stable collective choices.

An even more profound risk emerges from agenda-setting. McKelvey's theorem shows that, in the presence of intransitive preferences, a strategic agenda-setter can maneuver the group toward nearly any outcome.[124] In most corporations, managers act as the de facto agenda-setters by virtue of deciding which proposals reach a shareholder vote and which ones remain off the ballot.[125] They may use this power to select (or exclude) proposals that serve their personal interests, a tactic that can magnify traditional agency costs. If managers also hold shares themselves, their ideologically driven preferences can similarly distort outcomes at the expense of other investors, compounding holdout or rent-seeking problems.

Even well-intentioned managers who seek to avoid cycles can introduce inefficiencies. By dividing decisions into single-issue votes, they may prevent the shareholders' joint preferences from being expressed in a cohesive manner. As Slutsky explains, such an approach can suppress legitimate trade-offs across different dimensions.[126] In the end, the corporation might achieve a form of stability, but only by disregarding important interactions among issues—thereby sacrificing efficiency in the process.

IV: Corporate Law and the Costs of Collective Decision-Making: A Descriptive Account

In Part III, I introduced various economic frictions among shareholders arising from the difficulty of aggregating their preferences. Because these frictions deviate from a "first-best" scenario, it follows that if corporate law truly responds to economic incentives, it should address not only agency costs but also the distinct costs of collective decision-making. How does it do so? In this Part, I provide three examples showing how corporate law responds to these collective frictions in ways that traditional agency-cost theories do not fully capture.

A. Voting and Participation Rules

Although agency-cost theories are adept at analyzing information asymmetry in bilateral contexts, they struggle to account for voting and participation rules in corporate law. For instance, while a

[121] James S. Weber, *An Elementary Proof of the Conditions for a Generalized Condorcet Paradox*, 77 PUBLIC CHOICE 415 (Oct. 1993).
[122] HANSMANN, *supra* note 19.
[123] Gharad Bryan et al., *Commitment Devices*, 2 ANNUAL REVIEW OF ECONOMICS 671 (2010).
[124] Richard D McKelvey, *Intransitivities in Multidimensional Voting Models and Some Implications for Agenda Control*, 12 JOURNAL OF ECONOMIC THEORY 472 (Jun. 1976).
[125] Infra Part IV.
[126] Steven Slutsky, *A Voting Model for the Allocation of Public Goods: Existence of an Equilibrium*, 14 JOURNAL OF ECONOMIC THEORY 299 (Apr. 1977).

voting rule aims to consolidate individual shareholder preferences into a single outcome that presumably represents the collective will, agency-cost theories offer little insight into why disagreements should be resolved via majority rule.[127] Indeed, even under an expanded view of agency costs, one might expect unanimous consent to be optimal: it would reduce ex-post opportunism and involuntary wealth transfers by requiring every shareholder's agreement before the corporation undertakes any action.

At first glance, unanimous agreement appears optimal, as it is the only voting rule that guarantees a Pareto-efficient outcome.[128] Indeed, minority shareholders' "veto rights" can be viewed as applying unanimity to specific issues, requiring the non-exercise of those rights—and thus every shareholder's assent—before the corporation proceeds. Owing to these efficiency advantages, unanimous decision-making has found many scholarly supporters. Wicksell, for instance, endorsed unanimity on the grounds that it would protect individuals from coercion by the rest of the community. [129]

Despite unanimity's theoretical appeal for ensuring Pareto efficiency, most corporate law regimes default to majority rule on numerous matters. In many jurisdictions, board elections hinge on majority votes, and in the U.S., most large companies use majority voting to appoint and dismiss directors.[130] In the UK, a majority of shareholders holds a non-waivable right to remove directors at any time, regardless of cause or term length.[131] Likewise, shareholder ratification of conflicted transactions in both the U.S. and UK typically follows majority-rule procedures;[132] where shareholder votes on executive pay are allowed, the rule is often majority-based as well.[133] Even when majority rule does not apply, unanimity seldom appears. Instead, supermajority thresholds of two-thirds or 75 percent are common for fundamental corporate changes, such when amendments of a company's charter in the UK are concerned.[134]

