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The Influence of Direct Democracy on Agency Costs:
Lessons from Corporate Governance

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Lessons from Corporate Governance

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Lessen vanuit corporate governance

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List of Abbreviations

1. ABA: American Bar Association
2. CAL. CORP. CODE: California Corporations Code
3. DGCL: Delaware General Corporation Law
4. FLA. STAT. ANN.: Florida Statutes Annotated
5. ISS: Institutional Shareholder Services
6. N.Y. Bus. CORP. LAW: New York Business Corporation Law
7. NYSE: New York Stock Exchange
8. OECD: Organization for Economic Co-operation and Development
9. OHIO REV. CODE ANN.: Ohio Revised Code Annotated
10. PA. CONS. STAT. ANN.: Pennsylvania Consolidated Statutes Annotated
11. PAC: Political Action Committee
12. SEC: Securities and Exchange Commission
13. TEX. Bus. CORP. ACT ANN.: Texas Business Corporation Act Annotated

1 INTRODUCTION

The administration of large public corporations and the administration of countries require frequent decision-making on complex problems. Big public companies and countries have a large number of shareholders and citizens respectively. This creates in shareholders and citizens alike an incentive to shirk the responsibility of gathering and analyzing the information required to make good decisions for two reasons. First, shareholders and citizens alike have reason to believe that there are numerous others who will take on their responsibilities if they fail to fulfil them; and second, because they would bear all the costs of making informed decisions but receive only a small share of the benefits. A large number of time sensitive decisions requiring complex information need to be made by companies and countries on a regular basis. This heavy requirement makes it very unlikely that sufficient numbers of shareholders or citizens will collectively inform themselves and effectively coordinate their actions in order to manage the regular affairs of a company or a country respectively. Excessive collective action problems, therefore, make direct decision-making by shareholders and citizens unworkable as a mechanism for making the large majority of such decisions.

Due to the inability of principals to make such decisions directly, corporate and constitutional law provide for systems of centralized delegated decision-making to avoid gridlock due to excessive collective action cost. This use of representatives introduces agency costs.

This dissertation focuses on identifying the circumstances under which representative decision-making is effective and where representative decision-making fails and instead imposes greater agency costs than the collective action costs it seeks to replace. In other words, when is it better for the principals to make decisions directly? In what circumstances is it better to incur the costs of collective action in order to change policy made by elected representatives? When does the use of direct decision-making reduce the total cost of decision-making?

In order to answer these questions in the sphere of constitutional law, this dissertation looks at the vast and sophisticated body of law and economics scholarship which deals with agency cost in the field of corporate governance. In particular, it looks towards the vigorous debate surrounding shareholder rights in the United States to study the influence of direct democracy on agency cost via a comparative analysis.

After pointing out the utility of this comparative approach to direct democracy, the dissertation seeks to answer two particular questions concerning the operation of direct democracy. They are as follows:

- Should citizens be allowed to initiate proposals (initiatives) or is it sufficient to have the power of veto (referendums)?
- Should initiatives and referendums be binding?

The normative criterion adopted for answering these questions is the reduction of the total cost of decision-making. This is the sum of the cost of using agents along with the cost of using direct decision-making as a monitoring mechanism. Since direct decision-making is used as a monitoring device rather than a replacement for delegated decision-making, the costs associated with such decision-making are characterized as a component of agency cost.

This dissertation aims to find the optimum balance between representative and direct decision-making in order to make the principal-agent contract more efficient.¹ This is done by examining how this balance is struck in the governance of large public companies primarily in the US and then seeing whether those methods can be replicated in constitutional law.

For the purposes of the comparative analysis, the dissertation defines “direct democracy” as any decision-making process by which citizens directly adopt laws without making use of their representatives.² This definition is used throughout in its wider sense which includes both initiatives and referendums.³ The definition of agency cost adopted for the purpose of this dissertation is typified by the work of Professors Jensen, Fama, Meckling and Ross.⁴ This

¹ The efficiency criterion is explained in the course of the subsequent discussion. It suffices to say that an agency contract can be considered efficient if it minimizes the cost of using an agent.

² Matsusaka, John G. “Direct Democracy.” *The Encyclopedia of Public Choice*. Springer US, 2003. 473-477.

³ Prof. Matsusaka defines them as follows. “Initiative” is understood to be a “process [that] allows ordinary citizens to propose new laws by petition, that is, by collecting a predetermined number of signatures from their fellow citizens. The proposal becomes law if approved by a vote of the electorate at large”. “Referendum” on the other hand is understood to mean “a process that allows the electorate to approve or reject a proposal by the legislature.” See Matsusaka, John G. “Initiative and Referendum,” *The Encyclopedia of Public Choice*. Springer US, 2003: 624-628.

⁴ See Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3, no. 4 (1976): 305-360; Jensen, Michael C., and Jerold B. Warner. “The Distribution of Power Among Corporate Managers, Shareholders, and Directors.” *Journal of Financial Economics* 20 (1988): 3-24; Fama, Eugene F., and Michael C. Jensen. “Agency Problems

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characterization of agency cost will be dwelt upon in suitable depth in Chapter two. It suffices to say that 'agency cost' as used here can generally be understood to be the total cost of using an agent, as accrued by the principal.

and Residual Claims." *Journal of Law and Economics* 26, no. 2 (1983): 327-349 and Ross, Stephen A. "The Economic Theory of Agency: The Principal's Problem." *The American Economic Review* 63, no. 2 (1973): 134-139.

1.1 RELEVANCE AND RELATED LITERATURE

This dissertation seeks to improve the existing understanding of agency cost and direct democracy in constitutional law by re-examining their relationship using paradigms from corporate governance literature. There is already considerable literature that seeks to address the relationship between agency cost in both the constitutional and corporate governance fields.⁵ However, no research could be found which carries out a comparative analysis of the two systems to study the relationship between direct democracy and agency cost.

This dissertation contributes to existing literature by creating a theoretical framework for the comparative analysis of agency costs in corporate and constitutional law. It also throws new light on the influence of direct democracy on agency cost and provides conclusions and recommendations to minimize agency cost by using referendums and initiatives more effectively.

The contribution of this dissertation to current literature can only be discovered through a study of the works that already exist. Accordingly, some papers that represent the existing understanding of the relationship between agency cost and direct decision-making in the corporate and constitutional system are presented below.

An excellent example of a comparative analysis of corporate and constitutional law involving a study of agency costs is the work of Professors Frey and Benz.⁶ In two articles, they argue that constitutional governance mechanisms have much to contribute to finding a solution for

⁵ There seems to be more research that examines constitutional law for insights to improve corporate governance rather than the other way around. For example, Ribstein, Larry E. "The Constitutional Conception of the Corporation." *Supreme Court Economic Review* (1995): 95-140; Frey, Bruno S., and Matthias Benz. "Can Private Learn from Public Governance?" *The Economic Journal* 115, no. 507 (2005): 377-396 and Benz, Matthias, and Bruno S. Frey. "Corporate Governance: What Can We Learn from Public Governance?" *Academy of Management Review* 32, no. 1 (2007): 92-104. See also working paper Benz, Matthias, and Bruno Frey. "Towards a Constitutional Theory of Corporate Governance." Available at SSRN 933309 (2006). On the other hand, See Rodrigues, Usha. "Seductive Comparison of Shareholder and Civic Democracy, The." *Wash. & Lee L. Rev.* 63 (2006): 1389. This paper examines the use corporate governance insights to improve constitutional law like this dissertation does. However, Professor Rodrigues does not deal with issues of direct democracy nor does she use a methodology based on agency theory.

⁶ See Frey, Bruno S., and Matthias Benz. "Can Private Learn from Public Governance?" *The Economic Journal* 115, no. 507 (2005): 377-396 and Benz, Matthias, and Bruno S. Frey. "Corporate Governance: What Can We Learn from Public Governance?" *Academy of Management Review* 32, no. 1 (2007): 92-104. See also working paper Benz, Matthias, and Bruno Frey. "Towards a Constitutional Theory of Corporate Governance." Available at SSRN 933309 (2006). See also Frey, Bruno S., and Margit Osterloh. "Yes, Managers Should be Paid like Bureaucrats." *Journal of Management Inquiry* 14, no. 1 (2005): 96-111 which specifically addresses the issue of paying corporate managers along the lines constitutional officials are paid.

recent corporate scandals. This research differs from the dissertation insofar as it seeks lessons from constitutional law to improve corporate governance rather than lessons from corporate governance to improve constitutional law. Furthermore, while Professors Frey and Benz also utilize a methodology based on agency theory as this dissertation does, they do not address the issue of direct democracy.

Professors Frey and Benz argue that corporate law is based on agency theory and it relies on extrinsic incentives to align the interests of directors with shareholders. They then demonstrate that constitutional law faces a similar problem in motivating agents to further the interests of their principals. In light of a spate of corporate scandals, the authors suggest that corporate governance incentives have failed to properly align the interests of agents to those of their principals. To remedy this situation, the authors propose the following solutions from constitutional law based on a study of its institutions:

1. Performance linked compensation of agents supplemented by fixed income.
2. The use of non-monetary incentives like titles to motivate agents.
3. Selection of corporate agents through a rigorous selection process inspired by tough civil services recruitment processes.
4. A clear delineation of power as is seen in constitutional law.
5. A clear plan for succession for senior positions in the corporation.
6. Institutionalized competition for positions in management.

The work by Professors Frey and Benz, therefore, illustrates an example of comparative analysis between corporate and constitutional law which proposes public governance solutions for corporate problems. This dissertation does the exact opposite and hopes to complete the circle by applying perspectives from corporate governance to constitutional law thereby allowing the enrichment of both fields.

A survey of positive constitutional economics was carried out by Professor Stefan Voigt in 1997.⁷ His book identifies a breadth of literature that discusses the role of citizens and legislators in the framework of the principal-agent paradigm of agency theory. The survey reveals that the use of agency theory in the field of constitutional law is not new and has been taken up by a number of authors. However, the survey does not identify works that carry out a substantial comparative analysis of corporate governance and constitutional law with

⁷ Voigt, Stefan. *Positive Constitutional Economics: A Survey*. Springer Netherlands, 1997.

agency theory adopted as the analytical framework. This dissertation seeks to build upon the literature dealing with the principal-agent conceptualization of constitutional law identified by Professor Voigt by providing insights from corporate governance. The argument why a study of corporate governance can extend and augment the voluminous literature that exists in the field of constitutional law which is identified in the survey can be found in section 2.5.

In 2006, Professor Rodrigues tried to use corporate governance insights to improve constitutional law.⁸ In her paper, she carries out a study of the historical basis behind the indirect election of the President in the United States of America via an electoral college. She compares this to the indirect appointment of the CEO and the senior managers of a company by the Board of Directors. This historical comparison addresses the fact that shareholders, like citizens, do not choose the top functionaries responsible for the day to day administration of the company or the country respectively. Rather, shareholders vote for a board of directors which in turn appoints the CEO and top executives. Similarly, US citizens vote for 'electors' who in turn choose the President and the Vice-President.⁹ She concludes by rejecting the comparison stating that there are too many significant differences between the Board of Directors and the Electoral College that give them characteristics too divergent for a valid comparison.

It is worth noting that Prof. Rodrigues does not use agency theory to compare the Electoral College and the board of directors. Having learnt from her paper, this dissertation compares the corporate setting with a parliamentary democracy rather than the Presidential system used by Professor Rodrigues and utilizes agency theory to be able to draw useful conclusions.

Another paper which touches upon the subject matter of this dissertation is a paper published in the same year by Professor Dunlavy.¹⁰ This paper limits itself to an analysis of the

⁸ Rodrigues, Usha. "Seductive Comparison of Shareholder and Civic Democracy, The." *Wash. & Lee L. Rev.* 63 (2006): 1389.

⁹ The President and the Vice-President of the United States of America are chosen by 'electors' who are chosen at the state level by popular vote. With exceptions in the case of Guam, Puerto Rico and the District of Columbia, all states vote to elect as many 'electors' as they appoint members to the US Congress. It should be noted that the manner in which the states appoint electors vary considerably from a pro rata system to a winner takes all model. For a detailed discussion into the election of the US President, see Peirce, Neal R., and Lawrence D. Longley. *The People's President: The Electoral College in American History and the Direct-Vote Alternative*. Simon and Schuster, 1968.

¹⁰ Dunlavy, Colleen A. "Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights." *Wash. & Lee L. Rev.* 63 (2006): 1347.

democratic nature of political representation as opposed to plutocratic nature of shareholder representation.¹¹ By providing a detailed historical background of shareholder voting rights, she explains why corporate and constitutional voting rights have the similarities and differences that they have today. Professor Dunlavy, however, stops short of a comparative study of corporate law with any particular constitutional institutions. All the same, she does compare corporate and constitutional systems of franchise i.e. the rules regulating voting to elect representatives in some instances.¹²

This dissertation will expand on existing literature by using agency theory¹³ as a framework to improve constitutional law by suggesting lessons learned from corporate governance. In particular, this comparative analysis will be used to optimize the use of direct democracy in order to minimize the costs incurred by principals to use an agent which is termed as 'agency cost'.

Other authors have examined the historical and philosophical relationship between the corporate and constitutional forms. In a fine paper tracing the historical origins of the constitutional state, Professor Enlow states that "In medieval and early modern history, the application of corporate law principles to the state contributed to the development of the idea of constitutionalism and to the idea of popular sovereignty."¹⁴ This research, supported by the words of James Madison, suggests that corporate law principles have indeed been influencing constitutional law for hundreds of years.¹⁵ The paper ends with an analysis of canon law and

¹¹ Democratic representation under constitutional law presupposes a rule of one person-one vote with universal adult franchise. Corporate voting rights are characterized as plutocratic because they are determined by shareholding (with consideration to their voting rights if stock is issued with differential voting rights) and not by individual membership.

¹² See section 3.1 for a discussion into the different ways voting rights are allocated under corporate and constitutional law.

¹³ Agency theory focuses on the study of the costs of using an agent as incurred by the principal. Please see Chapter 2 for a detailed explanation.

¹⁴ Enlow, Eric. "Corporate Conception of the State and the Origins of Limited Constitutional Government, The." *Wash. UJL & Pol'y* 6 (2001): 1. "The word "corporations", in its largest sense, has a more extensive meaning than what people are generally aware of. Any body politic (sole or aggregate), whether its power be restricted or transcendent, is in this sense "a corporation". The King, accordingly, in England is called a corporation... So also, by a very respectable author... is the Parliament itself. *In this extensive sense, not only each state singly, but even the United States may without impropriety be terms "corporations"*. (emphasis added)

¹⁵ In the paper, Professor Enlow explains that the corporate law influences led to the conceptualization of both the sovereign and the state as corporations. He argues that "corporate principles expressed the purely legal nature of the king's political office and its consequential subordination to the law." This changed the position of

the popular sovereignty tradition where Professor Enlow proposes that “corporate analogies enabled political theorists to postulate a legal authority in the people themselves”.

Professor Enlow argues that this conceptualization only got stronger since medieval times and has become a cornerstone of the American constitution. As early as 1793, in a case concerning state sovereign immunity, the US Supreme Court clearly upheld the idea of the corporate nature of the American constitutional structure. Deciding an issue of constitutional law, four out of five judges in *Chisholm v. Georgia* held that “*there is no other part of the common law... which can by any person be pretended in any manner to apply to this case, but that which concerns corporations.*”¹⁶

In light of this paper and its coverage of these issues, the dissertation does not carry out a historical study of the evolution of the two institutions. Rather, it extends the literature by building upon similarities in the structure and the functional parallels which exist between institutions in corporate and constitutional law. This is done by characterizing the similarities in the way decision-making authority is delegated in the two systems in terms of agency theory. By analyzing the relationship between shareholders and the board of directors using the same theoretical framework used to study the relationship between citizens and the legislature, this dissertation can import insights that may be useful in improving constitutional law. Specifically, it examines how and when shareholders can bypass the board of directors to make decisions directly under corporate law in order to improve the use of direct democracy in constitutional law.

This dissertation seeks to fill an important gap. The shareholder rights debate has not yet educated our understanding of the relationship between agency cost and direct democracy mechanisms like referendums and initiatives. This dissertation will extend existing scholarship by providing new findings and a novel framework to analyze the impact of direct democracy on agency costs in constitutional law. These steps will allow the use of numerous

the King from being divinely appointed and all-powerful to having a political office with its accompanying limitations. The second point made by Eric Enlow is that corporate law influences led to the conception of the various organs of the government acting together as a corporation. This meant that the King held power only by virtue of being the head of this corporation. The King therefore lost political power in his individual capacity.

¹⁶ *Chisholm v. Georgia*, 2 U.S. (2 Dall.) 419 (1793). Cited from Enlow, Eric, “Corporate Conception of the State and the Origins of Limited Constitutional Government, The.” *Wash. UJL & Pol’y* 6 (2001): 1.

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insights about the law and economics of corporate governance that are widely known to also be used to improve constitutional law.

1.2 RESEARCH QUESTIONS AND PURPOSE

The purpose of this dissertation is to better understand the influence of direct democracy on agency cost in constitutional law. To accomplish this, the dissertation adopts an agency theory framework for the comparative study of the direct decision-making processes used in corporate and constitutional law. The adoption of a single theoretical framework allows the structural and functional similarities in corporate and constitutional decision-making institutions to be compared effectively. This allows insights from corporate governance to be used to minimize agency cost in constitutional decision-making.

The dominance of the corporate form as the vehicle of choice for large-scale collective endeavor by large and dispersed groups of individuals has driven enormous resources and expertise into the study of its governance. The study of corporate governance has also had the benefit of observing the results of experimentation over centuries. Companies are constantly forced to respond to the perceptions of shareholders about how well their agents represent their interests. This is because investors react to changes in corporate structure that affect agency costs by increasing or decreasing their investment accordingly. The pressure to convince large numbers of investors that their interests will be better protected as shareholders in a company rather than as investors in competing organizational forms like partnerships, cooperatives etc. puts intense pressure on the corporate system. The need to maintain investor confidence in their ability to control agency cost has forced companies to evolve mechanisms such as providing for direct decision-making by shareholders for certain types of decisions.

The evolution of the corporate form has also led to corporate governance scholarship accumulating a rich body of learning on how to minimize agency cost. This is highlighted in the fact that the literature on agency cost focuses on corporate governance much more than it discusses constitutional law. While there are a number of institutional contexts where agency theory is critical to the understanding of the delegation of authority, corporate governance was the field that initiated the scholarly debate on agency cost. This fact is underscored by the fact that the scholarship of Professors Jensen, Meckling and Fama,¹⁷ which forms some of the most prominent scholarship on agency theory, used corporate law to discuss issues related

¹⁷ See Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3.4 (1976): 305-360; Jensen, Michael C., and Jerold B. Warner. "The Distribution of Power Among Corporate Managers, Shareholders, and Directors." *Journal of Financial Economics* 20 (1988): 3-24 and Fama, Eugene F., and Michael C. Jensen. "Agency Problems and Residual Claims." *Journal of Law and Economics* 26, no. 2 (1983): 327-349.

to, and stemming from, the principal-agent relationship. This dissertation uses the rich corporate governance scholarship in order to solve constitutional problems that are similar in nature. The potential for a productive comparative study is greatly enhanced by the recent developments in corporate governance, particularly in the US, which have sparked a vibrant debate over shareholder rights and in particular over the role, limitations and viability of shareholder proposals and shareholder bylaw amendments.¹⁸

To further the purpose of this dissertation, the following questions are examined:

- What are the agency costs involved with direct democracy that can be studied using a comparative study of corporate governance and constitutional law?
- What legal solutions can be recommended to minimize these costs?

To help answer these questions and further the existing understanding of these issues, this dissertation will focus on the following sub-questions:

- What influence does direct democracy have on agency cost in corporate and constitutional law?
- Should voters be allowed to initiate proposals or should they only have the power to veto fundamental changes?
- Should the results of direct decision-making by the principals (through initiatives and referendums) be precatory or binding on the agents?

¹⁸ See, for example Bainbridge, Stephen. "Case for Limited Shareholder Voting Rights, The." *UCLA l. rev.* 53 (2005): 601; Harris, Milton, and Artur Raviv. "Control of Corporate Decisions: Shareholders vs. Management." *Review of Financial Studies* 23, no. 11 (2010): 4115-4147; Hutchison, Harry G. "Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm." *Loyola University Chicago Law Journal* 36, no. 4 (2005): 1111; Hayden, Grant, and Matthew T. Bodie. "Shareholder Democracy and the Curious Turn Toward Board Primacy." *Wm. & Mary L. Rev.* 51 (2010): 2071-2095; Yermack, David. "Shareholder Voting and Corporate Governance." *Annu. Rev. Financ. Econ.* 2, no. 1 (2010): 103-125; Fairfax, Lisa. "The Future of Shareholder Democracy." *Indiana Law Journal* 84 (2009): 2012-93 and Stout, Lynn A. "The Mythical Benefits of Shareholder Control." *Virginia Law Review* (2007): 789-809.

1.3 METHODOLOGY

This dissertation utilizes a law and economics methodology, centers on an agency cost based analysis and relies on the extrapolation of corporate governance paradigms to solve constitutional problems. More specifically, this dissertation adopts a normative approach to provide recommendations to minimize agency cost in constitutional law by identifying and analyzing insights taken from corporate governance.

The criterion for the normative analysis is limited to the minimization of agency cost. It disregards other factors and externalities outside this framework. Externalities are costs or benefits visited upon parties that did not agree to incur them.¹⁹ In this context, this means that the theoretical framework of this dissertation will not consider the impact of direct democracy on stakeholders other than those defined as the principals.

Due to this limitation, under certain circumstances, this framework might identify solutions that are socially sub-optimal (because they do not optimize social welfare) as optimal solutions because they might incur the least possible agency cost. For example, a government might expropriate the property of foreigners or wage wars of conquest against other nations. In the corporate governance context, a board might take actions that are detrimental to the environment or to the interests of debtors and bond holders provided that they are not represented on the board. In both these scenarios, the methodology adopted by this dissertation would not take into account the cost to economic actors other than citizens and shareholder respectively. In other words, a situation with optimal agency costs might on the whole prove to be socially sub-optimal because agency theory does not internalize costs to third parties.²⁰ The framework of the dissertation does not account for externalities imposed on economic actors other than the principals (shareholders and the electorate respectively)

¹⁹ Buchanan, James M. "Externality." *Economica* 29, no. 116 (1962): 371-384.