A collective decision-making framework explains why the unanimity rule is often unworkable. In principle, unanimity suffers from significant free-riding and holdout problems. Regarding free-riding, scholars note that achieving a Pareto-efficient agreement (through a tâtonnement process, for example) can be extremely time-consuming in large, diverse groups.[135] As mentioned, the high costs of gathering information—which reflect the opportunity costs of each shareholder's time and effort—create free-riding problems, in which no individual shareholder has sufficient motivation to invest in becoming well-informed.[136] At the same time, unanimity also invites strategic behavior akin to holdouts: any friction in the bargaining process gives a shareholder reason to leverage her pivotal vote to secure a disproportionate share of gains while minimizing the benefits for others.[137]

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[127] Notably, Kraakman and colleagues link the existence of voting rules (like the majority rule) to "information and coordination costs," yet do not clarify what those costs entail. KRAAKMAN ET AL., *supra* note 12.
[128] KNUT WICKSELL, FINANZTHEORETISCHE UNTERSUCHUNGEN: NEBST DARSTELLUNG UND KRITIK DES STEUERWESENS SCHWEDENS (G. Fischer 1896); Black, *supra* note 106.
[129] WICKSELL, *supra* note 127.
[130] In the UK, see Art. 20 of Schedule 3, Companies (Model Articles) Regulations 2008. In the U.S., see Stephen J. Choi et al., *Does Majority Voting Improve Board Accountability?*, 83 THE UNIVERSITY OF CHICAGO LAW REVIEW 1119 (The University of Chicago Law Review 2016).
[131] See Sections 168 and 303 of the Companies Act 2006.
[132] For the U.S., see § 144 Del. Code Ann. tit. 8 (2022). For the UK, see Art. 70 of Schedule 3, Companies (Model Articles) Regulations 2008.
[133] KRAAKMAN ET AL., *supra* note 12.
[134] See Section 21 of the Companies Act 2006.
[135] 100 BUCHANAN ET AL., *supra* note 81.
[136] Supra Part III.
[137] Supra Part III.

Although the costs of majority versus unanimity rules ultimately depend on empirical evidence, majority rule is generally expected to yield lower collective decision-making expenses. As Kominers and Weyl note, a key insight is that the majority rule limits any individual shareholder's ability to engage in rent-seeking or holdout behavior.[138] For example, in a corporation with five shareholders, a single strategic actor operating under unanimity could block the entire surplus—even if the other four vote sincerely. Under majority rule, however, that same shareholder would be unable to derail the collectively beneficial outcome. A more pronounced example occurs when a single shareholder—such as a controlling shareholder or a dual-class share controller—possesses over 50% of the voting power, effectively eliminating the minority's scope for rent-seeking or holdout altogether.

To illustrate the rationale behind supermajority rules, imagine a variant of majority voting where the percentage of shareholders required for passage can range from 0 to 100. Starting with a simple majority, raising this threshold above 50 percent reduces the likelihood of rent-seeking, as fewer shareholders will expect to profit from ex-post opportunism. However, this same adjustment also heightens each individual shareholder's leverage in shaping the collective outcome, thereby increasing incentives to "hold out."[139] While many scholars endorse majority rule for striking a reasonable balance between these opposing costs, [140] supermajority rules can better accommodate contexts where rent-seeking risks loom larger than holdout concerns—such as situations in which a bare majority might amend the corporate charter to forcibly acquire minority shares.[141] Here, the risks of minority shareholder expropriation outweigh any potential benefit of an individual's ability to "hold out," making a higher threshold a more attractive safeguard.

Furthermore, although adopting a majority rule can lead to intransitive collective preferences, economic theory suggests that no cycle will arise if a majority of voters share the same preferences, a condition met when a controlling shareholder is in place. Independently of political-economy theories of corporate law,[142] this insight helps explain why jurisdictions with dominant shareholders or stable coalitions of blockholders, such as France, Italy, and Brazil, generally rely on a majority voting rule for a broad array of corporate matters.[143] For example, these legal frameworks often permit directors to be dismissed without cause by a simple majority vote.[144]

Finally, a theory of collective decision-making costs also sheds light on participation rules designed to counter free-riding in modern corporations with multiple shareholders. In contrast, agency cost theories do little to explain the existence of these rules. As Kraakman et al. observe, corporate law employs a variety of mechanisms to circumvent free-riding problems.[145] In particular, small shareholders can minimize voting costs through four main avenues: mail-in or distant voting, proxy solicitation by corporate partisans, proxy voting via institutional investors or other intermediaries, and participation in electronic meetings.[146] France, Germany, Italy, and the UK all permit remote voting, and—following the EU Shareholder Rights Directive—have extended this

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[138] Kominers & Weyl, *supra* note 112.
[139] A similar logic applies when the threshold falls below 50 percent.
[140] BUCHANAN ET AL., *supra* note 81.
[141] See *Brown v British Abrasive Wheel Co* [1919] 1 Ch. 290 Ch D. and *Sidebottom v Kershaw, Leese & Co Ltd* [1920] 1 Ch. 154 CA.
[142] Mariana Pargendler, *The Grip of Nationalism on Corporate Law*, 95 IND. L.J. 533 (2020).
[143] KRAAKMAN ET AL., *supra* note 12.
[144] Indeed, these efficiency gains which arise from controlling ownership (i.e., the reduction of indeterminacy costs and the foreclosure of holdout and rent-seeking costs) are often ignored by the prevailing scholarship in corporate law and governance, which tends to focus on the controlling shareholder's private benefits from control and the reduction of managerial-shareholder agency costs. See Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARVARD LAW REVIEW 1641 (The Harvard Law Review Association 2006).
[145] KRAAKMAN ET AL., *supra* note 12.
[146] *Id.*

allowance to electronic meetings and voting as well.[147] In the U.S., the longstanding reliance on proxy voting has evolved to encompass electronic forums for shareholder communication, alongside online proxy solicitation and appointment.[148] Meanwhile, the SEC's informal stance that investment funds have a fiduciary duty to vote in their beneficiaries' best interests—combined with rules mandating disclosure of voting decisions—effectively compels mutual funds to cast votes on all shares, thereby boosting institutional investor participation in corporate elections.[149]

B. Centralization of Power within the Board

Agency-cost theories also struggle to explain why most jurisdictions concentrate a corporation's decision-making authority in the board of directors, even though this can magnify agency costs. As Kraakman and colleagues note, the majority of business corporations worldwide delegate nearly all decisions—aside from the most fundamental—to the board.[150] This insight dates back at least to Berle and Means, who highlighted the benefits of separating ownership and control.[151] While scholars such as Blair and Stout, and Rajan and Zingales have argued that centralizing authority in a mediating board can encourage relationship-specific investments among multiple parties and limit the "wasteful shirking and rent-seeking" inherent in collective activity,[152] a theory of collective decision-making costs further illuminates which issues shareholders are allowed to control (for instance, the power to remove directors or vote on mergers) and, by extension, which matters are more efficiently handled by the board.

In most jurisdictions, shareholders may only vote on matters that involve fundamental changes to the risks and returns of their investment, while issues falling under the board's authority seldom go to a shareholder vote.[153] Moreover, in the U.S., corporate and securities laws often grant managers broad discretion to exclude proposals encroaching on their managerial powers,[154] and directors' decisions are typically protected by the "business judgment rule," making them difficult for shareholders to challenge.[155] In the UK, controlling shareholders who exert overt control risk being classified as "de facto" or "shadow" directors.[156] However, from an agency-cost perspective, one would expect that as the corporation's nominal "owners," shareholders should be able to override board decisions in areas under directorial purview, thereby reducing directorial–shareholder agency costs.

Under a collective decision-making framework, delegating authority to a board arises naturally once we recognize how the law can narrow the scope of issues that shareholders must jointly resolve. By circumscribing the "issue space", corporate law reduces the dimensionality of the problems shareholders face. If shareholders could vote on a wide range of matters, each issue would be subject to the free-riding, rent-seeking, holdout, and indeterminacy problems described earlier in Part II. Nevertheless, this does not mean shareholders should relinquish all control rights.