²⁰ See Barnett, Michael L. "Stakeholder Influence Capacity and the Variability of Financial Returns to Corporate Social Responsibility." *Academy of Management Review* 32, no. 3 (2007): 794-816. Professor Barnett explains that an action taken by management that results in great social welfare but costs more than the benefit captured by the shareholders is an example of very high agency costs. For example, a \$1 anonymous charitable contribution by a company that results in millions of dollars' worth of social welfare may well be an example of an agency problem since an anonymous donation will not net the company and hence its shareholders public goodwill or enhanced reputation.

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when optimizing agency costs. This is a key limitation of the methodology adopted and is discussed further in the section on the scope and limitations of this research.²¹

The dissertation will utilize law and economics literature from the field of corporate governance to analyze the agency issues arising from the use of direct democracy. This will provide a set of concepts that, to the extent of their applicability in constitutional law, will extend the existing understanding of these issues. This methodology should provide a whole new set of tools to examine other issues in constitutional design and functioning as well.

²¹ Jensen, Michael, and Clifford W. Smith Jr. "Stockholder, Manager, and Creditor Interests: Applications of Agency Theory." *Recent Advances in Corporate Finance*. Harvard University Press (1985). See section 1.4 for more details.

1.4 SCOPE AND LIMITATIONS OF RESEARCH

The aim of this dissertation is to use insights from corporate governance literature to fine tune the use of direct democracy in constitutional law in order to minimize the total agency cost. To do this, a theoretical framework is established that allows insights from corporate governance to be used to understand and improve the principal-agent relationship in the constitutional system. Since agency theory is adopted for the comparative analysis, the scope of this research is exclusively limited to agency issues.

The normative criterion for the analyses in this dissertation is the minimization of net agency cost. This is the agency cost of representative decision-making plus the cost of using direct decision-making as a monitoring mechanism when necessary. The selection of agency theory as the analytical framework, however, has a serious limitation that must be highlighted.

As mentioned in the research methodology, agency theory only considers the relationship between two constituencies, namely the principals and the agents. An agency relationship is defined as a relationship whereby a party (the principal) engages another (the agent) to perform some service and delegates some decision-making authority to the agent in order to allow him to do so. The agency cost in such a relationship is the cost of using an agent as borne by the principals.²² This means that an analysis based on agency theory does not take into account the interests of other stakeholders who may be involved and does not consider the interests of society at large.

This limitation of agency theory means that the conclusions of the dissertation will not necessarily lead to an outcome that maximizes social welfare. Accordingly, caution must be exercised when evaluating the applicability of corporate governance paradigms in the constitutional setup based on the conclusions presented. Admittedly, issues such as human rights, equal treatment of citizens etc. are key issues in constitutional law. However, this does not negate the value of understanding how agency cost can be minimized by the use of direct democracy. Once this is understood, other requirements can always be examined to decide the best course of action when designing constitutions and democratic processes.

²² See Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3, no. 4 (1976): 305-360 at 308. Professors Jensen and Meckling characterize agency cost as the sum of monitoring cost, residual loss and bonding cost. These concepts will be discussed in detail in chapter two. The key thing to note at this stage is that in their conceptualization, agency cost is borne exclusively by the principals and not by other stakeholders.

Another important limitation is the specificity of the findings to constitutional law in a narrow sense. The scope of this dissertation is limited only to a comparative analysis of agency problems in the corporate and constitutional systems. It does not extend to issues of administrative law and administrative organization. This limitation means that the theoretical framework and the recommendations of this dissertation should not be used to analyze and improve the pervasive adoption of corporate governance philosophies at the administrative level. The recommendations of this dissertation are, therefore, not directed at organizations such as the non-departmental public bodies of the UK even though they are very closely based on the corporate model.²³

Another key limitation of this dissertation is that it is restricted to a comparative analysis of the corporate form specifically with the parliamentary system of democracy.²⁴ This means that the analysis and recommendations of this research are tailored to the parliamentary system where voters elect legislators who then select the executive. This system is seen in countries such as the UK, Australia and India.

This approach is not designed to address the presidential form of democracy where the legislators as well as the head of the executive can be directly elected by the citizens. It is believed that a comparative study between the corporate model and the presidential system is also possible but this would require a reworking of the structural and functional parallels that underpin the analysis. That discussion is therefore reserved for subsequent research.

²³ Wilks, Stephen. "Boardization and Corporate Governance in the UK as a Response to Depoliticization and Failing Accountability." *Public Policy and Administration* 22, no. 4 (2007): 443-460. Professor Wilks points out the UK as a prime example of a country where non-departmental public bodies (commonly referred to as 'quangos') advise ministers, deliver certain public services, serve a judicial or quasi-judicial function or fulfill a monitoring role. He points out that their governance structure is remarkably similar to that of the public corporation.

²⁴ For a discussion on the differences between the parliamentary and other forms of democratic government, see Stepan, Alfred, and Cindy Skach. "Constitutional Frameworks and Democratic Consolidation: Parliamentarism versus Presidentialism." *World Politics* (1993): 1-22. and Lijphart, Arend. "Democracies: Forms, performance, and constitutional engineering." *European Journal of Political Research* 25, no. 1 (1994): 1-17. For the purposes of this dissertation, the dictionary definition of parliamentary democracy is sufficient. It is defined as a system of government where the real executive power is vested in a cabinet composed of members of the legislature who are individually and collectively responsible to the legislature. See "parliamentary government." *Merriam-Webster.com* 2012. <http://www.merriam-webster.com> (1 May 2012). This is in contrast to the presidential system of democracy which provides for the direct election of the President (or through an electoral college as in the United States of America).

It should be noted that when the dissertation refers to corporate law without specifying the jurisdiction, the corporate law of the State of Delaware is being referenced. Also, when the dissertation mentions ‘companies’ or ‘corporations’, it is referring to very large public companies with dispersed shareholders such as Boeing, Microsoft or General Electric.

There are also certain notable differences between the corporate and constitutional setups that restrict the applicability of corporate governance solutions to constitutional law. Companies and countries allot principals the right to vote differently. The rule of one person-one vote is universal under the constitutions of democratic countries while one share-one vote or stock with differential voting rights is commonplace in corporate governance. The process for holding elections is also quite different in corporations and countries.

These factors, together with the inability of the agency cost methodology adopted here to account for externalities, means that the recommendations of this dissertation must be reviewed carefully before being adopted.

This research should, therefore, not be seen as a general attempt to correlate constitutional and corporate agency problems. It should certainly not be seen as an attempt to equate the two schemes of design. In this dissertation, several comparisons are made between the organs of a company and those of a political unit. It must be noted that these comparisons are valid only for the analysis of agency issues that are involved in direct decision-making and may not be applicable for other analyses. These limitations preclude any correlation or extrapolation between the corporate and constitutional systems that is not related to the study of agency cost.

Lastly, this dissertation does not examine the use of direct democracy with respect to a ‘recall’. This term refers to a direct democratic process by which citizens can end the term of an elected official before his or her term ordinarily expires. The process does not involve direct decision-making by principals on policy issues but rather seems to augment the function played by elections. This is because the only action possible through a recall vote is to undo the result of the previous election and nothing more can be accomplished.

These limitations on the scope of the dissertation do not invalidate the fact that much can be gained by using corporate governance paradigms to develop our knowledge of the agency costs that burden democracies of all forms. While there are no universal equivalencies

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between corporate and constitutional law, there are several instances where unique parallels exist between corresponding organs of the corporate and the constitutional setup. When these conditions are met, practical insights can indeed be gained by using agency theory to carry out a comparative analysis.

1.5 STRUCTURE

This dissertation is divided into two main parts. The first part comprises of chapters two, three and four and explains what can be learned about direct democracy from corporate governance and why.

Chapter two forms the foundation of the comparative analysis. It points out the structural and functional similarities in the corporate and constitutional schemes for delegating decision-making authority. This is done by highlighting the delegation of decision-making authority by numerous and dispersed principals to a small group of elected agents. This chapter also shows that both systems also provide for exceptions whereby the principals can make certain types of decisions, under certain circumstances, by means of a direct vote.

This forms the basis of the theoretical arguments that underpin the whole dissertation: (1) The agency relationship between shareholders and the board of directors is similar to agency relationship which exists between citizens and the legislature. (2) Both systems use direct decision-making as a monitoring mechanism in a similar manner to address these agency problems.

It should be noted that direct democracy performs functions besides that of monitoring in the constitutional context but it is undeniable that the monitoring function is a key role of direct decision-making and it is this role that is examined by the dissertation.

Understanding the agency relationship in both corporate and constitutional law in terms of a shared theoretical framework then allows the following chapters to apply corporate governance insights to minimize agency cost in constitutional law.

Chapter two concludes with an argument that highlights why insights and principles for managing agency cost derived from corporate governance are not only theoretically applicable to constitutional law but are also uniquely useful. This is because large public companies are organizations that come closest to duplicating the scale and complexity of the decision-making required in a country or a federal sub-division.

Chapter three is devoted to addressing important divergences in the corporate and constitutional setups. Carefully examining these differences ensures that the recommendations of this analysis are not rendered inapplicable due to practical differences in

the way the two systems work. This chapter begins by examining how voting rights are allocated in the corporate and constitutional systems. It identifies two main differences. First, only shareholders vote under corporate law as compared to universal adult franchise²⁵ in constitutional law. Secondly, voting rights in corporate law are tied to the number of shares owned as compared to the rule of one person-one vote prevalent under constitutional law.

The next difference in the two systems examined to ascertain its impact on agency cost is the legal liability of agents under the corporate and constitutional law. This is followed by an examination of the role played by intermediaries under corporate and constitutional law. These intermediaries, referred to as 'super agents', have a strong impact on agency cost. This discussion looks at how the role they play in both systems influences the applicability of corporate governance solutions to minimize agency cost in the constitutional setup.

The chapter then looks at the difference in the nature of elections for appointment to the board of directors as opposed to elections to win seats in the legislature. The significant difference in the competitiveness of these elections creates a difference in the entrenchment of agents. The consequences of this difference in the nature and competitiveness of elections to be appointed as the agent is then factored into the comparative analysis.

The last issue discussed here is the difference in the ease of exit between the corporate and constitutional systems. It is argued that it is easier for shareholders to sell shares and to end the agency relationship with a public company than it is for citizens to emigrate from a country in order to end the agency relationship with its government.²⁶ Therefore, difference in the ease of exit is also identified as an issue that must be considered when borrowing corporate governance insights for minimizing agency cost in constitutional law.

Chapter four provides an explanation of certain key principles of corporate governance scholarship that are important for understanding how agency cost is managed in corporate law. In order to establish a common vocabulary for corporate and constitutional law to be used in the comparative analysis, this chapter introduces the concepts of 'rules of the game'

²⁵ Universal adult franchise refers to a system where all adult citizens have the right to vote with limited exceptions being possible to exclude convicts, the mentally infirm etc.

²⁶ Note that even emigration may not suffice to end the agency relationship with one's country in certain circumstances. For example, US citizens living anywhere in the world may be required to pay tax to the US government unless they relinquish their citizenship.

and ‘specific business decisions’ and explains how they apply to both corporate and constitutional law.

This discussion marks the end of Part I. Part II includes chapters five through eight.

Chapter five examines whether referendums and initiatives serve a function complementary or supplementary to each other. First, it examines whether agency cost can be suitably minimized by giving voters the power to veto fundamental decisions. Once this is done, chapter five examines whether the power to initiate decisions is also required in order to minimize agency costs assuming the right to veto government proposals via referendum already exists.

The first part of the problem which compares shareholder approval of fundamental corporate decisions to referendums is relatively uncomplicated. The corporate laws of virtually all major economies of the world give shareholders the right to veto fundamental corporate decisions. It is shown that such a veto right typically has an impact on the principal-agent relationship and on agency cost. In light of this, the dissertation uses well-reasoned arguments which support the provision of this right in nearly country’s corporate laws to make a case for requiring major decisions which change the relationship between citizens and their government to be approved via referendum.

The issue of initiatives is more subtle because modern economies do not have a uniform position regarding the ability of shareholders to initiate decisions. Since there is no clear answer, corporate governance literature is scrutinized for arguments for and against the need for shareholders to have the power to initiate decisions under different circumstances. Section 5.3 shows that shareholders may need the right to initiate decisions (1) when the board prefers the status quo; (2) when there are two value enhancing proposals and the board prefers the less value-enhancing of the two, and lastly, (3) when the board bundles a self-serving proposal with a value enhancing one. These arguments are then extrapolated to the political context where they are generally found to be applicable.

Section 5.4 then examines how initiatives can allow citizens to change a particular policy without requiring them to replace a majority of the legislators. Using insights from corporate governance, it argues that this has the advantage of requiring citizens to only get informed about one specific issue rather than getting informed about all the issues required to elect new

legislators. On the other hand, corporate governance literature also cautions that separating specific decisions from elections can dilute the accountability of representatives. This is because it can be very difficult to determine whether future consequences are the results of decisions made via representative or direct decision-making in the past.

The chapter then compares corporate and constitutional law to see how allowing principals to initiate decisions can help the board of directors and the legislature to determine the true preferences of shareholders and citizens respectively. This is particularly important because the board of directors and the legislature normally rely on the management and the executive who may have conflicting interests and have the potential to pass on biased information that favors their retention and promotion.

Section 5.6 deals with unique problems relating to the long life of corporate charters and the constitutions of countries. Using insights from corporate governance, it argues that the cumulative effect of amendments over several decades or centuries can transfer more power to the agents than the principals intended if only the agents are allowed to initiate the amendments. By looking at the literature relating to ‘empire building’ in corporate law, solutions are offered to alleviate similar concerns in constitutional law.

Mindful of the analysis in all the sections of Chapter five, section 5.7 advocates for initiatives to be provided for as a reversible default in newly framed constitutions. Based on the corporate governance insights, the option more restrictive on the legislature should be chosen as the default arrangement because the legislature is well positioned to amend the constitution and to ban the use of initiatives if they are later found to be undesirable.

Chapter five concludes with a comparative analysis of the indirect benefits of allowing principals to initiate decisions and how they influence the comparative analysis in this dissertation.

Chapter six analyzes corporate governance to draw lessons for implementing initiatives as effectively as possible. The first issue discussed is the incentives of shareholders and citizens to get informed regarding the matter they are deciding. This is done by comparing the incentives of citizens with different types of shareholders such as individual shareholder activists, mutual funds, pension funds, hedge funds and social activists.

Section 6.2 then looks at how corporate governance solutions for avoiding nuisance shareholder proposals can be adapted to keep out nuisance initiatives in constitutional law. The next section looks at how corporate law scholarship addresses concerns that shareholders will not be sufficiently informed to further their interests by proposing and deciding matters directly and applies them to constitutional law.

Section 6.4 then looks at how strategies to prevent myopic decision-making by shareholders can be used to ensure long-term planning and consistency in decision-making in constitutional law. Section 6.5 looks at how interference and blackmail by special interest groups can be avoided.

The last issue examined in this chapter is the subject matter of initiatives. By looking at state and federal laws which regulate what can be submitted as a shareholder proposal and the scope of shareholder bylaw amendments, section 6.6 suggests which issues should be open to decision-making via the initiative process. It argues that corporate law is an excellent guide to identify exactly what types of policy decisions should be open to initiatives. This is because the board of directors, like the legislature, makes policy decisions whereas the management of a company and the executive of a country focus on micromanagement. This creates a very similar allocation of decision-making responsibility under corporate and constitutional law.

Chapters seven and eight answer the following question: Should the results of referendums and initiatives be binding or non-binding (i.e. precatory) in order for such interventions to be effective in minimizing agency cost? Chapter seven compares the binding or non-binding nature of referendums under constitutional law with the finality of shareholder approval or rejection of fundamental corporate decisions under constitutional law. On the other hand, chapter eight compares initiatives to the rights of shareholders to propose and adopt certain decisions by means of a direct vote.²⁷

After looking at whether or not agents are bound by decisions initiated or approved by their principals, Chapters seven and eight examine whether or not boards and legislatures should be allowed to repeal or amend already existing amendments that were brought about by direct

²⁷ Shareholders in the US initiate decisions under Rule 14a-8 passed under the Securities and Exchange Act, 1934 and via shareholder bylaw amendments. Rule 14a-8 passed under the Securities and Exchange Act, 1934 allows shareholders to have their proposal circulated to all the company's shareholders at the expense of the company. This mechanism can, in certain circumstances be used to circulate a proposal to amend the bylaws of the company.

democratic action. This issue is addressed separately in both chapters because by taking such an action, the agents appear to be actively undoing the will of the principals rather than just passively ignoring it.

Lastly, both chapters seven and eight analyze the impact of non-binding shareholder voting on the actions of the board. This analysis is used to determine whether or not the persuasive value of non-binding direct decision-making is sufficient to incentivize its use by the voters under constitutional law. In other words, it carries out a comparative analysis to answer whether principals have enough confidence in non-binding direct democracy mechanisms to utilize them effectively? Answers to these questions obtained from the corporate governance debate are then used to evaluate whether agency problems caused by the delegation of power to the legislature are best overcome by precatory or by mandatory direct decisions making.

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PART I: WHAT CAN BE LEARNED ABOUT DIRECT DEMOCRACY
FROM CORPORATE GOVERNANCE?

2 AN AGENCY COST FRAMEWORK FOR DECISION-MAKING IN CORPORATE AND CONSTITUTIONAL LAW

Chapter 2 begins by demonstrating that the agency problems prevalent in companies and democratic polities are shaped by similar factors. This is done by showing that both systems delegate decision-making authority in a manner that converges in terms of the structure of the decision-making hierarchies employed. Additionally, it is shown that they also converge in terms of the functions that are discharged by the principals and agents in the two systems. The delegation of decision-making authority from principals to agents in both these systems creates the principal-agent relationship in both systems.²⁸ Since converging systems of delegation create the principal-agent relationship in both systems, it is argued that they would create similar agency problems that can benefit from a comparative analysis.

Having demonstrated that the agency problems in the corporate and constitutional setups share parallels in terms of characteristics and causes, the next section will demonstrate how both systems can be understood in terms of agency theory.²⁹ While the first section demonstrates the intuitive connection between the two systems, section 2.2 provides the theoretical basis for addressing agency problems in constitutional law using corporate governance insights.

Section 2.3 highlights the similarity in the use of direct decision-making by principals in the corporate and constitutional context. In other words, this section demonstrates that both the corporate and constitutional systems provide for the limited use of direct democracy in somewhat similar circumstances.³⁰

²⁸ Ross, Stephen A. "The Economic Theory of Agency: The Principal's Problem." *The American Economic Review* 63, no. 2 (1973): 134-139 at 134. "We will say that an agency relationship has arisen between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal, in a particular domain of decision problems."

²⁹ Eisenhardt, Kathleen M. "Agency Theory: An Assessment and Review." *Academy of Management Review* 14, no. 1 (1989): 57-74 at 58. "Specifically, agency theory is directed at the ubiquitous agency relationship, in which one party (the principal) delegates work to another (the agent), who performs that work. Agency theory attempts to describe this relationship using the metaphor of a contract"

³⁰ In both systems, the principals can approve or reject certain types of decisions (typically major decisions) and propose new policies if they can get a specified amount of support for a petition. These provisions are limited insofar as they only constitute a small minority of the decisions taken in the governance of the company or polity. The default source of decision-making is the agents to whom authority has been delegated.

This is followed by section 2.4 which uses agency theory to understand the impact of direct decision-making by the shareholders on agency cost. This section provides the theoretical basis for the subsequent analysis that suggests ways to minimize agency cost by fine tuning the use of direct democracy in constitutional law.

Having shown that corporate governance can theoretically help to inform the use of direct democracy to minimize agency cost in constitutional law, section 2.5 shows why these insights are uniquely valuable. In other words, it explains why lessons from corporate governance have the ability to improve the framework for minimizing agency cost that exists in constitutional law scholarship through the use of direct democracy.

Chapter 2 therefore shows that not only do the corporate and constitutional systems have similar designs of delegation that create similar agency problems, but that they also provide for the similar use of direct democracy to control these agency problems.³¹

2.1 THE PRIMA FACIE PARALLELS IN DELEGATION

At first glance, the modern public company and a representative democracy like a nation state share a key quality, which in turn creates agency problems in both systems. This key commonality is the delegation of decision-making authority from a large dispersed constituency of principals to an elected body of representatives. The following discussion will demonstrate two key points. First, how corporate and constitutional law share key similarities in terms of the structure of authority created by this delegation of decision-making powers. And second, that the key participants in this shared scheme of delegation also fulfil similar functions.

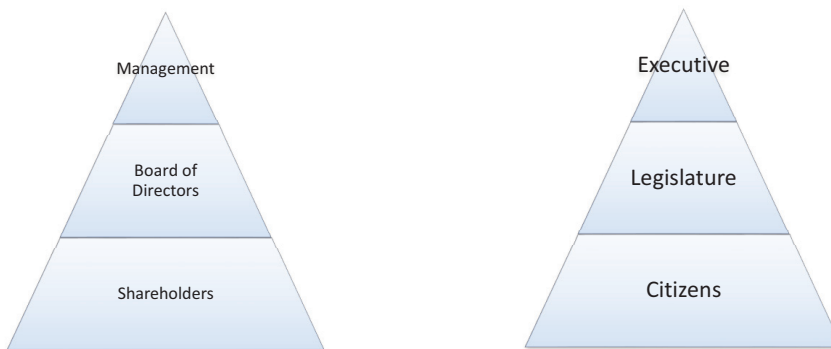
2.1.1 Structure

At first glance, Figure 1 shows that the governance arrangements of public companies and political democracies share a pyramidal scheme. The pyramid structure of the corporation has been characterized as having the shareholders at the base “whose vote is required to elect the board of directors and to pass on other major corporate actions...” At the middle comes the

³¹ In both the constitutional and corporate setups, there is a uniform trend whereby direct democracy is only provided for in limited circumstances. For example, both may allow direct democratic measures to approve fundamental decisions, require a certain allow for an initiative or shareholder proposal only if a certain percentage of votes back it etc.

board of directors “who constitute the policy making body of the corporation, and select the officers...” At the top lie the officers of the corporation “who have some discretion but in general are deemed to execute policies formulated by the board.”³²

Figure 1



In the Parliamentary system of government,³³ a similar setup is present. The base, as it were, is formed by the citizens who elect the legislature and whose vote may also be “required to pass on major actions” such as a constitutional amendment, a major treaty like joining the EU etc. that needs to be approved in a referendum.