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[147] See, for instance, Art. L. 225- 107 Code de commerce (France), Art. 2370(4) Civil Code and Art. 127 Consolidated Act on Financial Intermediation (Italy) and Art. 8 Directive 2007/ 36/ EU, 2007 O.J. (L 184) 17. (Europe).
[148] See Rule 402.04(A) Listed Company Manual of the New York Stock Exchange and Rules 4350(g) and 4360(g) of the NASDAQ Marketplace Rules.
[149] Infra Part V, Section B.
[150] In the U.S., see § 141(a) Del. Code Ann. tit. 8 (2022). In the UK, see Art. 3 of Schedule 1, Companies (Model Articles) Regulations 2008, and Art. 3 of Schedule 3, Companies (Model Articles) Regulations 2008. See also KRAAKMAN ET AL., *supra* note 12.
[151] BERLE & MEANS, *supra* note 6.
[152] Blair & Stout, *supra* note 10; Rajan & Zingales, *supra* note 58.
[153] KRAAKMAN ET AL., *supra* note 12.
[154] Rule 17 C.F.R. § 240.14a-8(i)(7).
[155] *Kamin v. Am. Express*, 383 N.Y.S. 2 (Sup. Ct. 1976).
[156] *Re Hydrodam (Corby) Ltd (In Liqudiation)* [1994] 2 B.C.L.C. 180 Ch D

They remain justified so long as the costs of collective decision-making for a given issue are lower than the agency costs of leaving that issue entirely to the board.

Shareholders often have joint preferences across multiple issues when those issues come to a vote.[157] In practice, two core themes underlie how corporate law narrows the "issue space" available for shareholder decision-making. First, corporate law tends to focus shareholder votes on matters linked to financial outcomes. For instance, in the U.S., shareholders may only ratify a relatively narrow range of fundamental decisions, such as charter amendments and mergers,[158] while in the UK, the general meeting is authorized to approve dividend distributions.[159] Because most shareholders are primarily concerned with their financial returns,[160] this focus on pecuniary matters reduces the diversity of shareholder preferences and thus the dimensionality of the issue space. Second, by limiting the number and scope of issues subject to a vote, corporate law constrains the preference interactions that might produce collective intransitivity—and thus indeterminacy costs. Of course, matters like charter amendments can still generate significant divergences between managerial and shareholder interests. As a result, the issues on which shareholders may exercise their decision rights reflect a balance between minimizing the costs of collective decision-making and mitigating directorial–shareholder agency costs.

A collective decision-making framework is also able to clarify why some shareholder votes are merely precatory—that is, non-binding on the corporation. In the U.S., for example, many proposals introduced by shareholders focus on environmental or social issues, which often entail multidimensional preferences among shareholders.[161] By keeping these votes advisory rather than binding, corporate law reduces the potential costs associated with unrepresentative outcomes on such inherently diverse matters.

C. Restrictions on Share Transfers

Finally, agency-cost theories offer only a partial explanation for one of the corporation's defining attributes: transferable shares. As Kraakman et al. note, the ability to freely transfer ownership is a central feature that sets the business corporation apart from partnerships and other standard-form legal entities.[162] Indeed, in most jurisdictions, at least one class of corporation is permitted to trade shares without restriction in public markets, ensuring that share ownership can change hands easily and efficiently.[163]

From an agency-cost perspective, hostile takeovers serve as the primary rationale for transferable shares. The ability to sell stock without restriction enables the replacement of existing shareholders with a new shareholder more adept at overseeing management. In this view, unimpeded transfer rights pave the way for hostile acquisitions in which dispersed investors in a poorly managed firm can sell their shares to a single, engaged buyer who holds a strong financial stake in boosting managerial efficiency. The possibility—or mere threat—of this takeover acts as a powerful disciplinary mechanism for management.[164] These transfer rights also benefit widely held

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[157] Supra Part III.
[158] § 144 Del. Code Ann. tit. 8 (2022).
[159] Art. 70 of Schedule 3, Companies (Model Articles) Regulations 2008.
[160] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (Harvard university press 1996); HANSMANN, *supra* note 19.
[161] See generally Rule 17 C.F.R. § 240.14a-8.
[162] KRAAKMAN ET AL., *supra* note 12.
[163] *Id.*
[164] Michael S. Weisbach, *Corporate Governance and Hostile Takeovers*, 16 JOURNAL OF ACCOUNTING AND ECONOMICS 199 (Elsevier 1993); Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 THE REVIEW OF FINANCIAL STUDIES 783 (Feb. 2009).

shareholders by providing a continuous evaluation of managerial performance via share prices. Consequently, agency-cost theorists advocate mandatory disclosure to bolster this "exit" strategy, ensuring both current shareholders and potential bidders have transparent information about the firm's performance under its present leadership.

In practice, however, this narrative often fails to materialize. For example, U.S. corporate law generally permits boards to implement "poison pills," or shareholders' rights plans, which set a relatively low ownership threshold (say, 10 percent).[165] Once crossed, other shareholders (but not the acquirer) can buy additional shares in the target or the acquirer on favorable terms, diluting the acquirer's stake so severely that buying more stock becomes prohibitively expensive. Because boards can adopt a poison pill quickly—even if one is not already in place—commentators have noted that they can effectively "just say no" to would-be acquirers.[166]

Although other explanations (such as those related to long-term investment commitments) certainly exist,[167] a collective decision-making framework offers a relatively more compelling justification for poison pills and other limitations on share transfers—whether to particular individuals or subject to approval by existing shareholders. Under this view, collective decision-making costs manifest as rent-seeking behavior, insofar as potential acquirers can capitalize on ex-post opportunism at the expense of shareholders who choose not to sell. In a regime of unconstrained transferability, shareholders who retain their stakes cannot anticipate the identities of future acquirers. Furthermore, because corporate contracts are inevitably incomplete, those shareholders may never have consented to the policies these acquirers ultimately implement—policies that could involve involuntary wealth transfers. Likewise, rules governing "freeze-out" mergers similarly aim to mitigate these collective decision-making frictions.[168]

V: Corporate Law and the Costs of Collective Decision-Making: A Normative Account

Although much of Part V applies a collective decision-making framework to explain corporate law descriptively, this theory also carries normative implications for potential legal reforms. In what follows, I offer two proposals for how corporate law might be restructured in light of these insights.

A. Agenda Setting and the Multidimensionality of Issues

As discussed earlier in Part IV, Section B, shareholders generally only vote on matters involving fundamental changes to their risks and returns, while the board retains authority over most other decisions. Closely tied to this division of powers is agenda-setting: determining which of the shareholder-circumscribed issues actually come to a vote. In the U.S., for instance, shareholders may ratify major corporate actions like mergers or charter amendments but typically lack the power to initiate them.[169] By contrast, in places like the UK, various European jurisdictions, and Japan, qualified shareholder majorities can propose resolutions on similar matters.[170] This divergence prompts a normative question: Is the U.S. model of agenda-setting ideal, or might corporate law be improved by adopting approaches from other jurisdictions?

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[165] *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985)

[166] Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001–2002).

[167] Dari-Mattiacci, *supra* note 75.

[168] *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)

[169] § 242(b)(1) Del. Code Ann. tit. 8 (2022), § 251(b) Del. Code Ann. tit. 8 (2022).

[170] In the UK, see Section 303 of the Companies Act 2006.

Building on the discussion above, McKelvey's analysis underscores how managers can exploit agenda-setting when shareholder preferences are intransitive (and thus indeterminate), using their control over the voting process to favor proposals that align with their personal interests.[171] This dynamic magnifies existing agency costs and, if managers also own shares, can further distort outcomes through rent-seeking or holdout behavior. A telling example concerns "say on pay" proposals, where managers may convene a specially formed compensation committee to advance proposals beneficial to themselves.[172] Even if one argues that such committees possess superior information compared to an uninformed shareholder base, the inherent conflict of interest here poses a greater threat than the risk of uninformed voting—particularly given the rise of proxy advisory firms and institutional investors who pool information across multiple corporations.[173] Consequently, there is a compelling argument for expanding shareholder rights by allowing them to set the agenda for such decisions.