In the middle comes the legislature that, like the board of directors is formally tasked with setting policy by making laws and appointing the executive by selecting the Prime Minister and the Cabinet.

³² Eisenberg, Melvin A. *The Structure of the Corporation: A Legal Analysis*. Beard Books, 1976 at 1-2.

³³ Strøm, Kaare. “Delegation and Accountability in Parliamentary Democracies.” *European Journal of Political Research* 37, no. 3 (2000): 261-290 at 263-64. In the context of agency cost, Professor Strøm identifies two essential characteristics of the parliamentary system. They are parliamentary supremacy and the notion of fused or unified powers. By ‘parliamentary supremacy’, he means that the legislature controls the executive branch and policy making. By ‘fused or unified powers’, Professor Strøm is referring to the fact that the executive comprising of the Prime Minister and the cabinet of Ministers are a part of the legislature and their resignation triggers a dissolution of the house. This is in contrast to the presidential system of democracy which provides for the direct election of the President who is not a member of the legislature (or through an electoral college as in the United States of America). See also “Parliamentary Government: a system of government having the real executive power vested in a cabinet composed of members of the legislature who are individually and collectively responsible to the legislature.” See “parliamentary government.” *Merriam-Webster.com*. 2012. <http://www.merriam-webster.com> (1 May 2012).

On the top of the pyramid comes the executive comprising of the Prime Minister and the Cabinet which (like the management of a corporation) is tasked with managing day-to-day affairs³⁴. Like corporate management, the executive is only empowered with limited discretion and must, in the long term, execute the policies formulated by the legislature.³⁵ It should also be noted that the executive under the parliamentary system and the management of a company are both indirectly appointed through the parliament³⁶ and the board of directors respectively.

In commonwealth countries such as the UK, India and Australia, the executive comprising of the Prime Minister and the Cabinet are appointed by majority in the legislature. The Prime Minister and the Cabinet are themselves members of the legislature and continue to be so after taking on their executive functions.³⁷ This situation is found mirrored in the corporate system where the CEO and top executives are appointed by the board. These top executives often comprise of executive directors who are both appointed by the board of directors and continue to be members of the board of directors thereby performing a dual role like the ministers mentioned earlier.

In terms of agency costs, the analogous presence of a pyramidal structure for the delegation of authority from principals to agents in the two systems makes a prima facie case for a comparative study. This case is strengthened by the parallel existence of a vast dispersed principal (shareholder/citizens) that delegates authority to an elected specialized group of agents (board of directors/legislature) to make policy. Furthermore, these elected agents are tasked with appointing and monitoring a group of agents (management/executive) to whom they subsequently delegate authority in both systems. These facts suggest that companies and

³⁴ See Moe, Terry M., and Michael Caldwell. "The Institutional Foundations of Democratic Government: A Comparison of Presidential and Parliamentary Systems." *Journal of Institutional and Theoretical Economics (JITE)/Zeitschrift für die gesamte Staatswissenschaft*. 150, no. 1 (1994): 171-195; Verney, Douglas V. "Parliamentary Government and Presidential Government." *Parliamentary versus Presidential Government* 31 (1992): 47 and Golder, Matt. "Democratic Electoral Systems Around the World, 1946–2000." *Electoral Studies* 24, no. 1 (2005): 103-121.

³⁵ The cabinet may deviate from the policy set by the legislature temporarily by passing laws by means of ordinances. However, these laws are not permanent and are subject to affirmation by Parliament.

³⁶ Persson, Torsten, Gerard Roland, and Guido Tabellini. "Separation of Powers and Political Accountability." *The Quarterly Journal of Economics* 112, no. 4 (1997): 1163-1202 at 1167.

³⁷ Strøm, Kaare. "Delegation and Accountability in Parliamentary Democracies." *European Journal of Political Research* 37, no. 3 (2000): 261-290 at 263.

parliamentary democracies share a similar ordering in terms of the structure whereby decision-making authority is delegated. In light of this, agency relationships, being relationships between parties that have delegated authority (the principals) to other parties (the agents) are also likely to have notable similarities.

It should be noted that the structural similarities alluded to relate only to the principal-agent relationship between citizens and the legislature on one hand and shareholder and the board of directors on the other. In other words, the structure of countries and companies is similar insofar as the aspects affecting the principal-agent relationship is concerned. It should be noted that the comparative analysis restricts itself to a study of the structural similarity in the manner in which the principal-agent relationship is structured in the corporate and constitutional contexts and does not make further equivalencies between the two systems.

Accordingly, this section establishes that a *prima facie* parallel exists between the principal-agent relationship that exists between shareholders and the board of directors and the principal-agent relationship that exists between citizens and the legislature due to similarities in the structure by which decision-making power is delegated.

2.1.2 Function

Having highlighted the structural parallels in the previous section, in this sub-section I focus on parallels in terms of function. I demonstrate that the *prima facie* structural parallels between shareholders, the board of directors and management on one hand and the citizens, legislature and the executive on the other also extend to the functions carried out by these constituents.

Together with the *prima facie* structural parallels illustrated earlier, the establishment of functional parallels between the corresponding principals and agents in both systems go a long way towards establishing that corporate and constitutional law suffer from similar agency problems. This similarity will then be used to set up the theoretical framework for comparison in the following sections. Subsequent chapters will then identify insights from corporate governance to optimize the said agency costs in the constitutional setting.

The parallels in the scheme for the delegation of power as laid down under corporate law and constitutional law can be conceived as follows. The right to vote and elect the main policy making body is vested with the shareholders of companies and with citizens in political democracies. In terms of the agency relationship, they both perform the function of electing the centralized decision-making body to which the power and the responsibility to govern the collective are delegated.

Additionally, shareholders and citizens (when the constitution provides for certain forms of direct democracy) also perform the function of directly voting to approve or reject certain types of proposals coming from the board of directors (major corporate changes, appointment of auditors etc.) or the government (various types of referendums). Shareholders and citizens of polities that provide for initiatives also retain the power to make proposals if they demonstrate the support of a certain number or proportion of votes.³⁸ If these qualifying requirements are met, shareholder and citizens further perform the function of voting to adopt or reject the said proposal that some of them earlier proposed.

The functional parallels of the board of directors and the legislature can be seen in terms of their role as decision makers and policy setters who are delegated with the power to manage the affairs of the company or polity. Additionally, their principals are bound by their actions with respect to third parties.³⁹ The board of directors and parliaments are both in turn tasked with appointing the management and the executive respectively.⁴⁰

As discussed earlier, in some parliamentary democracies, the functional parallel is further extended since the executive comprising of the Prime Minister and the Cabinet continue to be members of the legislature which appointed them.⁴¹ This means that members of the legislature in a number of countries serve a dual function by also being part of the executive.

³⁸ This is possible through shareholder proposals under corporate law and through initiatives under constitutional law.

³⁹ The rule of limited liability restricts shareholders' liability for the actions of the Board of Directors to the extent of their investment in the company while citizens are bound by the actions of their legislatures in terms of international agreements, treaties and debt obligations.

⁴⁰ This is an element of divergence in the Presidential system where the executive is directly appointed. See Persson, Torsten, Gerard Roland, and Guido Tabellini. "Separation of Powers and Political Accountability." *The Quarterly Journal of Economics* 112, no. 4 (1997): 1163-1202. at 1167. "The procedure for appointing the executive is direct in a presidential system, but indirect, through the legislature, in a Parliamentary system."

⁴¹ This system is common in commonwealth countries such as the UK, India and Australia.

This duality is also witnessed in corporate law which provides for executive directors who remain members of the board of directors while also being part of the management of the company.

The board of directors and the legislature share further parallels insofar as their function of monitoring the management and the executive respectively.^{42,43} To enable them to perform this function, they are both empowered with the authority to investigate the workings of the management/executive and to demand and receive access to the information required by them to do so. The analogies drawn between the monitoring function of board of directors⁴⁴ and legislatures⁴⁵ are amply highlighted by the similar use of committees and procedures to facilitate investigation and oversight in both systems.

The parallels in the monitoring function performed by boards of directors and legislatures are clear in the allocation of the power to parliament to appoint and remove the executive which only remains in office while it enjoys the confidence of the majority of its members. This situation is analogous to the corporate situation where the CEO and the top executives may be removed from office by the board of directors.⁴⁶

At the last level of delegation lie the management and executive who manage the daily running of the organization and implement and fructify the policies of the board or the legislature, as the case may be. This level of the decision-making hierarchy will usually be included together with the board of directors in the category of “agent” in the forthcoming comparative analysis whenever the distinction is unimportant.

⁴² Eisenberg, Melvin A. “Board of Directors and Internal Control, The.” *Cardozo L. Rev.* 19 (1997): 237.

⁴³ Galloway, George B. “The Investigative Function of Congress.” *The American Political Science Review* 21, no. 1 (1927): 47-70.

⁴⁴ *Supra* note 42.

⁴⁵ *Supra* note 43.

⁴⁶ The CEO serves at the pleasure of the board and while his/her employment contract might provide for compensation in the event of removal, the board retains the power to both hire and fire the CEO. See § 142 (2), Delaware General Corporation Law:

Delaware General Corporation Law § 142 (2): “Officers shall be chosen in such manner and shall hold their offices for such terms as are prescribed by the bylaws or determined by the board of directors or other governing body. Each officer shall hold office until such officer's successor is elected and qualified or until such officer's earlier resignation or removal. Any officer may resign at any time upon written notice to the corporation.”

It can, therefore, be said that there is a mirroring of the functional and structural delegation of power in the corporate and constitutional systems. This extends to the provision of exceptions whereby some types of decisions may be made directly by the shareholders or the citizens.

The next section examines the consequences of this prima facie similarity on agency costs by applying an appropriate theoretical framework to facilitate the comparative analysis.

2.2 THEORETICAL FRAMEWORK

This section examines the parallels in the causes and the nature of the agency problems experienced by companies and representative democracies in terms of agency theory. The characterization of the agency problems of both systems in terms of a shared agency theory paradigm allows the use of corporate governance insights to understand and to help improve constitutional law.

Needless to say, the applications of such insights would also be limited to addressing agency costs due to the limitations of the common thread of agency theory that makes the comparison possible. In the previous discussion, the delegation of authority from a dispersed group of shareholders or citizens to a small specialized group of decision makers was identified as the key to agency cost in the corporate and constitutional systems.⁴⁷ This section explains how the factors that influence agency cost in corporate and constitutional law can both be explained using the same theoretical framework.

2.2.1 Agency Theory

Agency theory can be characterized as an attempt to use the metaphor of a contract to understand the relationship between two parties where one (the principal) delegates certain

⁴⁷ Ross, Stephen A. "The Economic Theory of Agency: The Principal's Problem." *The American Economic Review* 63, no. 2 (1973): 134-139 at 134. "We will say that an agency relationship has arisen between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal, in a particular domain of decision problems."

work or responsibility to the other (the agent) to be performed by the latter.⁴⁸ It focuses on three main problems that arise in such relationships:⁴⁹

- (a) The desires or goals of the principal and agent conflict and;
- (b) It is difficult or expensive for the principal to verify what the agent is actually doing.
- (c) It is not possible to make a complete contract.

The characterization of the principal-agent relationship as a contract means that the goal of this analysis using agency theory is to maximize the efficiency of the contract. This is done given “assumptions about people (e.g., self-interest, bounded rationality, risk aversion), organizations (e.g., goal conflict among members), and information (e.g., information is a commodity which can be purchased).”⁵⁰ In this dissertation, the analysis will look for the optimum balance between representative and direct decision-making in order to make the principal-agent contract more efficient.⁵¹

The theoretical framework adopted for this purpose is agency theory as typified by the work of Professors Jensen, Meckling, Fama and Ross.⁵² This approach has two advantages. It focuses on the study of governance mechanisms to deal with the impact of conflicting interests of principals and agents. Additionally, it also specializes in the study of the agency problem between the shareholders and managers of large corporations.⁵³ On the other hand,

⁴⁸ See Jensen, Michael, and Clifford W. Smith Jr. “Stockholder, Manager, and Creditor Interests: Applications of Agency Theory.” *Recent Advances in Corporate Finance*. Harvard University Press (1985) at 3.

⁴⁹ Eisenhardt, Kathleen M. “Agency Theory: An Assessment and Review.” *Academy of Management Review* 14, no. 1 (1989): 57-74 at 58.

⁵⁰ *Ibid.*

⁵¹ The efficiency criterion is explained in the course of the subsequent discussion. It suffices to say that an agency contract can be considered efficient if it minimizes the cost of using an agent.

⁵² See Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3.4 (1976): 305-360; Jensen, Michael C., and Jerold B. Warner. “The Distribution of Power Among Corporate Managers, Shareholders, and Directors.” *Journal of Financial Economics* 20 (1988): 3-24; Fama, Eugene F., and Michael C. Jensen. “Agency Problems and Residual Claims.” *Journal of Law and Economics* 26, no. 2 (1983): 327-349 and Ross, Stephen A. “The Economic Theory of Agency: The Principal’s Problem.” *The American Economic Review* 63, no. 2 (1973): 134-139.

⁵³ See Eisenhardt, Kathleen M. “Agency Theory: An Assessment and Review.” *Academy of Management Review* 14, no. 1 (1989): 57-74 at 59. See also Jensen, Michael, and Clifford W. Smith Jr. “Stockholder,

constitutional law is also characterized as an agency contract between citizens and their government and can be treated in a similar fashion.⁵⁴

Under the agency theory propounded by Professors Jensen and Meckling, an agency relationship is defined as “a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent.”⁵⁵

The shareholders of a company delegate decision-making authority to the board of directors and the management and entrust them to manage the affairs of the company.⁵⁶ In the constitutional scenario, the citizens delegate power to the legislature and the executive entrusting them to govern the polity.⁵⁷ This delegation of decision-making authority from shareholders to the board of directors and managers and the delegation of power from citizens to the legislature and executive creates a relationship typical of a principal-agent contract.⁵⁸

Manager, and Creditor Interests: Applications of Agency Theory.” *Recent Advances in Corporate Finance*. Harvard University Press (1985) at 3.

⁵⁴ Merville, Larry J., and Dale K. Osborne. “Constitutional Democracy and the Theory of Agency.” *Constitutional Political Economy* 1, no. 3 (1990): 21-47 at 22. “The United States Government was established as an agent of the people. Its founders (e.g., Hamilton in *The Federalist* No. 78) often spoke of the proposed new government as “the agent” or “the people’s agent,” and the incidental nature of their remarks leaves no doubt that the concept of government as agent was widely understood and accepted. Therefore, the constitutional convention of 1787 can be interpreted as the search for a defining relation between the people as principal and the government as agent. And the search resulted in a contract, the explicit part of which is the United States Constitution. *The U.S. Constitution is an agency contract.*” (emphasis added)

⁵⁵ Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3.4 (1976): 305-360 at 308.

⁵⁶ Berle, Adolph Augustus, and Gardiner Gardiner Coit Means. *The Modern Corporation and Private Property*. Transaction Books, 1932.

⁵⁷ See *The Federalist* No. 78 in Hamilton, Alexander, James Madison, and John Jay. *The Federalist Papers*. Oxford University Press, 2008. The role of the government as the agent of the people with their power stemming from the people is clearly established in both the preamble of the US Constitution and the Indian Constitution. Both clearly state that the people delegate power to government. Such sentiments are enshrined in the constitutions of most democratic republics.

⁵⁸ The United States Government was characterized as an “agent” or “the people’s agent” by Alexander Hamilton in *The Federalist* No. 78. See Merville, Larry J., and Dale K. Osborne. “Constitutional Democracy and the Theory of Agency.” *Constitutional Political Economy* 1, no. 3 (1990): 21-47. The principal-agent relationship in the corporate context has of course been explored and recognized in the whole of ‘positivist’ agency theory literature. See Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3.4 (1976): 305-360; Jensen, Michael C., and Jerold B. Warner. “The Distribution of Power Among Corporate Managers, Shareholders, and Directors.” *Journal of Financial Economics* 20 (1988): 3-24; Fama, Eugene F., and Michael C. Jensen. “Agency Problems and Residual Claims.” *Journal of Law and Economics* 26, no. 2 (1983): 327-349

In terms of agency theory, decision-making authority is delegated by the shareholders and citizens. As such, they are characterized as the principals for the purposes of the analysis.⁵⁹ As the board of directors and management jointly perform the task of administering the affairs of the company and are delegated power directly or indirectly by the shareholders, they will be jointly characterized as the agents. The same is true for the legislature and the executive which also jointly perform the function of government and enjoy power delegated by the citizens. Accordingly, they are jointly characterized as the agents in the principal-agent relationship under constitutional law.⁶⁰

Having established this, an analysis of agency theory shows that in principal-agent relationships, the tendency of both the agents and principals to maximize their own utility can lead to situations where the former will not act in the best interests of the latter.⁶¹ This means that:

- Both the principal and the agent are expected to act in their own self- interest.
- The agent's interests may not always be the same as those of the principal.
- The agent will, therefore, act in his own interest and not in the interest of the principal in such circumstances.

“Both agency and political perspectives assume the pursuit of self-interest at the individual level and goal conflict at the organizational level.”⁶² It is, therefore, clear that agency theory identifies the same problem to be central to the creation of agency problems in the both systems.

and Ross, Stephen A. “The Economic Theory of Agency: The Principal’s Problem.” *The American Economic Review* 63, no. 2 (1973): 134-139.

⁵⁹ See Strøm, Kaare. “Delegation and Accountability in Parliamentary Democracies.” *European Journal of Political Research* 37, no. 3 (2000): 261-290 at 267. “Democracy as popular sovereignty means that ordinary citizens are the ultimate principal.”

⁶⁰ Due to this, the direct election of the executive in the Presidential form of democracy as opposed to the indirect delegation of power to the management and executive in the corporate and parliamentary systems becomes irrelevant in this instance.

⁶¹ Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3.4 (1976): 305-360 at 308.

⁶² Eisenhardt, Kathleen M. “Agency theory: An assessment and review.” *Academy of management review* 14, no. 1 (1989): 57-74 at 63.

This is the first factor that gives rise to agency problems. In addition to the conflict of interest between the principal and the agent, another factor responsible for agency problems is the difficulty experienced by the principals in determining whether or not the agents are behaving appropriately.⁶³ At first glance, it is clear that this problem is a strong factor in both the corporate and political systems due to the complex and specialized information and decision-making involved. The existence of a large number of external factors influencing the performance of the agents only makes matters worse. This is because principals have trouble deciding whether poor performance is due to bad decision-making by agents or bad conditions outside of their control. This problem in assessing the performance of the agents is further exacerbated by the fact that the principals are numerous and uncoordinated, lack the required information and specialized skills to make reasoned decisions and do not have the proper incentives to acquire such resources.⁶⁴

This sentiment is echoed by Professors Jensen and Meckling who explain that it is almost impossible to ensure at zero cost that the agents will act in the best interests of the principals. They argue the use of an agent necessarily entails a cost. This cost known as agency cost is comprised of 3 parts namely monitoring cost, bonding cost and residual loss.⁶⁵ These are discussed in the following discussion.

As per Professors Jensen and Meckling's conception of agency theory followed in the dissertation, principals must expend resources to monitor the actions of their agents. This is

⁶³ *Id* at 61.

⁶⁴ See Arrow, K. E. *The Limits of Organization*. Norton, 1974 at 69. Using a cost-benefit analysis, shareholders can only be expected to expend effort to gather the information required for them to make informed decisions if the perceived benefit exceeds the effort. In this instance, the costs of gathering the required information are substantial due to the voluminous and complex nature of numerous disclosures and the acquisition of specialist skills required to make informed decisions.

On the other hand, shareholders can typically expect only a miniscule proportion of any benefits due to their relatively small proportion of the stock of the company. Relatively small holding also mean that shareholders only have a negligible chance of influencing the outcome of the decision which makes them more apathetic. See Bainbridge, Stephen. "Director Primacy and Shareholder Disempowerment." *Harvard Law Review* 119 (2006): 1735-2644 at 1745. This leads to shareholders delegating decision-making authority to a smaller group (the board of directors) to ensure long term maximization of shareholder value. See Bainbridge, Stephen. "Case for Limited Shareholder Voting Rights, The." *UCLA L. rev.* 53 (2005): 601 at 624.

These problems can also be seen mirrored in the constitutional system with the free rider problem, rational ignorance and lack of specialized human capital emerging as serious problems for direct democracy. These will be discussed later.

⁶⁵ *Supra* note 61.

known as *monitoring cost*. It includes not just the cost of “measuring and observing the behavior of the agent” but also the resources expended by the principal to control the behavior of the agent.⁶⁶ Accordingly, resources have to be spent to monitor the actions of the agent and to induce the agent to incur bonding costs.

Bonding costs can be characterized as the resources expended by the agent to guarantee that he or she will not take actions detrimental to the interests of the principal. As the agent is compensated for his services by the principal, bonding costs are ultimately borne by the latter.

Furthermore, despite the expenditure of these resources, the interests of the agents and principals will still not coincide perfectly. The company or polity will also incur the cost of the divergence of the actions of the agents from those that would be in the principal’s best interests.⁶⁷ This cost is termed as *residual loss*.

This shows that a comparative analysis of agency cost and the influence of limited direct decision-making in the corporate and constitutional setups can be studied in terms of agency costs measured as the sum of the following:⁶⁸

- The monitoring expenditures by the principal,
- The bonding expenditures by the agent, (but ultimately paid for by the principal)
- The residual loss.

Therefore, as per Professors Jensen and Meckling, agency cost can be summarized by the following equation:

$$\text{Agency Cost} = \text{Monitoring Cost} + \text{Bonding cost} + \text{Residual Loss}$$

⁶⁶ “As it is used in this paper the term monitoring includes more than just measuring or observing the behavior of the agent. It includes efforts on the part of the principal to ‘control the behavior of the agent through budget restrictions, compensation policies, operating rules etc.’” See Footnote 9, *Supra* note 61.