In a collective decision-making framework, the key point is that any expansion of shareholder agenda-setting rights should remain limited to the kinds of issues shareholders have traditionally voted on in most corporate law jurisdictions. As elucidated earlier, these typically align with shareholder pecuniary interests and are narrowly defined to avoid multidimensional preferences. However, recent SEC regulatory developments have moved in the opposite direction. Historically, the SEC has allowed board members to exclude "significant social policy" proposals deemed "[in]sufficiently significant in relation to the company," as well as those mandating specific time frames or methods for addressing complex matters—deeming such proposals "too complex for shareholders as a group to make an informed judgment."[174]

In November 2021, the SEC rescinded these bulletins in Staff Bulletin No. 14L ("SLB 14L"), reversing its approach to "significant social policy issues" under the "ordinary business" exclusion.[175] The SEC announced that proposals "seeking detail or seeking to promote timeframes or methods do not per se constitute micromanagement."[176] For instance, any proposal requesting that a company adopt time frames or targets to address climate change would now be considered non-excludable. Observers widely viewed this policy shift as substantially expanding shareholder voice, leading to more environmental and social issues either appearing on company proxy statements or ending in negotiated settlements.[177] However, given that environmental and social questions often involve non-pecuniary trade-offs and myriad dimensions, many scholars regard them as "multidimensional" issues that elevate the costs of collective decision-making.[178] Indeed,

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[171] McKelvey, *supra* note 123.
[172] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111- 203, § 951, 124 Stat. 1376, 1899 (2010). See also Securities Exchange Act of 1934 § 14A, 15 U.S.C. § 78n-1, and 17 C.F.R. § 240.14a-21.
[173] Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance*, 97 CORNELL L. REV. 1213 (2011–2012).
[174] *SEC.Gov | Shareholder Proposals: Staff Legal Bulletin No. 14I (CF)*, https://www.sec.gov/rules-regulations/staff-guidance/staff-legal-bulletins/shareholder-proposals-staff-legal-bulletin-no-14i-cf?; *SEC.Gov | Shareholder Proposals: Staff Legal Bulletin No. 14J (CF)*, https://www.sec.gov/rules-regulations/staff-guidance/staff-legal-bulletins/shareholder-proposals-staff-legal-bulletin-no-14j-cf?; *SEC.Gov | Shareholder Proposals: Staff Legal Bulletin No. 14K (CF)*, https://www.sec.gov/rules-regulations/staff-guidance/staff-legal-bulletins/staff-legal-bulletin-14k-shareholder-proposals?
[175] *SEC.Gov | Shareholder Proposals: Staff Legal Bulletin No. 14L (CF)*, https://www.sec.gov/rules-regulations/staff-guidance/staff-legal-bulletins/shareholder-proposals-staff-legal-bulletin-no-14l-cf?
[176] *Id.*
[177] Colin Diamond et al., *SEC's New Approach to No-Action Requests for Shareholder ESG Proposals*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Dec. 4, 2021), https://corpgov.law.harvard.edu/2021/12/04/secs-new-approach-to-no-action-requests-for-shareholder-esg-proposals/.
[178] Tallarita, *supra* note 87; Zytnick, *supra* note 15.

a recent study indicates that following the introduction of SLB 14L, the influx of newly permissible proposals coincided with a sharp decline in their average level of shareholder support.[179]

B. Mandatory Voting

As noted in Part I, shareholder conflicts have become more prominent in recent years alongside the rise of institutional ownership with sizable blockholdings. Historically, in jurisdictions such as the U.S. or the UK—where shareholdings were widely dispersed—retail investors typically remained rationally passive due to persistent free-riding problems, making the primary conflict that between the board and shareholders.[180] Conversely, in concentrated-ownership jurisdictions, a controlling shareholder typically exerted decisive influence over both the board of directors and the general shareholder meeting, making the principal conflict one between majority and minority shareholders.[181] With the rise of institutional investing,[182] however, significant (non-controlling) blockholders now have stronger incentives to vote and lobby against each other—bringing the costs of collective decision-making squarely into focus.

There is considerable debate in the literature about whether institutional investors are truly "well equipped to represent the interests of shareholders as a class." [183] Nonetheless, recent empirical work shows that many institutional investors in the U.S. do, in fact, participate in shareholder votes.[184] As Lund notes, this participation may have been spurred by the SEC's informal stance that investment funds have a fiduciary duty to vote in their beneficiaries' best interests, coupled with a rule requiring fund advisors to disclose both their votes and voting policies.[185] That rule was widely interpreted as obliging mutual funds to vote on all shares in their portfolios, thereby boosting institutional investor engagement in corporate elections. Furthermore, while some scholars argue that passive index fund managers lack sufficient incentives for informed voting, prevailing empirical evidence suggests that even passive investors cast their votes with the goal of improving corporate performance.[186] This dynamic is further supported by a robust ecosystem of proxy advisory services, which reduce the information-gathering costs for otherwise uninformed voters.[187]

In the UK, a different approach emerged with the introduction of the "Stewardship Code," a non-mandatory framework aimed at enhancing asset managers' accountability over their voting practices.[188] Unlike the U.S. model, however, UK asset managers need only "comply or explain" rather than face explicit mandates. However, empirical evidence for the Code's effectiveness

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[179] Kenneth Khoo & Roberto Tallarita, *Expanding Shareholder Voice: The Impact of SEC Guidance on Environmental and Social Proposals*, No. 4913660 (Jul. 2024).
[180] Oliver D. Hart, *On Shareholder Unanimity in Large Stock Market Economies*, 47 ECONOMETRICA 1057 ([Wiley, Econometric Society] 1979).
[181] Gilson, *supra* note 143.
[182] Gilson & Gordon, *supra* note 95.
[183] G. P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE (Oxford University Press Jul. 1996); Dorothy S. Lund, *The Case against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2017–2018); Bebchuk & Hirst, *supra* note 95.
[184] Alon Brav et al., *Shareholder Monitoring through Voting: New Evidence from Proxy Contests*, 37 THE REVIEW OF FINANCIAL STUDIES 591 (Tarun Ramadorai ed., Jan. 2024); Alon Brav et al., *Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting*, 144 JOURNAL OF FINANCIAL ECONOMICS 492 (May 2022).
[185] Lund, *supra* note 182. See also Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) (codified at 17 C.F.R. pts. 239. 249, 270, 274).
[186] Brav et al., *Shareholder Monitoring through Voting*, *supra* note 183.
[187] Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality*, 59 EMORY L.J. 869 (2009–2010).
[188] See, for example, Financial Reporting Council (UK), *The UK Stewardship Code* (2012); Council of Experts.

remains sparse; indeed, some scholars find no indication that, in jurisdictions adopting the Stewardship Code, investors have significantly changed the way they vote.[189]

From a collective decision-making standpoint, the main economic friction in shareholder voting stems from free-riding problems. Mandatory rules can thus help address this problem. Drawing on theoretical work on free-riding, Holmstrom argues that a third party could resolve these issues by administering an incentive scheme that penalizes shareholders when the firm's financial performance is strong and rewards them when performance is weak.[190] Yet managers themselves have little motive to create such mechanisms for shareholders, since manager-monitoring functions as a public good. Consequently, a regulator imposing costs on shareholders who fail to vote (as is often perceived to be the case in the U.S.) may prove more effective than a voluntary regime like the one in the UK. Even in jurisdictions with a controlling shareholder, the free-rider problem among minority investors is partially alleviated by "majority of the minority" rules that bar the controlling shareholder from voting in certain transactions.