⁶⁷ See *Supra* note 61. On the other hand, in Jensen, Michael, and Clifford W. Smith Jr. “Stockholder, Manager, and Creditor Interests: Applications of Agency Theory.” *Recent Advances in Corporate Finance*. Harvard University Press (1985) at 3, Prof. Jensen provides an alternate definition. He defines it as follows: “(R)esidual loss represents the opportunity loss remaining when contracts are optimally but imperfectly enforced.”

⁶⁸ *Supra* note 61.

For the purposes of this dissertation, the focus of analysis will be on monitoring costs and residual loss. This is because it is difficult in practice to require agents to incur bonding costs in the constitutional scheme for the following reasons.

One way to discourage agents from acting against the interests of the principals is to require them to put up a credible commitment in the form of a hostage or to require them to post a bond that would be forfeited in the event of misbehavior is required to be given by the agent.⁶⁹ The cost of incentivizing the agent to do so is the bonding cost. Under constitutional law, requiring a monetary surety large enough to constitute a ‘credible commitment’ from legislators would mean that poor people would be impeded from contesting elections. Furthermore, the potential for improper gain through corruption in high political office is exceptionally large. This means that the forfeited bond amount would recover little of the lost value for the principals and even more importantly, do very little to deter agents from appropriating potentially vast fortunes.⁷⁰

This section, therefore, establishes that agency theory can help to characterize insights from corporate governance in terms of a shared theoretical framework allowing these insights to be used to understand and improve constitutional law. It also characterizes the cause of agency cost in both systems to be the sum of the residual loss and the monitoring expense (factoring in bonding expenses such as internal information gathering etc.). This discussion is continued in the following section with the introduction of direct democracy into this shared understanding of agency cost.

⁶⁹ See Hill, Charles WL, and Thomas M. Jones. “Stakeholder-Agency Theory.” *Journal of Management Studies* 29, no. 2 (1992): 131-154 at 139; Williamson, Oliver Eaton. *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. Free Press, 1985 and Alchian, Armen A., and Susan L. Woodward. “The Firm is Dead; Long Live the Firm: A Review of Oliver E. Williamson’s *The Economic Institutions of Capitalism*.” *Journal of Economic Literature* 26, no. 1 (1988): 65-79.

⁷⁰ The World Bank estimates that \$1 trillion was paid as bribes as per 2001-02 economic data. This figure is expected to be much larger now and does not include embezzlement of public funds or theft of public assets. It goes without saying that the forfeiture of no realistic bond will deter a corrupt agent from accepting bribes and acting against the interests of the principals when the rewards of such breach are so truly astronomical. See “The Costs of Corruption”, *World Bank News & Broadcast*, April 8th, 2004 at permanent URL <http://go.worldbank.org/LJA29GHA80> visited on 20 May 2012.

2.3 INTRODUCING DIRECT DEMOCRACY

This section introduces the use of direct democracy into the theoretical framework outlined above. The objective behind this is to demonstrate that corporate and constitutional law provisions allowing for the use of direct democracy to make certain types of decisions are similar in nature and have a similar impact on agency costs in the two systems.

This opens the way for corporate governance insights into the impact of ‘direct democracy in limited circumstances’ on agency costs to be used to understand and improve constitutional law by fine tuning the balance between representative and direct democracy.⁷¹ Additionally, it can even help to determine the optimum form and procedure to carry out the direct democratic decision-making that is provided for.

To be clear, by ‘direct democracy in limited circumstances’, I refer to the norm in corporate and constitutional law that agents vested with delegated decision-making authority make the vast majority of policy decisions. Principals on the other hand ordinarily restrict themselves to participating in periodic elections. It is only in exceptional circumstances that the approval of the principals is required and they may only initiate decisions after satisfying certain thresholds and conditions.

Such exceptions to the norm of delegated decision-making are found in both systems typically in the form of a provision requiring the approval of certain major decisions by a direct vote of the principals. For example, the approval of the principal may be required to amend the articles of association⁷² or the constitution⁷³.

In certain circumstances, shareholders and citizens may even be allowed to initiate decision-making by demonstrating that their proposal is supported by a specified threshold of their fellow shareholders or citizens and by meeting some certain specified conditions. If this is done successfully, such proposals are voted on by the principals who may adopt or reject them. Such initiation of decisions by the principals can be seen in the form of the corporate

⁷¹ Direct decision-making is only used in limited circumstances in the corporate and constitutional systems since regular decision-making is delegated to the management and the government respectively. The principals only make decisions via a direct vote in extraordinary circumstances.

⁷² See for example § 242(b)(2), Delaware General Corporation Law.

⁷³ See Article 46 of the Constitution of Ireland and Section 128 of the Constitution of Australia for examples of provisions requiring national referendums in order to amend the constitution.

shareholder proposal⁷⁴ and the initiative under constitutional law⁷⁵. The result of direct democratic activity may or may not be binding and indeed this forms the basis of chapter 3.

This section outlines the provisions of corporate and constitutional law that allow principals to make certain types of decisions directly by voting upon them instead of relying on their representatives. Whenever not specified otherwise, the corporate law used in this analysis is the corporate law of the State of Delaware read together with US federal securities laws that apply to public companies. A reading of this section will demonstrate the parallels in this corporate legal system and the constitutional setup in terms of their provisions for the exercise of direct democracy.

2.3.1 *Direct Democracy in Corporate Governance*

“Direct democracy in limited circumstances” and by implication delegated decision-making under typical circumstances can be seen in the corporate form. Corporate law functions by delegating decision-making to the board of directors.⁷⁶ However, there exist exceptions to this rule that allow for the limited use of direct democracy to make decisions under certain circumstances.

Shareholders are required to directly vote to approve certain major decisions of the board. These decisions where the shareholders may veto a decision of the board by not approving it are:

- Changes to the articles of association,⁷⁷

⁷⁴ See Rule 14a-8 passed under the Securities Exchange Act, 1934 which regulated shareholder proposals in the United States.

⁷⁵ See Article II, Section 8 of the Constitution of California which allows citizens to propose amendments of the constitution which, if the proposal meets certain conditions, is then voted on by the citizens who may adopt or reject it.

⁷⁶ § 141(a), Delaware General Corporation Law places the responsibility of managing the business and affairs of the company on the board of directors.

“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.” (extract)

⁷⁷ § 242(b)(2), Delaware General Corporation Law

- Mergers and consolidation,⁷⁸
- The sale of all or substantially all the company's assets not in the ordinary course of business,⁷⁹
- Dissolution,⁸⁰
- Reincorporation,
- A non-binding vote is even required on executive pay post the Dodd-Frank Act.⁸¹

While the initiation of policy is typically the function of the board of directors,⁸² shareholders are also empowered to initiate proposals if they meet certain requirements. These qualifications are typically in the form of shareholding requirements. These may be measured in terms of duration of ownership and the voting rights carried by the shares held by the group of shareholders initiating the proposal.

The shareholder proposal has gained a lot of attention in light of the shareholder rights debate centered on Rule 14a-8 passed under the Securities Exchange Act, 1934. This rule sets out the conditions that a shareholder proposal must meet in order for the Securities and Exchange Commission to consider it suitable. It should be noted that one of the key requirements set out in this rule is that the shareholder proposal must be in compliance with the law of the state of the company's incorporation. Accordingly, corporate governance scholarship covering both Delaware corporate law and US securities laws dealing with this issue will be of particular interest in sourcing insights for constitutional law.

⁷⁸ § 251(c), Delaware General Corporation Law

⁷⁹ § 271(a), Delaware General Corporation Law

⁸⁰ § 275, Delaware General Corporation Law

⁸¹ § 951 of the Dodd-Frank Act, 2010

⁸² See for example the case of amendments to the certificate of incorporation after receipt of payment for stock. While § 242(b)(2), Delaware General Corporation Law provides for shareholder to vote to approve or reject a proposal to amend the certificate of incorporation, § 242(b)(1) places the power to initiate the proposal exclusively with the board of directors.

§ 242(b)(1), Delaware General Corporation Law: "If the corporation has capital stock, its board of directors shall adopt a resolution setting forth the amendment proposed, declaring its advisability, and either calling a special meeting of the stockholders entitled to vote in respect thereof for the consideration of such amendment or directing that the amendment proposed be considered at the next annual meeting of the stockholders."

2.3.2 *Direct Democracy in Constitutional Law*

The constitutional schemes of nations and other polities also exhibit this use of ‘direct democracy in limited circumstances’ in a system otherwise based on delegated decision-making. The use of referendums and initiatives empowers citizens to directly vote on the following types of decisions:⁸³

- On fundamental decisions such as constitutional amendments (mandatory referendum),
- When the legislature refers decisions to a vote of the citizens (legislative or optional referendum)
- To vote down laws already passed after having collected a predetermined number of signatures (petition referendum).

They may also have the right to put up a proposal that, if supported by enough signatures, is voted upon as if it were a referendum. This poll may take place in the form of a special poll or the proposal may be included on the ballot in the next election. This is known as a ballot initiative.

This use of direct democracy exists, as it exists in corporate law, as an exception to the rule of governance by agents delegated with decision-making authority.

2.3.3 *The Role of Direct Democracy: Balancing Accountability & Authority*

It can be surmised from this discussion that the corporate and constitutional forms both provide for similar exceptions to the rule of representative decision-making when principals can make decisions directly. Under both systems, critical or fundamental decisions are typically subject to be put to a vote before the principals for approval. They both also allow for the principals to petition for a proposal to be put to the vote if certain qualifying requirements are met.

⁸³ See Matsusaka, John G. “Economics of Direct Legislation.” *The Quarterly Journal of Economics* 107, no. 2 (1992): 541-571 and Matsusaka, John G. “Direct Democracy Works.” *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206. As explained earlier, referendums refer to the process where citizens ratify or veto a proposal initiated by the government. On the other hand, initiatives refer to the process whereby citizens themselves come up with a proposal by demonstrating that a specified number or proportion of voters are in favor of the proposal, typically by collecting signatures on a petition. If this requirement is met, the proposal is voted upon by all the citizens and if ratified becomes law.

A balance must be maintained to ensure that the collective action problems caused by monitoring through direct decision-making do not outweigh the savings in terms of a reduction in residual loss.⁸⁴ Accountability through direct democracy should not destroy the value of authority. After all, it is the transfer of decision-making power to a centralized authority comprising of agents which makes the corporate and constitutional systems effective.⁸⁵

Lacking the specialized information available to their representatives, principals might deviate from superior decisions made on their behalf by their agents. They might also concentrate their energies on campaigning and pursuing short term policies. Additionally, agents that tend to be second guessed repeatedly tend to lose managerial initiative.⁸⁶

An examination into this trade-off shows that corporate and constitutional laws both share the same problems in determining the right balance. Intuitively, it might be said that principals may reserve the power to make major decisions to ensure accountability while keeping their hands off the regular decisions required for day-to-day operations, in order to preserve authority.⁸⁷ The shared problem in this respect is that the board of directors and the legislature themselves only make ‘major’ decisions involving policy. In fact, the day-to-day operations and associated decision-making is left to the management and executive respectively.

⁸⁴ Collective action problems in this context refers to the following issue: All principals must bear the considerable cost of gathering and assimilating information to monitor the agents in its entirety but they only receive a pro-rata share in the benefits of better monitoring in proportion to their shareholding in the company. This results in a situation where no individual principal has proper incentives to effectively monitor the agents.

⁸⁵ Hutchison, Harry G. “Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm.” *Loyola University Chicago Law Journal* 36, no. 4 (2005): 1111. See also Bainbridge, Stephen. “Case for Limited Shareholder Voting Rights, The.” *UCLA L. Rev.* 53 (2005): 601 and Bainbridge, Stephen. “Director Primacy and Shareholder Disempowerment.” *Harvard Law Review* 119 (2006): 1735-2644.

⁸⁶ Setälä, Maija. “On the Problems of Responsibility and Accountability in Referendums.” *European Journal of Political Research* 45, no. 4 (2006): 699-721.

⁸⁷ The delegation of decisions making power to a centralized decision-making authority is the key feature of both corporate and constitutional law. This is because collective action problems make direct decisions making for ordinary matters impractical. This is made impossible by the volume and complexity of the information required to make reasoned decisions. This issue is discussed further on the following page with the help of Professor Arrow’s analysis.

Since the entire debate centers around the principal's intervention in decision-making that is not of the day to day kind, corporate law can help to shed light on exactly what kinds of policy decisions would benefit from the possibility of such intervention.

2.4 THE IMPACT ON AGENCY COST

The previous sections of this chapter have established that agency theory can provide a common or shared characterization of agency cost under the corporate and constitutional systems. It has also been demonstrated that both systems provide for direct decision-making by the principals along similar lines.

In this section, I characterize the influence of direct decision-making by shareholders in terms of agency theory. This will allow corporate governance insights to be used to address agency problems in constitutional systems (now understood in terms of agency theory) since both systems provide for similar types of decisions to be made directly by the principals under similar circumstances.

In order to carry out a useful comparative analysis to optimize the agency costs present in the constitutional system, it is essential to understand the purpose behind delegating authority in the first place. This will then lead to an understanding of the relationship between agency cost and the total cost of decision-making for companies and democratic polities.

A large and dispersed principal along with the frequency and specialized nature of decision-making required in the two systems makes decision-making by 'true direct democracy' or plebiscite on every issue unmanageable. This is caused by a combination of factors such as the free rider problem, the need for specialized human capital, problems in coordinating with thousand if not millions of individuals etc. as explained below.

The free rider problem and the lack of specialized human capital here refers primarily to the lack of incentive for voters to collect enough information and skills to make informed decisions. It is analyzed here in light of Professor Arrow's information condition.⁸⁸ He states,

⁸⁸ See Arrow, K. E. *The Limits of Organization*. Norton, 1974; Bainbridge, Stephen. "Director Primacy and Shareholder Disempowerment." *Harvard Law Review* 119 (2006): 1735-2644 and McDonnell, Brett H. "Professor Bainbridge and the Arrowian Moment: A Review of the New Corporate Governance in Theory and Practice." *Del. J. Corp. L.* 34 (2009): 139. Professor Kenneth Arrow's analysis of the collective decision-making

*“Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success”.*⁸⁹

Using a cost-benefit analysis, shareholders can only be expected to expend effort to gather the information required for them to make informed decisions if the perceived benefit exceeds the effort. In this instance, the costs of gathering the required information are substantial due to the voluminous and complex nature of the information and the acquisition of specialist skills required for making informed decisions.

On the other hand, shareholders can typically expect only a miniscule proportion of any benefits due to their relatively small proportion of the stock of the company. Relatively small holdings also mean that shareholders only have a negligible chance of influencing the outcome of the decision which makes them all the more apathetic.⁹⁰

This leads to shareholders delegating decision-making authority to a smaller group (the board of directors) to ensure long term maximization of shareholder value. This is because it is ‘cheaper and more efficient to transmit all the pieces of information once to a central place’, and for the central place to ‘make the collective decision and transmit it rather than retransmit all the information on which the decision is based’.⁹¹

These problems can also be seen mirrored in the constitutional system with the free rider problem, rational ignorance and lack of specialized human capital emerging as serious problems for direct democracy. After all, both companies and countries require the acquisition and assimilation of vast quantities of specialized information in order to make reasoned decisions. Neither shareholders nor citizens have the incentives to engage in such a

process in terms of consensus and authority is used here. (Arrow, K. E. *The Limits of Organization*. Norton, 1974 at 68-70) He argues that organizations whose constituents have divergent interests and suffer from information asymmetries naturally tend towards authority based decision-making structures. The shareholders of modern public corporations with widely dispersed shareholders can be said to fit this description. (Bainbridge, Stephen. “Director Primacy and Shareholder Disempowerment.” *Harvard Law Review* 119 (2006): 1735-2644)

⁸⁹ Arrow, K. E. *The Limits of Organization*. Norton, 1974 at 69.

⁹⁰ Bainbridge, Stephen. “Director Primacy and Shareholder Disempowerment.” *Harvard Law Review* 119 (2006): 1735-2644 at 1745.

⁹¹ Bainbridge, Stephen. “Case for Limited Shareholder Voting Rights, The.” *UCIA I. rev.* 53 (2005): 601 at 624.

herculean task and acquire such skills when they must bear all the cost of doing so yet stand to gain only a pro-rata share of the benefits.⁹²

The other problem with collective decision-making is the issue of divergent interests of the principals. While it is assumed that the shareholders of a company seek to maximize profits, this in no way reduces the conflict of interest that exists between them. There are often differences in preferences for long or short term profits, varying risk appetites that dictate shareholder's support for new investments by the company and divergence of opinion regarding dividends. In fact, there may even be divergence of opinion between shareholders whether the company should pursue profits to the detriment of social, political, environmental or environmental interests. See for example the case of *State of Minnesota ex rel. Charles A. Pillsbury v. Honeywell Inc.*⁹³ In this case, Charles Pillsbury, a shareholder in Honeywell Inc. wanted the company to stop manufacture of napalm for use in the war in Vietnam on humanitarian grounds. This created a conflict of interest with the management and shareholders who wanted to maximize profits by carrying out an unsavory yet perfectly legal activity.

In the constitutional context, similar conflicts can arise. While citizens may agree that enhancing social welfare should be the objective of government, how to achieve this is the subject of all political movements and consensus can rarely be found. It is, therefore, clear that direct democracy will not automatically produce a result that maximizes social welfare or even that such a decision will have popular support.

Accordingly, corporate and constitutional law deliberately provide for a system of delegated decision-making and create the principal-agent relationship which gives rise to agency costs because it is the lesser of two evils. The less preferable option would be for the dispersed and large principal to govern via plebiscite leading to unmanageable collective action problems. It can, therefore, be seen that the agency costs inherent in representative decision-making is a

⁹² Macey, Jonathan R. "Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory." *Va. L. Rev.* 74 (1988): 471.

⁹³ See for example *State of Minnesota ex rel. Charles A. Pillsbury v. Honeywell Inc.* 191 N.W.2d 406 (1971). See also *Supra* note 90.

rational choice made by the principals in terms of minimizing the total cost of decision-making.⁹⁴

Professors Jensen and Meckling have argued that the existence of agency cost does not mean that the (corporate or constitutional) system is “non-optimal, wasteful or inefficient” just as the fact that iron must be mined and is not available at zero cost does not make the world a “non-optimal, wasteful or inefficient” place. They also note with approval that the view that agency cost must be eliminated has been criticized by Professor Demsetz as the “nirvana form of analysis.”⁹⁵

The goal of this dissertation is, therefore, not to eliminate agency costs. This can be done instantly by terminating the agency relationship and making all decisions through direct ballot.⁹⁶ This, however, is only possible as long as the principal is willing to incur collective action problems that would exceed the savings in terms of agency cost which would, of course, be counterproductive.⁹⁷

This trade-off is excellently characterized by Professors Jensen and Meckling. They argue that agency cost understood as the sum of monitoring and bonding cost as well as residual loss is an unavoidable result of the agency relationship. Next, they state that because principals bear the cost of creating the relationship and capture the savings when these costs are minimized, they have incentives to minimize agency cost. Most importantly, they argue “*agency costs will be incurred only if the benefits to the owner-manager from their creation are great enough to outweigh them.*”⁹⁸ (emphasis added)

⁹⁴Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3.4 (1976): 305-360 at 328.

⁹⁵ See *Ibid.* See also Demsetz, Harold. “Information and Efficiency: Another Viewpoint.” *Journal of Law and Economics* 12, no. 1 (1969): 1-22.

⁹⁶ Jensen, Michael, and Clifford W. Smith Jr. “Stockholder, Manager, and Creditor Interests: Applications of Agency Theory.” *Recent Advances in Corporate Finance*. Harvard University Press (1985) at 7. “In the extreme, agency problems in the open corporation between managers and common stockholders can be eliminated by combining the two functions, that is, by abandoning the open corporate form.”

⁹⁷ Arrow, K. E. *The Limits of Organization*. Norton, 1974 at 68.

⁹⁸ Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3.4 (1976): 305-360 at 328.

The dissertation considers the use of direct democracy in limited circumstances not as a replacement for the system of delegated decision-making but rather, as a monitoring tool existing within the rubric of representative democracy. Therefore, rather than a substitute, direct democracy is conceived as a monitoring mechanism and a tool for intervention in exceptional circumstances when the principals consider that their agents are not acting in their best interests.⁹⁹ This is because monitoring cost includes not just the cost of measuring or observing the behavior of the agent but also includes the cost of controlling the ‘behavior of the agent through budget restrictions, compensation policies, operating rules etc.’¹⁰⁰

The threat of intervention by the principals via direct democracy provisions serves to align the actions of the agent with the wishes of the principal. Besides the threat of intervention which serves a monitoring function, direct democracy also allows citizens and shareholders to actively make decisions by adopting ballot initiatives and shareholder proposals or bylaws respectively. Actual interventions by which citizens and shareholders make policy decisions also allow the principals to actively align the policy to the will of the collective.¹⁰¹ Therefore, whether direct democracy affects policy indirectly (by ensuring that agents do not make decisions that decrease value for principals) or directly (when principals make decisions that increase value themselves), such decisions have a monitoring effect by reducing residual loss.

As discussed before, intervention via direct decision-making would happen only in situations when two conditions are satisfied. Firstly, there must be a large divergence between the will of the principal and the actions of the agents. And next, this divergence must cause the agency costs to exceed the costs of collective action that intervention via direct decision-making entails. Direct democracy is, therefore, useful only when the costs of using it are

⁹⁹ “As it is used in this paper the term monitoring includes more than just measuring or observing the behavior of the agent. It includes efforts on the part of the principal to ‘control the behavior of the agent through budget restrictions, compensation policies, operating rules etc.’” See footnote 9, Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3.4 (1976): 305-360. at 308. In this vein, direct democracy is conceived as a monitoring tool. The threat of intervention by the principal via direct democracy provisions serves to align the actions of the agent with the wishes of the principal. Actual intervention allows the principal to actively align the policy to the will of the collective. This simplification of the monitoring via direct democracy will be discussed in detail in the subsequent chapters. In these chapters, the impact of direct democratic provisions becomes central to the positive and normative discussion and will be further elucidated.

¹⁰⁰ See Footnote 9, Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3.4 (1976): 305-360 at 308.

¹⁰¹ The relative efficacy of the threat of intervention versus the impact of actual intervention will be discussed at length in Chapter 3 dealing with binding versus non-binding direct decision-making.

lesser than the residual loss incurred by allowing representatives from following their preferred course of action.

These conditions can be expressed as follows:

Assuming Delegated Decision-making

When decisions are made by representatives under the corporate and constitutional setups, agency cost can be characterized as follows:¹⁰²

$$\text{Agency Cost} = \text{Monitoring Cost} + \text{Bonding cost} + \text{Residual Loss}$$

When direct democracy is introduced into this equation, the collective action problems it entails add to the monitoring cost. This is because provisions for the use of direct democracy are treated as monitoring and intervention mechanisms rather than a replacement for representative decision-making.

On the other hand, direct decision-making reduces the divergence between the actions of the agents and the preferences of the principals. This is because direct decision-making compels the agents to do what the principals decide to do by voting on the matter. Since residual loss is defined as the divergence of the actions of the agents from the preferences of the principals, the alignment of policy with the majority preferences of the principals caused by direct decision-making is characterized as a reduction in residual loss.¹⁰³

Therefore:

After the exercise of Direct Democracy Provisions:

$$\text{Agency Cost} = \text{Monitoring Cost (including the Cost of Collective Action)} (\uparrow) + \text{Bonding cost} + \text{Residual Loss} (\downarrow)$$

¹⁰² Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3.4 (1976): 305-360 at 308.

¹⁰³ See Section 2.2.1 for the definition of residual loss and other components of agency cost.

In light of this, the use of direct democracy can only serve to reduce agency costs under an otherwise representative system if the reduction of residual loss exceeds the increase in collective action problems incurred by direct decision-making.

In other words, direct democracy should only be used when the marginal increase in the monitoring cost is exceeded by the marginal decrease in residual loss i.e.

$$\frac{dMC}{dDD} < \frac{dRL}{dDD}$$

This expression denotes the first derivative where:

MC = monitoring cost,

DD = cost of direct decision-making

RL = residual loss

Now, limited direct democracy enabling mechanisms are characterized as monitoring mechanisms for the purposes of the dissertation. Since the use of such devices creates problems of collective action, monitoring costs can be said to increase by the amount of collective action problems introduced by such measures.

Therefore:

$$\Delta \text{Monitoring Cost} = \Delta \text{Cost of Collective Action}$$

In light of this, direct democracy will reduce the cost of decision-making and, therefore, be efficient only if the following condition is satisfied:

$$\Delta \text{Cost of Collective Action} < \Delta \text{Residual Loss}$$

Therefore, for direct decision-making to reduce agency cost, the cost of collective action borne by the principals must be less than the reduction in residual loss caused by the decision. This is, therefore, the normative criterion for minimizing agency cost used in this dissertation.

To conclude, it is prudent at this stage to reemphasize that the above characterization of the agency problem and its relationship with provisions for direct democracy apply to both the

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corporate and constitutional systems. An analysis under this framework, therefore, allows insights from corporate governance to be used to understand and optimize constitutional law. This relationship will be further developed in the analysis that follows.

2.5 THE UNIQUE VALUE OF CORPORATE GOVERNANCE INSIGHTS TO INFORM CONSTITUTIONAL LAW

The section explains why the insights from corporate governance that this dissertation offers to constitutional law are of particular significance. The previous sections have explained why corporate governance insights can help to understand and improve constitutional law in terms of the balance between the cost of direct decision-making and the overall agency cost that comes from delegated decision-making. This concluding section of the chapter explains the unique value of the insights themselves.

The use of corporate governance insights allows the use of a body of learning and experience that has evolved to mitigate agency problems in order to attract investment and survive in competitive business. The corporate form and associated governance rules are the result of inter-jurisdictional competition. The theory of inter-jurisdictional competition in the context of American corporate law refers to the idea that competition between different states to attract companies leads to states enacting corporate laws that are more attractive than those of other states. Since shareholders will not invest in companies subject to laws that impose high agency costs, states have an incentive to pass laws that involve lesser agency cost than those of other states. This causes states to compete to attract companies by passing laws that minimize agency costs.¹⁰⁴

The corporate form itself is also subject to the evolutionary pressures of the business market. The corporate structure that underpins the large public corporation being discussed in this dissertation is subject to competition from other organizational forms throughout its existence. After all, forces of competition would put out of business any organization that imposed higher agency costs on investors than other competing organizations without creating correspondingly greater returns. This would happen because the investors in public companies would exit and invest their money in organizations such as limited liability partnerships, cooperatives etc. if such organizational structures offered substantially lower agency cost.

¹⁰⁴ See Romano, Roberta. "State Competition Debate in Corporate Law, The." *Cardozo L. Rev.* 8 (1986): 709. For a criticism of this theory, see Bebchuk, Lucian Arye. "Federalism and the Corporation: the Desirable Limits on State Competition in Corporate Law." *Harvard Law Review* (1992): 1435-1510 and Kahan, Marcel, and Ehud Kamar. "The Myth of State Competition in Corporate Law." *Stanford Law Review* (2002): 679-749.

This means that corporate governance is in perpetual competition with other organizational structures in terms of the agency cost its functioning entails. The fact that they have emerged as the undisputed leader in attracting investment from dispersed investors for very large and complex ventures suggests that investors feel that it does not impose excessive agency costs compared to the benefits it provides. This intense evolutionary competition has also had a considerable amount of time to improve the corporate principal-agent relationship.¹⁰⁵

The dominant role of regulatory competition in pushing corporate governance towards the goal of minimizing agency cost is felt to a lesser extent in constitutional law. After all, it is easier to transfer one's investment from a company with higher agency cost to one with lower agency cost than it is to change citizenship and immigrate to a country more responsive to citizen's interests. In fact, oppressive regimes representative of constitutional systems with high agency cost often bar their citizens from emigrating freely and immigration laws of more attractive destination discourage such citizens from moving there. This stymies the ability of their citizens to opt out of their country's governance arrangements thereby disallowing regulatory competition from functioning as freely as it does in the corporate system.

There has also been enormous resources and effort expended in reconciling the need for authority and accountability in the field of corporate law. Additionally, the right to make decisions directly in corporate law, unlike the provision for referendums and initiatives has been introduced based on economic rather than moral or philosophical considerations. This means that shareholders' rights to make decisions directly under corporate law have been created on the basis of objective evidence as compared to citizen's rights under constitutional law which are affected by non-economic considerations like freedom, human rights etc.

In light of this, it can be said that the minimization of agency cost is a key goal of corporate governance. On the other hand, minimizing agency cost is one of the many goals of constitutional law. The combination of strong regulatory competition and competition with other business forms for attracting investors gives corporate governance a laser like focus on minimizing agency costs. This laser like focus on agency cost in corporate governance makes

¹⁰⁵For a detailed discussion on the evolution of the modern public corporation, see Cooke, Colin Arthur. *Corporation, Trust and Company: An Essay in Legal History*. Harvard University Press, 1951; Laski, Harold J. "The Early History of the Corporation in England." *Harvard Law Review* 30, no. 6 (1917): 561-588 and Alva, Curtis. "Delaware and the Market for Corporate Charters: History and Agency." *Del. J. Corp. L.* 15 (1990): 885.

it a valuable source of insights when we seek to re-examine direct democracy mechanisms in constitutional law with the express and singular view of minimizing agency cost.

By examining the scope and limits on the power of shareholders to make decisions directly, a more objective evaluation of the role and the costs of direct democracy in constitutional law becomes possible. This will further allow the minimization of agency cost by analyzing direct democracy in constitutional law through the lens of corporate governance.

Additionally, insights from corporate governance also have the unique advantage of coming closest to addressing the scale and complexity of the political principal-agent relationship. Along with this, insights from corporate governance on the use of direct decision-making also come closest to being able to capture the collective action problems inherent in referendums and initiatives. These claims are well supported by the sheer scale of some of the largest corporations. As of January 2014, Walmart had annual revenues of approximately \$476 billion,¹⁰⁶ greater than the GDP of all but 26 of the countries of the world.¹⁰⁷ This similarity is not just in terms of the scale of their finances. As of 2010, Walmart, with over 2.1 million employees¹⁰⁸ also employed a greater number of people than the population of over 80 of the world's nations.¹⁰⁹

While anecdotal, this information only underscores the fact that the public company is the dominant organizational structure used to carry out private commercial activity involving a large number of investors. Where the scale of operations becomes large enough and of sufficient complexity to parallel the complexity of administering a political unit such as a nation state or a federal sub-unit, the corporate form is a natural candidate for comparative study.

Lastly, the position of the public corporation as a principal mover of the modern economy has driven considerable resources into the study of the principal-agent relationship. It has also

¹⁰⁶ As per Walmart Inc.'s income statement available on the company's website.

¹⁰⁷ As per the International Monetary Fund's data for 2013.

¹⁰⁸ <http://money.cnn.com/magazines/fortune/global500/2009/performers/companies/biggest/> (Figures for 2010. Visited on March 2, 2012)

¹⁰⁹ United Nations, Department of Economic and Social Affairs, Population Division (2011). "*World Population Prospects: The 2010 Revision*", CD-ROM Edition.

funded and inspired sophisticated scholarship on the consequences of direct decision-making by shareholders on this delicate balance. It is not insignificant that Jensen and Meckling's seminal work universally recognized as the leading article on agency cost is about companies, and not constitutions.¹¹⁰

These practical considerations are further extended by the large amount of scholarship surrounding the recent academic debate concerning shareholder rights and the treatment of shareholder proposals in particular. In other words, constitutional law could benefit from a debate on the value and nature of delegating decision-making authority as well as the checks and balances that principals should retain in the form of the ability to make certain decisions directly. This is not to say that constitutional law does not have high quality research on the management of agency cost. It is merely argued that corporate governance has attracted a lot of attention regarding the study of agency costs and that a comparative study can provide valuable lessons. In light of all the arguments in this chapter, it is expected that constitutional law can further benefit from the work of scholars who have focused on the corporate form.

Some key applications of this approach are presented in the subsequent chapters.

¹¹⁰ Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3.4 (1976): 305-360.

3 RECONCILING THE COMPARATIVE ANALYSIS WITH KEY DISTINCTIVE FEATURES OF CORPORATE AND CONSTITUTIONAL LAW

Chapter 3 looks at key differences in the corporate and constitutional systems that may have an impact on the comparative study.

The first section of this chapter discusses the differences in the way voting rights are allocated under the two systems. In other words, the constitutional rule of universal adult franchise along with one person-one vote is compared to the corporate norm of allocating voting rights only to shareholders along with a trend of one share-one vote. It is acknowledged that a non-negligible number of corporations issue stock with differential voting rights. However the key point here is that voting rights in corporate law are determined by the number of shares held rather than the number of shareholders. This discussion will examine how the divergence in voting rights impacts agency cost in the two systems and identify any resultant limitations on the use of corporate law to understand and improve constitutional law.

Section 3.2 examines the impact of the unique legal liability regime that governs the accountability of directors and legislators on agency cost in corporate and constitutional law respectively. It finds that that directors and legislators are subject to more relaxed liability rules than regular agents such as lawyers, trust fund managers etc. This has a direct impact on agency cost as this reduces the ability of principals to use judicial means to monitor their agents.

Section 3.3 examines the influence that ‘super agents’ (agents tasked with monitoring agents) have on agency costs. In the corporate field, ‘super agents’ used by shareholders to monitor the board of directors can be proxy advisory companies like ISS and GlassLewis, social and ethical groups that report on the company’s wider impact on the world etc. In the constitutional system, they may be civil society groups, political action groups such as PAC’s, environmental groups such as the Sierra Club and other such organizations.

The role of intermediaries is critical under both systems as they help a huge dispersed body of principals to make informed decisions. By including the role of ‘super agents’ into the comparative analysis, the influence of key institutions like PAC’s¹¹¹, civil society groups, political and social organizations etc. can be factored into the recommendations of the dissertation. Additionally, this analysis will ensure that corporate law insights will not be rendered unhelpful due to the key role played by such ‘super agents’ in the two systems.

Section 3.4 examines two important factors whereby the agency relationship in the corporate and constitutional setups may diverge. Before corporate governance insights can be utilized to address agency costs under the constitutional democratic setting, the implications of the very different degrees of competition in corporate and constitutional elections as well as the impact of the Wall Street Rule must be examined.¹¹² These factors have a strong bearing on agency costs and their influence will be discussed in this section.

Chapter 3 concludes with a section highlighting why insights from the law and economics of corporate governance are of particular value in informing our understanding of the influence of initiatives and referendums on agency costs. The reasons presented here underscore the utility of looking at large public companies rather than other business organizations to minimize agency cost through the regulation of these direct democracy mechanisms.

3.1 THE NATURE OF FRANCHISE

This section begins with an examination of the role played by voting rights in corporate and constitutional law. It finds that elections for vacancies on the board of directors are less competitive than those for vacancies on the legislature. Taking in account the role played by

¹¹¹ PACs refer to Political Action Committees typical to the United States. Such groups engage in measures supporting or attacking particular legislators typically during elections. They have received a lot of attention since the ruling in *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010) which allowed PAC’s to spend unlimited funds to influence the outcome of elections as long as they did not ‘coordinate’ with the candidates.

¹¹² ‘The Wall Street Rule’ refers to the practice whereby shareholders unhappy with the management of a company sell their shares in that company rather than using shareholder activism to address the cause of their dissatisfaction with the management. This is often the case with stocks with high liquidity that can be easily sold. For a discussion on the pros and cons of both approaches, see Admati, Anat R., and Paul Pfleiderer. “The ‘Wall Street Walk’ and Shareholder Activism: Exit as a Form of Voice.” *Review of Financial Studies* 22, no. 7 (2009): 2645-2685.

the market for corporate control¹¹³ which is dependent on voting rights for its operation, the first sub-section concludes that voting rights are important for managing agency cost in both systems, albeit for somewhat different reasons.

This is followed by an analysis of the two main differences in the way voting rights are distributed in corporate and constitutional law. In general, there are two main differences which are discussed in sub-sections 3.1.2 and 3.1.3. They are:

- Only shareholders vote under corporate law as compared to universal adult franchise in constitutional law.
- Voting rights are a function of shareholding under corporate law as compared to the rule of one person-one vote under constitutional law.

These sub-sections look at the consequences of the divergence on the utility of using insights from corporate governance to help understand and optimize agency costs in constitutional law. Furthermore, I explain why many of these differences in allocating franchise rights do not affect the applicability of corporate governance paradigms to constitutional law within the proposed framework.

3.1.1 Why the Allocation of Voting Rights Affects Agency Costs?

Voting rights are central to managing agency costs in the corporate and constitutional systems. This remains true regardless of the fact that the election of directors is typically not as competitive as political elections. The vast majority of board elections are fought uncontested by the slate of candidates nominated by the board.¹¹⁴ This is in complete contrast

¹¹³ See the following sub-section for an explanation of the market for corporate control. See Manne, Henry G. "Mergers and the Market for Corporate Control." *The Journal of Political Economy* 73, no. 2 (1965): 110-120. In short, it argues that there is an incentive for potential buyers to buy the stock of a company that is underperforming due to its poor management, replace or improve the management and benefit from the resulting increase in share price.

¹¹⁴ See Bebchuk, Lucian A. "The Myth of the Shareholder Franchise." *Virginia Law Review* (2007): 675-732 at 677. In the period from 1996 to 2005, there were only 118 cases of rival slates being put up for election against the management slate. In larger companies with a capitalization of greater than \$200 million which this dissertation is more concerned with, there were only 24 cases of rival slates contesting with only 8 of them being successful.

NYSE listing rules post the Sarbanes-Oxley Act require that the boards slate of nominees be selected by a nomination committee comprising of independent directors. This still means there is one slate of candidates for election who typically contest unopposed.

to the highly contested elections for the legislature where many or at least two political parties compete furiously to represent the vast majority of constituencies. Much time, money and effort is often expended in these fierce contests.

It is argued that the relatively lower competitiveness of director elections does not make voting rights unimportant under corporate law. This is because directors can be replaced in the event of takeovers which are a result of the market for corporate control. The motivation of challenger groups to displace the board of directors (the agents) when agency cost becomes excessive was first outlined by Professor H.G. Manne in his celebrated paper as follows:¹¹⁵

“The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently. And the potential return from the successful takeover and revitalization of a poorly run company can be enormous.”

This leads the consolidation of shares with a single or a few individuals or corporate entities. These entities buy enough shares to gain sufficient voting rights to try to appoint their representatives to the board of the underperforming company. This is done by garnering the support of other shareholders to gain the requisite votes required. The acquiring group gets this support by canvassing for the ‘proxies’ of various other shareholders who are dissatisfied with incumbent management and would prefer to see them replaced.¹¹⁶ These ‘proxies’ are documents denoting permission by the shareholder to the proxy holder to exercise their voting rights at the shareholder meeting in favor of the acquiring group’s candidates.

The role of voting rights in corporate governance is, therefore, central to dealing with agency problems even though regular elections to the board of directors are typically far less competitive than political elections. This is because the market for corporate control that

The term ‘slate of candidates’ refers to a list of candidates proposed to fill all the vacancies on the board of directors that are to be filled up in an election. Such a ‘slate’ is proposed by the board of directors and in rare circumstances, by a challenger group.

¹¹⁵ Manne, Henry G. “Mergers and the Market for Corporate Control.” *The Journal of Political Economy* 73, no. 2 (1965): 110-120.

¹¹⁶ See Bebchuk, Lucian, and Oliver Hart. *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*. No. w8633. National Bureau of Economic Research, 2001. and Bebchuk, Lucian A., and Scott Hirst. “Private Ordering and the Proxy Access Debate.” *Bus. Law*. 65 (2009): 329.

plays a key role in monitoring agents relies on the threat of takeovers which pivot around the control and exercise of voting rights.¹¹⁷

It should also be noted that some US companies use staggered boards where only a fraction of the board of directors (typically 1/3rd) are appointed in each election.¹¹⁸ This means that more than one election is required to entirely replace the agents. This makes elections for the board of directors even less competitive.

The use of staggered boards to make the replacement of agents a slower and more difficult process is, however, not unique to corporate law. It is seen mirrored in constitutional law as seen in rules governing election to the upper house of the Indian Parliament known as the

¹¹⁷ The importance of the market for corporate control as a principal tool for the monitoring of corporate agents is a key element of agency theory. See Manne, Henry G. "Mergers and the Market for Corporate Control." *The Journal of Political Economy* 73, no. 2 (1965): 110-120. See also Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3.4 (1976): 305-360; Fama, Eugene F., and Michael C. Jensen. "Agency Problems and Residual Claims." *Journal of Law and Economics* 26, no. 2 (1983): 327-349; Jensen, Michael C., and Jerold B. Warner. "The Distribution of Power Among Corporate Managers, Shareholders, and Directors." *Journal of Financial Economics* 20 (1988): 3-24 and Jensen, Michael, and Clifford W. Smith Jr. "Stockholder, Manager, and Creditor Interests: Applications of Agency Theory." *Recent Advances in Corporate Finance*. Harvard University Press (1985).

It should also not be forgotten that per Delaware law, shareholders may remove the board of directors by a majority vote albeit with certain exceptions. This default rule has however been opted out of by a majority of the largest corporations with which this dissertation is most concerned with. The relevant provisions of the Delaware General Corporation Law are as follows:

§ 141(k), Delaware General Corporation Code.

"Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors, except as follows:

(1) Unless the certificate of incorporation otherwise provides, in the case of a corporation whose board is classified as provided in subsection (d) of this section, stockholders may effect such removal only for cause; or

(2) In the case of a corporation having cumulative voting, if less than the entire board is to be removed, no director may be removed without cause if the votes cast against such director's removal would be sufficient to elect such director if then cumulatively voted at an election of the entire board of directors, or, if there be classes of directors, at an election of the class of directors of which such director is a part."

¹¹⁸ Staggered boards are boards of directors of companies whose corporate charter mandates that only a proportion of the board will retire and be filled by elections every year. Delaware allows a maximum of 3 deferrals of elections i.e. the whole board must be subject to election every three years. Therefore 1/3rd of the board must retire every year. For a detailed discussion into the impact of staggered boards, see Bebchuk, Lucian Arye, John C. Coates IV, and Guhan Subramanian. "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy." *Stanford Law Review* (2002): 887-951.; Bebchuk, Lucian Arye, John C. Coates IV, and Guhan Subramanian. "The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants." *Stanford Law Review* (2002): 885-917 and Bebchuk, Lucian A., and Alma Cohen. "The Costs of Entrenched Boards." *Journal of Financial Economics* 78, no. 2 (2005): 409-433.

Rajya Sabha and the French Senate.. In the Rajya Sabha, 1/3rd of the members retire every two years meaning each of the members serves a term of six years.¹¹⁹ These measures, in both corporate and constitutional law make the replacement of agents more difficult. In constitutional law, staggered elections restrict the power to replace agents through elections. On the other hand, in corporate law, staggered boards act indirectly by restricting the replacement of agents by making it harder for the market for corporate control to act.

In the political scenario, the accountability created by competitive elections directly explains the influence of voting rights on agency costs.¹²⁰ Because elections for the legislature are competitive and there is a viable opposition, citizens have the ability to replace their agents if they are not satisfied with their performance. More importantly, they can do so during general elections without any direct procedural or financial burden. After all, it is just as easy to vote for the incumbent party as it is to vote for the opposition. This threat of replacement makes voting in elections a powerful monitoring tool in constitutional law.

When intervention via direct democracy is considered, it is seen that the principals vote directly upon proposals in both systems. For example, in both settings, whether or not a referendum or a fundamental corporate decision is approved by the principals is solely dependent on how many votes are polled for and against it. Such direct democratic action brings policy into alignment with the preferences of the majority of the voting principals.

¹¹⁹ See the FAQ page of the Rajya Sabha website at rajyasabha.nic.in/rsnew/faq/freqa.asp. It should be noted that members of the Rajya Sabha are elected indirectly. This means that they are elected not directly by the citizens but by the members of the Assemblies of States and Union Territories in accordance with the system of proportional representation by means of a single transferable vote. See also Weston, Margaret. "One Person, No Vote: Staggered Elections, Redistricting, and Disenfranchisement." *Yale Law Journal* 121 (2012) which discusses staggered elections in the United States. For example, 28 of the 50 US states have staggered elections for one or both houses of their legislature.