Building on the idea of public-good taxation in polities, Bebchuk and Hirst propose going further than current U.S. requirements.[191] They suggest imposing mandatory rules on fund managers to devote a minimum fraction of their indexed assets under management to stewardship, and urge lawmakers to allow index fund managers to directly charge stewardship costs to the fund itself, thus internalizing a greater share of those expenses.[192] These measures aim to counteract free-riding by ensuring fund managers invest sufficient resources in governance, rather than relying on other shareholders to do the heavy lifting.

V: Conclusion

This article has developed a comprehensive theory of the costs of collective decision-making—in this context, the economic frictions that arise among shareholders. These costs, conceptually distinct from "agency costs," stem from the challenges of aggregating individual preferences and can lead to efficiency losses that do not depend on asymmetric information. I have argued that current corporate law already helps mitigate these costs of collective decision-making, and have proposed some modest reforms to enhance its effectiveness. Although the precise magnitude of these costs is an empirical matter, the insights offered here provide useful "microfoundations" for a broader theory of corporate law and governance that moves beyond agency-cost essentialism.

Although I have briefly addressed the role of prospective or future shareholders in this discussion, much of the analysis has assumed a stable shareholder base and has thus focused on the internal dimension of the corporation. In reality, exit rights for shareholders introduce a more complex interplay. In a recent paper, Hansmann and Kraakman posit that shareholders' control rights complement, rather than substitute, their rights to exit. [193] From a bargaining perspective, a party with strong bargaining power typically expects to benefit from ex-post wealth transfers and is unlikely to relinquish its control rights in her organization—or to allow robust exit rights for

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[189] Trang Nguyen & Charles C. Y. Wang, *Stewardship Codes and Shareholder Voting on Contested Ballot Measures*, No. 4986759 (Oct. 2024); DIONYSIA KATELOUZOU & DAN W. PUCHNIAK, GLOBAL SHAREHOLDER STEWARDSHIP (Cambridge University Press May 2022); Brian R. Cheffins, *The Stewardship Code's Achilles' Heel*, 73 THE MODERN LAW REVIEW 1004 (2010); Brian R. Cheffins & Bobby V. Reddy, *Thirty Years and Done–Time to Abolish the UK Corporate Governance Code*, 22 JOURNAL OF CORPORATE LAW STUDIES 709 (Taylor & Francis 2022).

[190] Holmstrom, *supra* note 101.

[191] Bebchuk & Hirst, *supra* note 95.

[192] *Id.*

[193] Henry Hansmann & Reinier Kraakman, *Exit, Voice, Liability, And Scope: Tradeoffs In Constraining Agency Costs*, 24 RETRIEVED APRIL 2022 (2020).

others. Consequently, future research might explore how the law can facilitate shareholder exit—such as through appraisal rights—to further reduce the costs of collective decision-making.

To see how exit might mitigate these costs, consider a market of multiple corporations, each reflecting a different median "ideal point" on a single issue. When collective decisions conflict with a given shareholder's interests, the shareholder must weigh the benefits of remaining (and preserving certain gains from trade) against the benefits of exiting (and finding a corporation better aligned with her preferences). As Buchanan notes, exit creates both advantages and disadvantages for the individual.[194] If all corporations in the market offer comparable gains from trade, shareholders may simply exit until corporations become homogeneous—or nearly so—a process akin to "Tiebout sorting."[195] In such a scenario, preferences reveal themselves through "voting with their feet," dramatically reducing the internal costs of collective decision-making. Indeed, recent work by Levit et al. indicates that endogenously determined trading and voting can give rise to self-fulfilling expectations, substantially diminishing these collective decision-making costs within any given corporation. [196]

[194] James M. Buchanan, *An Economic Theory of Clubs*, 32 ECONOMICA 1 ([London School of Economics, Wiley, London School of Economics and Political Science, Suntory and Toyota International Centres for Economics and Related Disciplines] 1965).
[195] *Id.*; Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 JOURNAL OF POLITICAL ECONOMY 416 (The University of Chicago Press Oct. 1956).
[196] Doron Levit et al., *The Voting Premium*, No. ID 3759761 (May 2021).