¹²⁰ The issue of which constituency has the right to vote and how voting power is distributed affects agency costs as this effects how elections carry out the following functions:¹²⁰

1. Aggregate and represent the preferences of the voters.
2. Aggregate and represent the information about past policy and its results.
3. Deal with adverse selection to select the best agents
4. Control moral hazard by holding the representatives (agents) accountable.

Excerpted from Persson, Torsten, Gerard Roland, and Guido Tabellini. "Separation of Powers and Political Accountability." *The Quarterly Journal of Economics* 112, no. 4 (1997): 1163-1202. at 1165

Voting rights are, therefore, a crucial factor in addressing agency costs when principals make decisions both directly and indirectly.¹²¹

It is, therefore, clear that the variation in the distribution of voting rights in the two systems has a bearing on this dissertation. These variations are examined in the following sub-sections to identify how they affect the use of corporate governance insights to help minimize agency costs in constitutional law.

3.1.2 *Shareholder Franchise v. Universal Adult Franchise*

This sub-section examines how the fact that only shareholders can vote under corporate law while all adult citizens can vote under constitutional law affects the applicability of corporate governance insights to understand agency problems in constitutional law.

The answer to this question lies in the conception of an organization as a nexus of contracts under agency theory. Professors Jensen and Meckling characterize both corporations and governmental bodies such as cities, states and the Federal Government as “legal fictions which serve as a nexus for a set of contracting relationships among individuals.”¹²²

This approach is distinct from the Alchian-Demsetz team production model which places the onus of management and decision-making on an “owner” or “employer” rather than on a board of directors or management that has been delegated that power. The Alchian-Demsetz model understands a classical firm to be a contractual structure with the following properties:¹²³

“1) joint input production; 2) several input owners; 3) one party who is common to all the contracts of the joint inputs; 4) who has the right to renegotiate any input's contract independently of contracts with other input owners; 5) who

¹²¹ Such measures in fact reduce residual loss which is a component of agency cost.

¹²² Jensen, Michael C., and William H. Meckling. “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” *Journal of Financial Economics* 3.4 (1976): 305-360 at 310. Also cited in Jensen, Michael, and Clifford W. Smith Jr. “Stockholder, Manager, and Creditor Interests: Applications of Agency Theory.” *Recent Advances in Corporate Finance*. Harvard University Press (1985) at 2.

¹²³ Alchian, Armen A., and Harold Demsetz. “Production, Information Costs, and Economic Organization.” *The American Economic Review* 62, no. 5 (1972): 777-795 at 794.

holds the residual claim; and 6) who has the right to sell his central contractual residual status. The central agent is called the firm's owner and the employer."

This model is rejected for the purposes of this dissertation because it fails to provide an economic theory to explain agency costs between the various levels of delegation of power from the shareholders to the board of directors and then further up to management. This model is, therefore, unsuitable as a theoretical framework for the comparative analysis central to the dissertation as it does not explain the separation of ownership and control seen in the modern corporation nor does it explain constitutional ordering arrangements.¹²⁴

It should be noted that the 'nexus of contracts' approach used here does not consider shareholders to be the 'owners' of the company. Rather, they are considered 'input providers' along with other 'input providers' such as bond holders, employees, managers etc.¹²⁵ The key difference is that shareholders typically have voting rights to the exclusion of the 'input providers'. These input providers may sometimes have conflicting interests. These may be conflicts between members of the same class of input providers such as disputes between various shareholders or disputes between the various bond holders. Or they may be conflicts of interest between the various classes of input providers such as one between shareholder and bond holders. Furthermore, one or some classes of input providers may have the right to vote while other input providers may not.

Similarly, in the constitutional system minors, expatriates, foreign economic and diplomatic partners and in some jurisdictions convicts are examples of input providers who are disenfranchised. The power to monitor the agents by voting in elections is based on the rule

¹²⁴ Having said that, it would be imprudent to fail to mention that Professors Alchain and Demsetz were aware that the problem of monitoring the management would arise under the corporate scheme where ownership is separate from control. They suggest that the problem can be addressed by making shares freely tradable. This allows shareholders to exit companies with unfavorable management and allows for monitoring through the market for corporate control. Additionally they suggest that this allows the concentration of shares or votes through the proxy process to a point where the free rider problem can be overcome.¹²⁴

¹²⁵ Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3.4 (1976): 305-360. at 311. "There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output."

of universal adult franchise. This is because modern democracies require citizens to be treated equally under law. Accordingly, all adult citizens of sound mind are entitled to vote with exceptions in certain circumstances for convicts etc. Other stakeholders in the country such as foreign trading partners and expatriates do not get to vote even though they have an interest in the success of the organization.

There is, however, an important exception to this equal treatment of input providers. Employees negotiate their salary and benefits, bond holders negotiate their coupon rate and executives negotiate their compensation package before entering into a contract with the company. Accordingly, all of them have fixed returns owed to them from the company's revenues. It is only the shareholders who do not get a pre-negotiated benefit from the company but rather a portion of the remaining proceeds once all other input providers have been paid. Shareholders are therefore the residual claimants of the company. Unlike other input providers who receive a predetermined share from the output of the company, the shareholders have a claim over whatever remains.

While bond holders, employees etc. only have an incentive to ensure that the company has sufficient output to meet their claims in the present and in the future, shareholders have an interest in seeing that the output of the company increases as much as possible. Therefore, they are given the right to vote because they have the greatest incentive to grow the company's output by monitoring the agents as effectively as possible.

In the constitutional context, citizens are, in a sense, like residual claimants. Once the fixed claims of other input providers such as trade partners, bond holders, government employees¹²⁶ etc., have been paid out, the remainder of the country's output goes towards providing social services and improving the lives of citizens, considered as a class. Citizens, like shareholders thus have an incentive to ensure not just that there is enough output to satisfy fixed claims but rather to ensure that output increases as much as possible. For the purposes of agency theory, in this limited sense, they are like the residual claimants of the country just as shareholders are the residual claimants of a company. Therefore, citizens, like shareholders are the only class of input providers vested with voting rights because they have the best incentives to monitor the elected agents and maximize output.

¹²⁶ Just like a company's employees can vote if they hold shares in their capacity as shareholders but not because they are employees, government servants vote in their capacity as citizens but get no franchise rights by virtue of being employees

Accordingly, it can be seen that the allocation of voting rights only to shareholders in companies as compared to all adult citizens under constitutional democracy is consistent with agency theory. While it might prima facie appear that there is a disparity in the way the right to vote is distributed amongst input providers, both systems in fact allocate such rights consistently to the group that has the strongest incentive to monitor the agents and maximize output.

3.1.3 Voting Rights Determined by Shareholding v. One person-One vote

The allocation of voting rights in companies differs from the constitutional practice in two ways. The consequences of the enfranchisement of shareholders to the exclusion of other input providers as opposed to universal adult franchise are discussed in the preceding subsection. This sub-section examines how linking voting rights to shareholding under corporate law as opposed to the rule of one person-one vote under constitutional law impacts the comparative analysis. In particular, this discussion will examine how this divergence in the two systems impacts the usefulness of corporate governance insights to help optimize agency costs through the use direct decision-making.

For the purpose of this examination, it is assumed that constitutional democracies function on the basis of one person-one vote while companies follow the general rule of one share-one vote. It, however, recognizes that there is a not insignificant quantity of stock with differential voting rights being seen in the market.¹²⁷

This situation, however, has not been typical of the two setups through their history and strangely enough the trend of allocating voting rights has interchanged between the two.

The currently basis for the distribution of voting power in the corporate space based on the number of shares owned began with an egalitarian democratic phase in corporate law that

¹²⁷ See Dunlavy, Colleen A. "Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights." *Wash. & Lee L. Rev.* 63 (2006): 1347 at 1348-49.

The New York Stock Exchange refused to list the shares of any company that issued non-voting common stock throughout the 20th century until it reversed this position in 1985. Since then, a not-insignificant number of companies have issued stock with differential voting. In Europe, a study commissioned by the Association of British Insurers (ABI) found that more than one third of 33 large companies had issued stock with differential voting rights.

would have made the political space of its day seem terribly oppressive and plutocratic. In the early 19th century when even universal male franchise was seen in isolated parts of the world, the default rule for companies in America was surprisingly one person or one shareholder-one vote rather than one-share, one-vote. This legal position was also translated into practice with a sample of over 1,200 companies granted corporate charters by state legislatures in America between 1823 and 1835 showing that over 38% of them followed the one shareholder-one vote default rule.¹²⁸ While the position of voting power allocation between the extremes of one share-one vote and one shareholder-one vote have changed over time, efforts continued to be made to find a “prudent mean” between the two.¹²⁹

Conversely, the modern liberal democratic ideal that educates the allocation of voting power in political democracies is the principle that every person is equal under the eyes of the law. This has also not always been the case and effective democracy with the rule of universal adult franchise is a relatively new phenomenon. Setting aside the millennia when monarchy and feudalism prevailed, the disenfranchisement of women remains fresh even in living memory. A number of countries still deny women the right to vote and even supposedly liberal democracies like the canton of Appenzell Innerrhoden in Switzerland gave them the right to vote only as late as 1990.¹³⁰

The use of wealth in determining the allocation of voting rights has also seen widespread use from the early Greek and Roman republics. An excellent and more contemporary illustration of such allocation of voting rights being the Prussian three-class franchise system or the ‘Dreiklassenwahlrecht’ introduced by the Prussian king Friedrich Wilhelm IV in 1849 (and lasted till as late as 1918). This system allocated weighted franchise for the election of the

¹²⁸ *Id* at 1354-55.

¹²⁹ See Alexander Hamilton, “Report on a National Bank”, communicated to the House of Representatives, 1st Cong, 2d Sess. (Dec. 14, 1790), reprinted in 2 *The Debates and Proceedings in the Congress of the United States*, app. 2032, 2049 (Washington, Gales & Seaton 1834). Refer to *Id* at 1356. “Alexander Hamilton serving as Secretary of the US Treasury Department in 1790 provided a characterization of such a ‘prudent mean’ for the nascent Bank of the United States. He described it as a balance between one share- one vote that might allow large shareholders to “monopolize the power and benefits of the bank” and one shareholder-one vote that gave their say insufficient weightage.”

¹³⁰ See Frenkel, Max. “The Communal Basis of Swiss Liberty.” *Publius: The Journal of Federalism* 23, no. 2 (1993): 61-70. Even this much overdue change had to be forced upon the canton by the Federal Supreme Court of Switzerland.

Lower House of the Prussian state parliament in three tiers of voting rights into which citizens were classified on the basis of their direct tax revenues.¹³¹

These illustrations demonstrate that not only are the principles for allocating voting power in companies and political democracy changeable but that they have indeed changed and reversed over time. This suggests that the systems for allocating voting rights in corporate and constitutional law have historically had strong similarities and a correlation of the two is not as farfetched as one might intuitively imagine.

As pointed out earlier, agency theory supports an explanation of agency cost that is compatible with the existence of numerous constituencies with sometimes conflicting interests even if only some of those constituencies have the right to vote. Agency theory only requires that the group of principals that bear the residual risk of the enterprise have voting power to most effectively monitor the behavior of the agents.¹³² Therefore, since shareholders and citizens can be understood to bear this residual risk, only they have (and should have) voting rights in order to minimize agency cost.¹³³

Extending this line of reasoning, the amount of possible benefit to the principal if agents are monitored effectively also defines the extent of the voting power conferred. In the constitutional context, this explains the distribution of voting power as all citizens are deemed to be equal under the law. Public policy, therefore, dictates that each is considered to have an equal risk and share in the polity.¹³⁴ Furthermore, it is objectively impossible to calculate the possible benefit available through effective monitoring that can be captured by each citizen in the fortunes of their city, province or country so this is the only practical solution. This is the reason each citizen is given an equal vote i.e. one person – one vote.

¹³¹ See Grunthal, Gunther, Hartwig Brandt, and Klaus Erich Pollmann. "Social Aspects of German Constitutionalism: Prussia, Wurtemberg and the norddeutscher bund in the Mid-Nineteenth century." *Parliaments, Estates and Representation* 9, no. 1 (1989): 65-69 and Hoffmann-Martinot, Vincent. "The Process of Citizen's Political Emancipation in European Cities: The Case of Stuttgart." *XIII Nordiske Kommunalforskerkonferansen*, Oslo, 26–28.11. 04. (2004).

¹³² Fama, Eugene F. "Agency Problems and the Theory of the Firm." *The Journal of Political Economy* (1980): 288-307 at 295.

¹³³ For a detailed discussion on this issue, please refer to the previous sub-section.

¹³⁴ Once the obligations of the polity in terms of paying its employees, its debt etc. are satisfied, the sole beneficiaries who enjoy the excess in the form of social welfare are the citizens of the polity. They are therefore the bearers of residual risk.

On the other hand, the possible benefits from effective monitoring that can be captured by a shareholder in a limited liability company is directly proportional to the proportion of shares held by that shareholder. Therefore, shareholders with different shareholdings cannot be deemed in any meaningful way to have an equal incentive to monitor the board of directors of the corporation. Instead, the interest that every shareholder has (and needs to protect through his voting power) is proportional to his stake in the company as represented by his shareholding. Furthermore, this stake can be easily determined by the quantity of shares held by the shareholder

The scope of this dissertation is limited to companies with one share, one vote.¹³⁵ However, it is admitted that many corporations issue stock with differential voting rights. The existence of such companies does not void the comparative analysis. The issuance of stock with variable voting rights can be explained as an arrangement whereby shareholders agree to alter this default balance either for a discount (shares with less voting rights) or for a control premium (shares with extra voting rights, golden shares etc.). In other words, shareholder buy or give up some of their ability to monitor the agents and protect the value of their investment in exchange for some consideration.

Since it is the incentive to monitor associated with equity shareholding that leads to voting power being allocated to shareholders, it is the only reasonable that the allocation also be proportional to the risk that creates those incentives.¹³⁶ In fact, the equal distribution of voting rights to shareholders regardless of their share in the equity would be inefficient in terms of monitoring to control agency costs. Shareholders with large holdings will be unable to adequately represent and protect the risk they bear while small shareholders would be inadequately motivated to monitor the agents.

What holds true for the monitoring influence of elections also applies to direct democratic measures because both use voting to gauge the preferences of the principals. Accordingly, voting rights for direct decision-making are rightly allocated in parallel with voting rights for electing representatives.

¹³⁵ See Section 1.4.

¹³⁶ For a discussion on why only shareholder have the right to vote to the exclusion of other groups such as bond holders and employees, see Bainbridge, Stephen. "Case for Limited Shareholder Voting Rights, The." *UCIA I. rev.* 53 (2005): 601, Chapter 1.

In light of these arguments, it is clear that the corporate system of allocating voting rights based on shareholding and the constitutional rule of ‘one person – one vote’ are both consistent with agency theory. Since voting rights are apportioned in both systems in keeping with the interests voting principals have to protect, it is argued that effective parallels can be drawn to identify valid insights using agency theory. Therefore, corporate governance insights can inform our understanding of agency costs in constitutional law and how they are conditioned by the impact of direct democracy despite the differences in the allocation of voting rights amongst the two systems.

3.2 LEGAL LIABILITY RULES

This section explores the consequences of the legal liability regimes governing the behavior of agents in corporate and constitutional law. This dissertation has followed a largely contractarian approach based on the premise that directors are disciplined by market forces. This approach, as espoused by Professors Easterbrook and Fischel maintains that corporate law is (or at least should be) merely a collection of contractual relationships between shareholders, managers and directors.¹³⁷

Previous sections have discussed how voting working together with market forces check the growth of agency cost in corporate law.¹³⁸ This is not, however, the only mechanism that exists to prevent agents from acting against the interests of their principals. The other tool used in corporate law to keep agents honest and reduce agency cost is agency cost is the legal system. More specifically, directors owe certain duties, known as fiduciary duties, to their

¹³⁷ Easterbrook, Frank H. *The Economic Structure of Corporate Law*. Harvard University Press, 1996.

¹³⁸ Bradley, Michael, and Cindy A. Schipani. “Relevance of the Duty of Care Standard in Corporate Governance, The.” *Iowa L. Rev.* 75 (1989): 1 at 5. (T)he "contractarian" view recognizes that market forces act to discipline corporate managers and cause the managers to align their interests with those of the firm's security holders. These forces stem from competition in the capital, labor, and product markets, as well as competition in the market for corporate control. This view of the large-scale corporation follows from the works of Coase, Manne, Alchian and Demsetz, Jensen and Meckling, Fama, and Fama and Jensen.

High agency costs suffered by a company would lead to reduction in share prices as dissatisfied principals sell their interest in the company causing supply to exceed demand. This causes a threat to the incumbency of managers (including the board of directors) through its impact on the market for corporate control. This can result in the disciplining of existing managers through the threat of removal or their replacement with a new management more aligned with the interests of the principals.

shareholders and the shareholders have recourse to the courts if the directors breach these duties.¹³⁹

If they are found guilty of such breach, the directors can face civil and criminal sanction. They may also be held personally liable even if the impugned action was taken while acting in the capacity of a representative of the company. This legal regime has an impact on the incentives of the agents to act for or against the interests of their principals and cannot be ignored in the comparative analysis.

The following arguments examine what duties legislators owe to their citizens for which they are personally liable and subject to prosecution. This comparison will reveal the differences in the legal consequences directors and legislators face for acting against the interests of their agents. These differences, if any, will have an impact on agency cost and their impact on the comparative analysis will be determined.

To identify insights from corporate governance, the actual state and application of liability rules within it must be understood. The Delaware Supreme Court has defined fiduciary duties as the duty of loyalty, the duty of good faith and the duty of care taken together.¹⁴⁰ These duties were then limited by the Delaware Supreme Court only to cases not covered by the business judgment rule.¹⁴¹ This rule requires judges to presume, in the absence of evidence of fraud or a conflict of interest that the directors acted in an informed manner, in good faith and in the best interests of the corporation.¹⁴²

This powerful presumption in favor of directors was shaken in *Smith v. Van Gorkom*.¹⁴³ In this case, the directors of the company were found to be in breach of the duty of care, a

¹³⁹ Fiduciary duties will be discussed at length in the following pages. The Supreme Court of Delaware has defined fiduciary duties as the duty of loyalty, the duty of good faith and the duty of care. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

¹⁴⁰ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

¹⁴¹ The Business Judgment Rule is characterized as "a judicially developed doctrine that has come to preclude inquiry into the merits of directors' decisions in the absence of evidence of bad faith, fraud, conflict of interest, or illegality". See Cohn, Stuart. "Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions through the Business Judgment Rule." *Texas Law Review* 62, no. 4 (1983) at 594.

¹⁴² *Aronson v. Lewis* 473 A.2d 805 (Del. 1984).

¹⁴³ *Smith v. Van Gorkom* 488 A.2d 858 (Del. 1985).

component of director's fiduciary duties. This duty requires directors to act in the best interests of the corporation and exercise the level of care an ordinary person in their position would exercise.¹⁴⁴ To clarify, the duty of care here refers to the requirement that agents take reasonable efforts to ensure that the interests of the principals are not harmed. On the other hand, the duty of loyalty refers to the requirement that agents not involve themselves in situations where they have a conflict of interest with the principals and if they do, the agents must put the interests of the principal ahead of their own.

The reason the court found the directors liable was because they had not properly reviewed a merger proposal and had accepted it without examining the related documents. The court held that the protection of the business judgment rule only extends to decisions taken on an "informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company".¹⁴⁵ The court found that since the directors had not acted on an informed basis, they could not claim the protection of the business judgment rule for a charge of breach of duty of care.

The legal position was again modified in 1986 with the adoption of § 102(b)(7), Delaware General Corporation Law.¹⁴⁶ This provision allows companies to modify their charters in order to exempt their directors for violations of fiduciary duties except for (a) violations of the duty of loyalty, (b) acts not performed in good faith, and (c) intentional misconduct and

¹⁴⁴ Bradley, Michael, and Cindy A. Schipani. "Relevance of the Duty of Care Standard in Corporate Governance, The." *Iowa L. Rev.* 75 (1989): 1.

¹⁴⁵ *Supra* note 150 at 872.

¹⁴⁶ § 102(b)(7), Delaware General Corporation Law:

"§ 102(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

...

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title."

illegal activities. Since then, the majority of Delaware companies have taken advantage of this law and included such provisions in their bylaws.¹⁴⁷

This legal regime governs the judicial repercussions for directors vis-à-vis the exercise of their fiduciary duties. Because agency cost in corporate governance is dependent on legal pressures on agents to protect the interests of the principals, a comparison with the personal liability of legislators follows. As explained below, legislators are entirely immune from personal liability for any vote they cast in the legislature and including the requirement to inform themselves as is mandated by *Smith v. Van Gorkom*.¹⁴⁸

When considered in light of the principal-agent scenario, citizen-principals have no means to legally compel their legislator-agents to act in their best interests. While citizens of several countries can approach their courts to repeal laws inconsistent with the country's constitution, no jurisdiction could be found which allows courts to strike down legislation based on whether or not the legislation is in the interests of the citizens. After all, that is a question for the legislature to decide. Therefore, citizens have no judicial redress against legislation on the basis that it hurts their interests nor are legislators legally liable for passing such laws. This means that constitutional law does not provide liability along the lines of the duty of care as found in corporate governance.

It must be noted that as per § 102(b)(7), Delaware General Corporation Law, a majority of the large corporations with dispersed shareholders in Delaware have adopted clauses absolving their boards of directors from liability for breach of the duty of care. Therefore, the de facto legal position is that both legislators and directors are personally immune for prosecution for breach of the duty of care.

The similarity in corporate and constitutional law regarding a de facto waiver of personal liability for breach of duty of care does not extend to the issue of duty of loyalty. The constitutions of a large number of the most prominent democracies in the world have

¹⁴⁷ For a specific discussion into the use of § 102(b)(7), Delaware General Corporation Law see Bishop, Joseph W. "Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers." *The Yale Law Journal* 77, no. 6 (1968): 1078-1103. For a general discussion on the duty of care applicable to directors, see Eisenberg, Melvin A. "Duty of Care of Corporate Directors and Officers, The." *U. Pitt. L. Rev.* 51 (1989): 945.

¹⁴⁸ *Smith v. Van Gorkom* 488 A.2d 858 (Del. 1985).

provisions that indemnify legislators for acts done in the legislature and in connection with law making. The immunity can be so encompassing that, for instance, in the United States and in India, courts have ruled that legislators may not be penalized for accepting bribes to make a speech and to vote on a bill respectively.¹⁴⁹

In *United States v. Johnson*,¹⁵⁰ a former Congressman was charged with seven counts of violating the federal conflict of interest statute, 18 USC 281, and on one count of conspiring to defraud the United States in violation of 18 USC 371. These charges were the result of the said former Congressman Johnson making a speech on the House floor in favor of certain savings and loan associations in exchange for consideration.

In the subsequent proceedings, the said congressman was acquitted by both the Court of Appeals for the 4th Circuit and later the US Supreme Court. This is because as per Art I, Section (6)(1) of the constitution of the United States, he had immunity from being questioned about anything said during the proceedings of Congress in any other place.¹⁵¹

In the Indian case of *P.V. Narasimha Rao v. State*,¹⁵² the government led by the then Prime Minister of India Mr. P.V. Narasimha Rao was faced with a vote of no-confidence in Parliament on July 28, 1993. In the run up to the vote, members of two political groups were allegedly bribed by him and his associates to vote in favor of the government. The result of the case before the Delhi High Court and subsequently before a constitution bench of the Supreme Court of India was that Members of Parliament who had voted in return for bribes

¹⁴⁹ The United States and India are given as examples since they are respectively the most influential and the largest democracy in the world. As such, they provide valuable anecdotal evidence. Such indemnifying provisions are however not unique to these two countries and are replicated in the constitutions of several countries.

¹⁵⁰ *United States v. Johnson*, 337 F.2d 180 (4th Cir. 1964), cert. granted, 379 U.S. 988.

¹⁵¹ Art. I Section (6)(1):

“The Senators and Representatives shall receive a Compensation for their Services, to be ascertained by Law, and paid out of the Treasury of the United States. *They shall in all Cases, except Treason, Felony and Breach of the Peace, be privileged from Arrest during their Attendance at the Session of their respective Houses, and in going to and returning from the same; and for any Speech or Debate in either House, they shall not be questioned in any other Place.* (Emphasis added). See generally Sisitsky. “The Bribed Congressman’s Immunity From Prosecution.” *Yale LJ* 75: 335-337.

¹⁵² *P.V. Narasimha Rao v. State*, (1998) 4 SCC 626.

were held to be protected under Article 105(2) of the Constitution of India.¹⁵³ Amazingly, the court held that taking bribes to vote in a particular way and then not voting accordingly (i.e. actually voting contentiously and keeping the money anyway) would not be protected behavior. In such a case, the legislator would be guilty of taking a bribe and not be protected by Article 105(2) since he or she never voted in furtherance of the act.

Similar positions are found in Article 26 of the constitution of France which establishes the ‘irresponsibility’ and ‘inviolability’ of legislators for actions done in their capacity as legislators. Another case of legislators being immune from breaches of the duty of loyalty can be found in Brazil. Its constitution provides immunity to members of the Chamber of Deputies as well as members of the Senate for all actions committed while serving as legislators whether or not these actions involved their work as legislators.¹⁵⁴

It can thus be concluded that while directors and legislators are typically immune from personal liability for breach of duty of care, legislators are sometimes even immune for breaches of the duty of loyalty besides having the same immunities as corporate directors.

It is clear that the exclusion of corporate and constitutional decision-making agents from certain types of legal liability normally attached to agents can lead to increases in agency costs. However, this risk is rationally taken on in both systems for a number of reasons.

Since agents cannot please all of the large number of principals, judicial review of every decision by disagreeing members of the principal would be impractical.¹⁵⁵ By providing immunity to the agents especially for breaches of the duty of care, corporate and constitutional law ensure that decisions that aggrieve a certain group do not result in such a group starting legal proceedings against the agents responsible for such decisions.

¹⁵³ *Ibid.* Article 105(2) of the Constitution of India reads as follows: “No member of Parliament shall be liable to any proceedings in any court in respect of anything said or any vote given by him in Parliament or any committee thereof, and no person shall be so liable in respect of the publication by or under the authority of either House of Parliament of any report, paper, votes or proceedings.”

¹⁵⁴ See Speck, Bruno Wilhelm. “Conflict of Interest: Concepts, Rules And Practices Regarding Legislators in Latin America.” *The Latin Americanist*. 2006, 49, 2, 65-97. Such acts may include homicide and other serious crimes. Prosecution can only proceed if it is approved by it is approved by an absolute majority of the relevant chamber and even then the legislator can demand to be tried only by the STF.

¹⁵⁵ Arsht, S. Samuel. “Business Judgment Rule Revisited, The.” *Hofstra L. Rev.* 8 (1979): 93 at 95.

By reducing the likelihood of vexatious and vindictive litigation, both corporate and constitutional law ensure that the most capable and qualified prospective agents are not deterred from working for the organization due to fear of harassment. Lastly, in the case of constitutional law, even the duty of loyalty is relaxed to ensure that legislators can vote independently without fear of persecution by their political rivals who may be in government or may later come to power.¹⁵⁶

Due to these reasons amongst others, directors and legislators are to a large extent immune from institutional pressures such as the influence of judicial review and liability rules to ensure that they work in the best interests of their principals. In the absence of judicial remedy for issues connected with the duty of care, corporate and constitutional laws are good subjects for a comparative study of the use of direct democracy to address agency problems. This is because in the absence of legal remedies, both systems are heavily reliant on other means including direct decision-making by principals to minimize agency costs.

In corporate law, direct decision-making helps to counteract the increase in agency costs caused by the diluted personal liability of the agents. Since a similar situation exists in the constitutional system whereby citizens have limited powers to sue legislators to bring their actions in line with the preferences of the principals, insights from corporate governance can be very helpful in understanding the impact of limited direct democracy on agency costs.

3.3 SUPER AGENTS

This section demonstrates that the corporate and constitutional systems both provide for a process whereby the principals use a second set of agents to help them monitor the behavior of the agents to whom decision-making authority is delegated. In the corporate governance system, such super agents can be proxy advisory agencies such as ISS and GlassLewis while the constitutional law system has super agents such as environmental groups like the Sierra Club and Greenpeace, human rights groups such as Human Rights Watch and Amnesty International, economic advocacy groups such as chambers of commerce, trade unions etc.

¹⁵⁶ This is the reason expressly given by the framers of both the US and the Indian Constitution for adopting Art I, Section (6)(1) of the constitution of the United States and Article 105(2) of the Constitution of India respectively in their constituent assembly debates.

This discussion shows that the use of such ‘super agents’¹⁵⁷ to monitor elected representatives creates similar agency problems in both systems. Additionally, the discussion shows that the use of the same entities that act as super-agents in the conduct of direct decision-making by principals in both systems also creates similar problems in the use of such measures.

For the purpose of this discussion, ‘Super-agent’ refers to an agent that acts as an intermediary to help principals monitor the behavior of another agent. This subsection has two objectives. The first objective is to understand how the use of intermediaries (termed ‘super agents’) to monitor representatives affects agency problems in corporate and constitutional law when decisions are made by the representatives. This step will demonstrate (a) that the use of such agents has a substantial impact on agency costs, (b) that corporate and constitutional systems extensively use super agents, and (c) that the use of such super agents has a similar result on the agency problems in both systems. This will show that corporate law can inform the understanding of agency costs in constitutional law even when super agents are introduced into the agency theory framework.

The next objective is to examine how the influence of these bodies also affects the process of direct decision-making under the corporate and constitutional systems. This discussion shows that the organizations that act as ‘super agents’ in delegated decision making help principals to make decisions through direct democracy mechanisms by helping to uncover, consolidate and evaluate information under both systems. The organizations that are treated as super agents in delegated decision making continue to be considered as super agents in the context of direct decision making because the theoretical framework adopted considers direct democracy as a monitoring mechanism.

It is argued that direct democracy can help to deal with some types of situations where the costs of using intermediate agents to monitor primary agents are extraordinarily high and it is preferable to make decisions directly. Since super agents are used to monitor the primary agents, the cost of using the super agents forms a part of monitoring cost and, therefore, adds to the agency cost.

¹⁵⁷ See Issacharoff, Samuel, and Daniel R. Ortiz. “Governing Through Intermediaries.” *Virginia Law Review* (1999): 1627-1670 for the origins of the concept of the ‘super-agent’

Here, corporate governance can help to identify circumstances where the cost of using super agents exceeds the savings in agency cost they provide through their monitoring activities. Corporate governance can also help to identify how super agents impact the process of direct decision-making by the principals. This is because super agents also have influence on direct decision-making since they play the role of information providers for direct democracy ballots and that will be considered where relevant.

This line of enquiry suggests that not only can corporate governance help improve our understanding of when to use direct democracy to optimize agency costs; it can also help to improve the direct decision-making process itself in terms of the use of intermediaries.

These questions must be answered in order for the dissertation to produce policy recommendation that have relevance to the real world. The use of intermediaries is essential to both the corporate and constitutional systems and their importance cannot be overstated. By examining the ramifications of super agents on agency costs and direct decision-making, this discussion shows that the parallels being established to allow the import of corporate governance insights is robust to the existence and operation of intermediaries in both systems.

3.3.1 *Super agents: Impact on Delegated Decision-Making*

Agency theory assumes a degree of information asymmetry amongst agents and principals that is only exacerbated by the multiplicity and dispersion of shareholders and citizens. This information asymmetry in turn “gives managers greater discretionary control over the use to which the firm’s resources are put, increasing the residual loss that stakeholders have to bear.”¹⁵⁸

This subsection examines corporate and constitutional systems to study the use of secondary agents that help “achieve economies of scale in information gathering and analysis, primarily

¹⁵⁸ Hill, Charles WL, and Thomas M. Jones. “Stakeholder-Agency Theory.” *Journal of Management Studies* 29, no. 2 (1992): 131-154 at 140. “An information asymmetry exists between managers and stakeholders...This is particularly likely when stakeholders are diffused. Diffusion refers to a situation where a stakeholder group contains many individuals or entities, no one of which has command over a significant proportion of the group’s total resources. In such circumstances, *ceteris paribus*, no one individual or entity may be able to finance the extensive information-gathering and analysis necessary to reduce significantly the information asymmetry between managers and stakeholders.”

through the employment of specialists”¹⁵⁹ to help principals to monitor their decision-making agents. The role of super agents in helping principals with the process of direct decision-making is discussed in the following sub-section.

Voters in the corporate and constitutional systems do not have the information or the capability to effectively monitor and evaluate the performance of the board of directors and legislature respectively. This discussion, therefore, moves towards how principals use cues to cast votes that advance and protect their interests on such issues effectively even though they do not have the relevant information. It is also demonstrated that these cues are provided by a second specialized group of agents (the super agents) who collect and analyze this information.¹⁶⁰

As Professor Eisenhardt explains,

*“In agency theory, information is regarded as a commodity: It has a cost, and it can be purchased... The implication is that organizations can invest in information systems in order to control agent opportunism.”*¹⁶¹

An examination of the corporate and constitutional systems reveals that they both use actors that provide cues regarding the behavior and agenda of the agents to help the principals make informed decisions. These intermediaries provide cues to voters that allow them to act on the basis of information that cannot ordinarily or cheaply be gathered or assimilated by them. These cues provided by an organization allow otherwise non-expert and uninformed consumers to quickly and cheaply evaluate a product. For example, the presence of the THX® or Dolby Surround® logos on audio equipment convey to the casual consumer that the products can deliver certain performance without requiring them to understand technical specifications. Similarly, a “FairTrade” logo on food products might indicate that the produce

¹⁵⁹ *Id.* at 140-41.

¹⁶⁰ For an authoritative reference on the importance of cues in decision-making by imperfectly informed voters see Lupia, Arthur. *The Democratic Dilemma: Can Citizens Learn What They Need to Know?* Cambridge University Press, 1998.

¹⁶¹ Eisenhardt, Kathleen M. “Agency theory: An Assessment and Review.” *Academy of Management Review* 14, no. 1 (1989): 57-74 at 64.

was ethically sourced without requiring research or specialized knowledge on the part of the consumer.¹⁶²

Similarly, it is argued that intermediaries can help principals by signaling certain negative or positive things about corporate and constitutional agents. It can, therefore, be said that such intermediation helps both the corporate and constitutional systems “to bring down the direct agency costs that would ensue if a principal had to assume the immediate task of overseeing and evaluating the work of an agent.”¹⁶³

In the political space, there exist a number of cues that voters use to understand the nature of decisions that they do not fully understand. This can be the endorsement or opposition of groups referred to as ‘super agents’ such as the Sierra Club, Green Peace etc., for policy decisions concerning environmental issues;¹⁶⁴ groups such as Amnesty International and Human Rights Watch for issues involving humanitarian assistance or military interventions;¹⁶⁵ labor unions¹⁶⁶ and chambers of commerce for economic legislation.

Since ordinary citizens do not fully understand the pros and cons of prospective legislation, they look to see how trusted super agents react to such proposals. This makes the monitoring of legislators subject to the information provided by such organizations.

The use of cues by voters to intelligently vote to further their interest on questions involving issues they themselves do not properly understand is also evident in the corporate space. This can be seen in the considerable deference given by shareholders to the opposition or

¹⁶² Issacharoff, Samuel, and Daniel R. Ortiz. “Governing Through Intermediaries.” *Virginia Law Review* (1999): 1627-1670 at 1629. Professor Issacharoff gives the example of Underwriter’s Laboratories but the meaning is the same. The presence of either of these marks on a product signals that it has been tested and approved by a trusted intermediary. This is a cue regarding the safety and quality of the device that cannot otherwise be ascertained by the consumer without extraordinary expense and effort.

¹⁶³ Issacharoff, Samuel, and Daniel R. Ortiz. “Governing Through Intermediaries.” *Virginia Law Review* (1999): 1627-1670. at 1630. Additionally, “Intermediaries take up some slack and help us to better monitor our representative’s actions, evaluate their behavior, and reward or punish them appropriately.”

¹⁶⁴ Rootes, Christopher, and Robert Brulle. “Environmental Movements.” *The Wiley-Blackwell Encyclopedia of Social and Political Movements* (2004).

¹⁶⁵ Bob, Clifford. “Merchants of Morality.” *Foreign Policy* (2002): 36-45.

¹⁶⁶ Asher, Herbert B., ed. *American Labor Unions in the Electoral Arena*. Rowman & Littlefield, 2001.

endorsement of proxy advisory services such as Institutional Shareholder Services (commonly known as ISS) and Glass, Lewis & Co.¹⁶⁷

Super agents are ‘second-order agents’ helping to manage the first order agency relationship between the voters and representatives. They are, however, still agents themselves. This means that their use creates further agency costs. The principals who use their services must (a) monitor the super agents, (b) provide bonding costs and (c) bear the residual loss caused by a discrepancy between their interests and the activities of the super agents. The use of super agents also implies another set of agency costs caused by a ‘double agency problem’. Needless to say, super agents should only be used if the cost of the ‘double agency problem’ is lesser than the reduction in primary agency costs brought about by the use of intermediaries

The ‘double agency problem’ alluded to here is complicated by the fact that the super agents are not relied upon by the entire body of shareholders or the entire citizenry of a country. While the legislators and directors are the agents of all the citizens and shareholders respectively, super agents only serve subsets of principals. This contributes to the cost of using super agents because of the following reasons:

- Super agents can have enormous influence over the primary agents.¹⁶⁸
- Super agents have no duty of neutrality or impartiality towards all the principals.

This means that super agents may influence the primary agents to advance the interests of the super agent’s principals to the detriment of the other principals represented by the first order agents but not represented by the super-agents. This can also lead to situations where groups

¹⁶⁷ See Choi, Stephen, Jill Fisch, and Marcel Kahan. “Director Elections and the Role of Proxy Advisors.” *Southern California Law Review* 82 (2008): 08-18; Choi, Stephen J., Jill E. Fisch, and Marcel Kahan. “The Power of Proxy Advisors: Myth or Reality?” *Emory Law Journal* 59 (2010): 869; Rose, Paul. “On the Role and Regulation of Proxy Advisors.” *Michigan Law Review First Impressions* 109 (2010): 62 and Alexander, Cindy R., Mark A. Chen, Duane J. Seppi, and Chester S. Spatt. *The Role of Advisory Services in Proxy Voting*. No. w15143. National Bureau of Economic Research, 2009. The opposition or endorsement of proxy advisors are the cues used by shareholders to decide how to cast their vote or more commonly, who to give their proxy to.

¹⁶⁸ Since the cues provided by super agents in both systems have a lot of influence over the preferences of the principals, super agents like political parties, social issue based organizations etc. on one hand and shareholder advocacy groups, proxy advisory services etc. have tremendous influences over governments and boards of directors respectively.

of principals try to capture super agents to advance their narrow interest to the exclusion of the combined interest of the principals as a whole.¹⁶⁹

Professor Issacharoff argues that by using the power of super agents, groups of principals do not equitably cancel out or compromise on each other's preferences and they seek to dominate opposing interests via the asymmetrical influence of favorable super agents. Once again drawing a parallel between corporate and constitutional law, he observes that while corporate governance has numerous features designed to reduce rent seeking¹⁷⁰ within the organization; such features are in short supply in constitutional law. This, he argues, creates a real problem of rent seeking by 'factions' which also troubled James Madison, a key drafter of the US Constitution and that nation's fourth president in the extreme.¹⁷¹ Since this issue relates to the relationship between voters and an elected government in the abstract, it can inform the understanding of Parliamentary democracies as well.

Since the super agents are used to monitor the primary agents, the costs imposed by the double agency problem are part of the monitoring cost as far as the use of the primary agents is concerned. This has to be considered when shareholder and citizens use super agents to provide them with cues that allow them to better monitor the decision-making agents and thereby reduce residual loss. The use of second order agents by the principals, therefore, has a powerful influence over the agency costs of the corporate and constitutional principal-agent relationship. It is proposed that the parallel use of such institutions and the existence of the double agency problem in both systems not only preserves the utility of the framework used for the comparative analysis but also furthers the analogy between the two systems that is advanced throughout the dissertation.

¹⁶⁹ Issacharoff, Samuel, and Daniel R. Ortiz. "Governing Through Intermediaries." *Virginia Law Review* (1999): 1627-1670 at 1631-32.

¹⁷⁰ Rent seeking in this context can be simply characterized as the expenditure of resources by group to increase the share of existing wealth allocated by the group rather than through the creation of more wealth. For a detailed discussion, see Tullock, Gordon. *Rent Seeking*. Brookfield: Edward Elgar, 1993.

¹⁷¹ See *Id* at 1632-33. "In essence, then, both narrow and general-purpose super agents may undo the central insight of James Madison's The Federalist No. 10. Factions will no longer cancel each other out. Those that employ the more powerful super agents or that can hold together a minimally winning stable group of primary agents will pluck the public purse. More dangerously, they may also seek "cultural" rents and try to impose their particular vision of the good on everyone else."

3.3.2 *Super agents: Impact on Direct Decision-making*

This discussion examines the impact of ‘super agents’ on direct decision-making. It should be borne in mind that for the purposes of this dissertation, direct democracy is conceived of as a monitoring mechanism rather than a replacement for delegated decision-making. This is because agency theory, adopted as the theoretical framework for the dissertation, examines the use of agents in decision making rather than decision making by the principals themselves. In light of this, the use of the term ‘super-agent’ as a facilitator of direct decision-making should be understood as tool to help monitor the primary agents and not to help replace their use with pure direct democracy.

Under both corporate and constitutional law, super agents act as the agents of the principals and supply coordination and information services when principals make decisions through direct democracy provisions. However, they can still properly be termed as super agents as their actions assist in direct decision-making that has been characterized as a monitoring function.

It is an interesting parallel to see that the same organizations that monitor the primary agents under corporate and constitutional law also provide information and coordination to the principals to help them make policy decisions directly when direct democracy measures are used. Put simply, some super agents help principals to not only decide whom to vote for in the elections, but also what to vote for when principals vote directly on proposals and make decisions directly. For example, proxy advisory services like Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co. provide recommendations for director elections and also recommendations for shareholder proposals.¹⁷² Similarly, groups like Greenpeace may endorse political parties in general elections and also provide cues on how to vote on a ballot initiative that has environmental repercussions.¹⁷³

¹⁷² See <http://www.issgovernance.com/> and <http://www.glasslewis.com/> for a list of their activities. Shareholder proposals are proposals made by shareholders that are distributed at the company’s cost to its shareholders. The proposal is voted upon at the next General Meeting of the company. There is a complicated set of regulations, procedural requirements and qualifications that govern what may be included in such proposals that will be discussed in detail in the following chapters.

¹⁷³ Ballot initiatives are the constitutional counterparts of shareholder proposals in this dissertation. Ballot initiatives are proposals made by citizens, which if certain requirements are met, are voted upon by the country to adopt or reject them. They will be discussed at length in subsequent chapters.

The impact of proxy advisors on shareholder voting has been studied with in great detail by Professors Choi, Fisch and Kahan. They find that while the direct impact of ISS recommendations is limited to a 6 to 10 percent change in how votes are cast, proxy advisors play a prominent role as information agents and are key players in shareholder decision-making. Moreover, they admit that the 6-10% impact figure is conservative and other researchers have found it to be higher.¹⁷⁴

The same can be said of organizations like civil society groups, religious organizations, environmental groups etc. which help citizens select representatives and also provide cues for referendums and initiatives by their endorsement or criticism.¹⁷⁵ Professor Hobolt points out that there are three main ways by which super agents influence direct democracy in the context of her research on the impact of cues provided by political parties on the outcome of referendums. They are as follows:¹⁷⁶

Firstly, the recommendations or condemnation of super agents will have a direct effect on voting. Since voters do not have adequate information to make sound decisions on particular issues, they use the cues provided by trusted super agents as a substitute. This would tend to result in voters casting their vote in a manner heavily influenced by super agents leading to a ballot result similarly influenced by the actions of the super agents.

Secondly, super agents help to frame the language and form of the alternative positions that will finally be voted upon. By influencing the form and substance of the competing proposals that will be voted upon, super agents influence the outcome of direct democracy.

¹⁷⁴ Choi, Stephen J., Jill E. Fisch, and Marcel Kahan. "The Power of Proxy Advisors: Myth or Reality?" *Emory Law Journal* 59 (2010): 869.

¹⁷⁵ Hobolt, Sara. "How Parties Affect Vote Choice in European Integration Referendums." *Party Politics* 12, no. 5 (2006): 623-647 and Hobolt, Sara Binzer. "Taking Cues on Europe? Voter Competence and Party Endorsements in Referendums on European Integration." *European Journal of Political Research* 46, no. 2 (2007): 151-182. These papers examine in detail how political parties which typically provide cues for legislative elections are also responsible for supplying cues to help voters decide how to vote on referendums. (In the case of Professor Hobolt's scholarship, the discussion is focused on referendums on European integration in particular).

¹⁷⁶ Hobolt, Sara. "How Parties Affect Vote Choice in European Integration Referendums." *Party Politics* 12, no. 5 (2006): 623-647 at 629.

Thirdly, super agents have an influence on the amount of information available to the voters about the issue to be decided. By influencing the quantity and nature of information available to the public, super agents also have an impact on the certainty of voters.

By providing information to principals that allows them to make informed decisions through direct democracy, super agents impact direct decision-making in both companies and constitutional polities. Therefore, their existence similarly conditions not only the agency problems but also the direct democratic checks and balances in corporate and constitutional law.

As this influences both systems in a similar manner by reducing collective action problems, the analogous use of super agents only supports the contention that corporate governance insights can help address agency costs in constitutional law. Furthermore, it has been demonstrated that both the corporate and constitutional setups provide for and actually make use of super agents capable of providing cues to enable informed direct democracy. Unfortunately, the use of super agents in both systems also creates similar increases in agency cost because the cost of the double agency problem in both systems becomes part of the overall monitoring cost. Due to this similarity, corporate insights can be presented as solutions to improve constitutional law.

The framework drawn up for the comparative analysis is, therefore, also robust to the existence and influence of super agents under both delegated and direct decision-making under the corporate and constitutional setups.

3.4 NATURE OF ELECTIONS & THE WALL STREET RULE: COMPETITION TO BECOME AGENTS

This section examines the impact of the difference in the nature of elections and the exit options available to the principals to exit the principal-agent relationship within the corporate and constitutional systems.

The ‘difference in the nature of elections’ refers to the highly competitive nature of political elections with the existence of a viable opposition as compared to the corporate system where

most elections are fought unopposed by the nominees of the board of directors.¹⁷⁷ While this is true, it should be noted that there is a move towards providing shareholder nominees with access to the company's proxy but this cannot be said to make corporate elections nearly as competitive as political ones. By allowing shareholders' nominees access to the company's proxy, such laws seek to allow candidates having certain shareholder support to campaign at the company's expense at par with director nominees. This leads to greater competition in director elections.¹⁷⁸

The reference to the difference in the exit options available refers to the ease whereby the principals in companies can end their relationship with the company by selling their shares on the market, whereas citizens have far greater costs in terms of emigrating to other jurisdictions.

This section shows that there are key differences between the two systems in terms of the nature of elections and in the ability of principals to exit the principal-agent relationship. This has consequences on the agency costs associated with corporate and constitutional law. While accepting this divergence in the agency problems associated with the two systems as an important and real difference, it is, however, argued that this disparity does not negate the utility of the comparative analysis to understand and improve constitutional law.

This section argues that the positive impact of highly competitive legislative elections in the form of lower agency costs is opposed by an increase in agency cost brought about by the high difficulty faced by citizens in exiting their relationship with the county. On the other

¹⁷⁷ See Bebchuk, Lucian A. "The Myth of the Shareholder Franchise." *Virginia Law Review* (2007): 675-732 at 677. In the period from 1996 to 2005, there were only 118 cases of rival slates being put up for election against the management slate. In larger companies with a capitalization of greater than \$200 million which this dissertation is more concerned with, there were only 24 cases of rival slates contesting with only 8 of them being successful.

NYSE listing rules post the Sarbanes-Oxley Act require that the boards slate of nominees be selected by a nomination committee comprising of independent directors. This still means there is one slate of candidates for election who typically contest unopposed.

The term 'slate of candidates' refers to a list of candidates proposed to fill all the vacancies on the board of directors that are to be filled up in an election. Such a 'slate' is proposed by the board of directors and in rare circumstances, by a challenger group.

¹⁷⁸ See Eisenberg, Melvin Aron. "Access to the Corporate Proxy Machinery." *Harv. L. Rev.* 83 (1969): 1489 and Bebchuk, Lucian A., and Scott Hirst. "Private Ordering and the Proxy Access Debate." *Bus. Law.* 65 (2009): 329.

hand, relatively less fiercely contested elections for the board of directors would tend to increase agency cost were it not for the countervailing effect of the relatively easy exit option open to shareholders. As such, the comparative analysis and results of this dissertation are robust to what are serious differences in the principal-agent relationship. This is argued further in the following subsections.

3.4.1 *Nature of Elections*

A critical difference in the corporate and constitutional polities is the manner in which candidature for elections is managed. Under the corporate model, the incumbent Board of Directors¹⁷⁹ nominates a slate of candidates for election during the Annual General Meeting and any challenger must engage in a costly proxy contest in order to challenge the Board's slate. This refers to the requirement for the challenger to solicit, at his own cost, the support of a majority of the company's shareholders. This support is given in the form of a permission to vote a certain way with their shares in the General Meeting which is called a 'proxy'.

Additionally, due to the default of plurality voting,¹⁸⁰ shareholders do not have the power to stop the election of the Board's candidates in the absence of a proxy contest if even one share is cast in favor of those candidates.¹⁸¹ This leads to a situation of remarkably high entrenchment for corporate agents, which in turn has the potential to translate into higher agency costs.

The default of plurality voting can, however, be opted out of. After the fiasco that saw Michael Eisner, the very unpopular CEO of Disney, Inc., remaining on the board of directors after 43% of shareholder votes for his election being withheld, Delaware law was adapted to

¹⁷⁹ Following the Sarbanes-Oxley Act, the Board of Directors must nominate candidates through a Nominations Committee comprised solely of independent directors.

¹⁸⁰ See § 216, Delaware General Corporation Law; § 7.28(a), Revised Model Business Corporation Act. Plurality voting can simply be described as a system of elections where the winner is the candidate who gets the largest number of votes cast. There is no requirement to get an absolute majority of the votes cast.

¹⁸¹ See Sjostrom, William, and Young Kim. "Majority Voting for the Election of Directors." *Connecticut Law Review* 40, no. 2 (2007) and Vaaler, Bryn R. "Majority Board Election: Where Do We Stand?" *Corporate Board* 168 (2008): 16. Note that there is an increasing trend for companies to adopt more onerous majority requirements for director elections. These modified plurality requirements are also known as Pfizer requirements after the first major corporation to adopt them and have now been adopted by other large companies such as Disney, Pfizer, General Electric, Safeway, Office Depot, Circuit City, Automatic Data Processing, US Bancorp and Best Buy.

address the problem. This was done by amending § 141 (b), Delaware General Corporation Law to allow bylaws to require directors not getting a specified vote to resign.¹⁸² Since then, starting with Pfizer, Inc., numerous companies have adopted such provisions often called ‘Pfizer policies’ after their first prominent adopter.¹⁸³ It is argued that despite this change, elections for the board of directors remains less competitive than political elections since the board of directors may refuse to accept a resignation tendered in compliance with such a bylaw.¹⁸⁴

This is in contrast to the multi-party democracy found at the constitutional level. The availability of opposition party candidates competing on a level playing field in political democracies creates a situation where there is undeniably lesser entrenchment. Unlike the nominees of the board of directors of Delaware corporations who are included on the slate circulated at the company’s expense in the company’s proxy, members of the incumbent ruling party are not allowed to take advantage of government resources that are not available to opposition parties in order to get re-elected.¹⁸⁵ To clarify, constitutions aim to either prohibit the ruling party from misusing state resources to campaign for legislative elections or they provide for equal public financing for the main political parties.¹⁸⁶ Either way, framers of constitutions make efforts to ensure that the ruling party is not given an undue advantage in contesting elections.

The advantageous position of incumbent directors vis-à-vis challengers means that the elections for positions on the board of directors will tend to be less competitive than legislative elections, which are contested by challengers on a more equal footing with the incumbents. Citizens can more easily replace their agents through regular elections than shareholders can

¹⁸² A similar provision was introduced into the Revised Model Business Corporation Act in the form of § 10.22 which also allows corporations to opt out of plurality voting by means of an amendment to their bylaws.

¹⁸³ Bainbridge S., “ABA Keeps Plurality Voting as the Default for Electing Directors”, <http://www.professorbainbridge.com/professorbainbridge.com/2011/11/aba-keeps-plurality-voting-as-the-default-for-electing-directors.html> (visited on August 19, 2013)

¹⁸⁴ *Ibid.*

¹⁸⁵ Pinto-Duschinsky, Michael. “Financing Politics: A Global View.” *Journal of Democracy* 13, no. 4 (2002): 69-86. This rule is not respected in certain countries but is nevertheless an essential condition for true democracy.

¹⁸⁶ Wertheimer, Fred, and Susan Weiss Manes. “Campaign Finance Reform: A Key to Restoring the Health of Our Democracy.” *Columbia Law Review* 94, no. 4 (1994): 1126-1159.

due to the relatively higher entrenchment of directors caused by the less competitive nature of corporate elections. This conclusion is well borne out in the real world with liberal democratic countries and federal units regularly changing governments while a successful challenge to an incumbent board of directors who opposes it is a comparatively rare occurrence.

It suffices to say that the principals under the corporate system find it more difficult to replace underperforming agents through periodic elections than principals under the constitutional system. This can be said to lead to greater entrenchment under the corporate model. Therefore, since entrenchment is an important factor with a bearing on agency cost, it can be said that the nature of elections is a factor that has the potential to create comparatively higher agency costs in the corporate system.

3.4.2 *The Wall Street Rule*

The Wall Street Rule refers to the tendency of shareholders unhappy with the management of a company to sell their shares rather than convince or try to force the management to change its behavior.¹⁸⁷ Shareholders do not have the proper incentives to actively reduce agency costs through electoral or direct democratic means due to the free rider problem. This means that while they must expend all the resources required to bring about positive change, they will only be able to capture a share of the benefits proportional to their shareholding in the company. Due to this, shareholders prefer to exit such companies by selling their shares. This is particularly true in the case of large public companies with a substantial float and high liquidity which makes the transaction cost of selling low.¹⁸⁸

If a sufficiently large number of shareholders get dissatisfied with the management and sell their shares within a narrow window of time, the increased supply of the shares in the market causes a fall in the stock price. This may lead to the consolidation of shares with enough voting rights to displace the management with one shareholder or a few large shareholders. This consolidation alleviates the free rider problem because a shareholder group with a big

¹⁸⁷ Admati, Anat R., and Paul Pfleiderer. "The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice." *Review of Financial Studies* 22, no. 7 (2009): 2645-2685.

¹⁸⁸ The 'float' of a company refers to the number of shares that are publicly owned and are available for trading.

enough shareholding gains a large enough position in the company that their share of the benefits outweighs the cost of replacing the management.¹⁸⁹ The large shareholder with reduced free rider problems then disciplines errant agents and stands to make a substantial profit when the share price increases due to the new improved management.

The key point here is, however, that shareholders can easily sell their shares and end their relationship with centralized delegated decision makers whose policies they do not support. Citizens on the other hand cannot.

Theoretically, the absence of an analogue for the Wall Street Rule in the constitutional space is not entirely accurate. As per the Tiebout Model¹⁹⁰ propounded by Charles Tiebout in 1956, there exists a non-political solution to the free-rider problem. According to this model, citizens will relocate to areas that maximize their personal utility conceiving municipalities as offering competing baskets of government services and taxes.¹⁹¹

However, unlike the case of the Wall Street Rule whose influence is seen regularly in the operation of public companies, the Tiebout Model has limited applications in real life. Companies are regularly taken over by hedge funds and private equity groups who change the management and policies of the company and reap the benefits by selling their shares once the company's value increases.

On the other hand, restrictions on immigration between countries and the high cost of personal mobility limits the possibility of most citizens to end their relationship with their government by moving to another country. Furthermore, history suggests that when the high agency cost of having a repressive government become high enough for sizable numbers of people to consider leaving the country, the regime puts physical and legal restrictions on their exit. This is well demonstrated by the building of the Berlin Wall and the restrictions on

¹⁸⁹ See Alchian, Armen A., and Harold Demsetz. "Production, Information Costs, and Economic Organization." *The American Economic Review* 62, no. 5 (1972): 777-795 at 788.

¹⁹⁰ Tiebout, Charles M. "A Pure Theory of Local Expenditures." *The Journal of Political Economy* 64, no. 5 (1956): 416-424.

¹⁹¹ The view that citizens, like shareholders, can also relocate to maximize their utility has also been discussed in Vanberg, Viktor, and Wolfgang Kerber. "Institutional Competition Among Jurisdictions: An Evolutionary Approach." *Constitutional Political Economy* 5, no. 2 (1994): 193-219 and Sinn, Stefan. "The Taming of Leviathan: Competition among Governments." *Constitutional Political Economy* 3, no. 2 (1992): 177-196.

leaving the country imposed by authoritarian governments like North Korea and the former USSR.

A consideration of these important factors supports the common sense suggestion that it is ordinarily easier to sell stock in a big public company than to change one's residence and domicile. Even though mobility costs are limited and vary from case to case, it can be said with certainty that the vast majority of people in the world cannot 'vote with their feet' and thereby discipline government.

3.4.3 *Consequences of Divergence*

The previous discussion in subsections 3.4.1 and 3.4.2 identified two key issues:

- Citizens can address agency problems more easily than shareholders through the mechanism of regular elections.
- Shareholders can address agency problems more easily than citizens by exiting the principal-agency relationship which leads to consolidation of shareholdings and the disciplining of agents via the market for corporate control.

These findings suggest that the corporate and constitutional systems have different strengths and weaknesses in terms of their mechanisms for minimizing agency cost. The constitutional system provides for strong monitoring through fiercely competitive regular elections but citizens find it very difficult to exit and end the agency relationship due to the high cost of mobility and border restrictions.

On the other hand, corporate governance provides for relatively poor monitoring of agents due to the entrenchment caused by relatively less competitive elections but corporate governance makes it easier to discipline agents through exit and the market for corporate control.

This shows that both the corporate and the constitutional systems have shortcomings in terms of their ability to minimize agency cost. Direct democracy is used when these methods of minimizing agency cost prove to be ineffective.

The corporate and constitutional systems thus diverge in how they manage agency cost when it comes to the competitiveness of elections and the ease of exit. Corporate law primarily uses the Wall Street Rule coupled with the market for corporate control while constitutional law uses fiercely competitive elections as the principal means of keeping agents honest. Both systems, however, ultimately rely on the threat of replacement if agents do not act in the interests of the principals to keep agency costs down.

For the purposes of this dissertation, it suffices to show that both systems have fundamentally similar principal-agent relationships, a shared scheme whereby authority is delegated and that both use direct democracy in a similar manner to address these problems. This allows the agency problems in both systems to be characterized in terms of agency theory whereby corporate governance insights can help optimize the relationship between direct democracy and agency cost.

The variations caused by differences in the format of elections and ease of exit shown in this section do not negate the basis of the comparison. It will be seen that the following chapters do not presuppose a quantitative equality of agency costs in the two systems but rather a convergence in the factors that cause and control them.

It is also proposed that that the use of direct democracy in corporate and constitutional law shows that the market for corporate control and fiercely competitive elections have both been found insufficient to control agency costs adequately. After all, if this were not the case, the principals would not incur the cost of collective action to replace their agent's decisions with their own. Given this and the similarity in the principal-agent relationship and monitoring mechanisms used in corporate and constitutional law, the use of direct democracy in corporate governance should prove useful to minimize agency cost in constitutional law.

In light of this, the divergence identified in this section does not bar the comparative analysis but rather presents manageable complications that will be addressed as the need arises.

4 KEY CORPORATE GOVERNANCE PRINCIPLES FOR MANAGING AGENCY COST

This chapter introduces the main principles for reducing agency cost found in corporate governance literature that are used in Part II of this dissertation to draw insights for constitutional law.

The following sections of this chapter examine arguments in respect to citizen's power to make decisions directly using the minimization of agency cost as the normative criterion.¹⁹² In respect to the power to veto major decisions taken by representatives, the clear position of corporate law provides a clear basis for drawing normative conclusions.¹⁹³ Accordingly, the discussion of this point will be relatively straight forward.

With respect to the power of principals to initiate policy, the visible success of both the US and the UK models of allocating the right to initiate decisions in a company mean that a clear answer cannot be found merely by comparing the relative success of the two jurisdictions. The influence of innumerable other factors that affect agency cost in both countries makes discounting these factors and attributing causality very risky. Therefore, the dissertation will look to corporate governance scholarship for theoretical lessons that may be of more help in minimizing agency costs in constitutional law. It will be argued that giving principals the right to approve and initiate decisions can reduce agency cost considerably when certain types of decisions are to be made under particular circumstances. This dissertation explores those conditions to arrive at useful conclusions for achieving the same positive results in constitutional law.

The first step towards this is to understand both corporate and constitutional decision-making in terms of two discrete processes. This is done by dividing decision-making into two steps,

¹⁹² See Chapter 1. The cost of collective action inherent in direct decision-making by citizens is considered a part of monitoring cost and therefore also a part of agency cost. Therefore, the normative criterion is expressed as minimizing agency cost rather than optimizing agency cost.

¹⁹³ The positive discussion preceding this section establishes that company law in most US states, English company law and the company law of all major economies clearly allow shareholders to veto the board of directors by requiring the approval of the shareholders before decisions of the board on many major corporate decisions can have effect.

namely decision management and decision control. Once this issue is discussed, the next section addresses the types of decisions that need to be made in the corporate and constitutional context. This is accomplished by borrowing Professor Bebchuk's classification of corporate decisions into three types. These categories are 'rules of the game decisions' and 'specific business decisions' along with its sub-categories. Decision Management and Decision Control

Chapter 2 has outlined how agency problems between citizens and their government can be addressed using lessons learnt from corporate governance. This can help us to fine tune the use of direct decision-making under constitutional law to optimize agency cost. Professors Fama and Jensen provide the key to identifying lessons from corporate governance in this regard. They propose that the key to minimizing such agency problems is to utilize "decision systems that separate the management (initiation and implementation) and control (ratification and monitoring) of important decisions at all levels of the organization."¹⁹⁴

This principle of managing agency cost is used by both the constitutional and the corporate schemes of governance. This approach has led to the establishment of decision hierarchies whereby the "decision initiatives of lower level agents are passed on to higher level agents, first for ratification and then for monitoring."¹⁹⁵ This formulation forms the basis of a key approach to reduce agency costs in corporate governance.

Professors Fama and Jensen further state that the utility of their prescription in reducing agency cost is correlated to the size and complexity of the organization.¹⁹⁶ They define complex organizations as organizations where firm-specific information relevant to decision-making is diffused amongst a large number of individuals whilst non-complex organizations are those where such information is concentrated amongst just a few people. Since the cost of separating decision management from decision control is diffused amongst all the

¹⁹⁴ Fama, Eugene F., and Michael C. Jensen. "Agency Problems and Residual Claims." *Journal of Law and Economics* 26, no. 2 (1983): 327-349 at 331. See Fama, Eugene F., and Michael C. Jensen. "Separation of Ownership and Control." *Journal of Law and Economics* 26, no. 2 (1983): 301-325 for a more detailed discussion on this issue.

¹⁹⁵ Fama, Eugene F., and Michael C. Jensen. "Agency Problems and Residual Claims." *Journal of Law and Economics* 26, no. 2 (1983): 327-349 at 332.

¹⁹⁶ *Id* at 307.

participants, the individual cost of adopting this strategy to reduce agency cost is lowest amongst large complex organizations.¹⁹⁷

In the case of countries and their federal sub-divisions, the information required for informed decision-making is distributed amongst their dispersed and numerous citizens. This makes constitutional bodies good examples of complex organizations that would benefit from the separation of decision management from decision control. Additionally, the considerable population of such bodies means that the costs of separation of decision management and decision control can be dispersed over a large number of principals. Since countries and states governed by constitutions have more citizens than the average corporation has shareholders, this is an additional reason to apply corporate governance solutions to constitutional law.

An examination of corporate and constitutional governance arrangements shows that both models have adopted a system whereby decision management can be separated from decision control. This is clear due to the following characteristics evident in the two systems:¹⁹⁸

Firstly, the corporate and constitutional systems provide for a rigid and hierarchical organizational design of the corporate management and the political executive respectively. Second, both systems provide for an elected body of representatives to “ratify and monitor the organization's most important decisions and hire, fire, and compensate top-level decision managers.” This is visible in the operation of the board of directors and the legislature which both perform exactly those functions. Third and last, both systems provide for “incentive structures that encourage mutual monitoring among decision agents.” This is done through the use of the competition for management and executive positions and promotions as well as through market forces and political competition.

While these provisions are visible in the corporate and constitutional structures, the system of checks and balances sometimes fails to perform adequately in certain circumstances. Under such conditions, the institutions set up to separate decision management from decision control fail to achieve their goal of controlling agency cost. This may be due to a conflict of

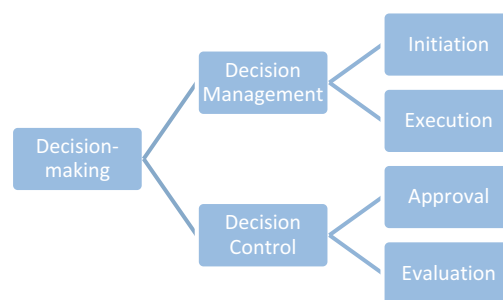
¹⁹⁷ Klein, Benjamin. “Contracting Costs and Residual Claims: The Separation of Ownership and Control.” *Journal of Law and Economics* 26, no. 2 (1983): 367-374 at 371-72.

¹⁹⁸ *Supra* note 215.

interest or inadequate incentives. An example of such a situation is the decision to set the compensation of directors and legislators where agents may propose and approve their own salary, a decision where there is an obvious conflict of interest. In such circumstances, the principals may need to assume the ratification function of decision control themselves in order to minimize agency cost in light of Professors Fama and Jensen's recommendations.

In both the corporate and constitutional setups, decision management pertains to the execution of the functions of the organization while decision control refers to the oversight and monitoring of the decision management function. This exercise of the ratification function by the principals is seen in the use of referendums in constitutional law and the approval of fundamental corporate matters by shareholders in corporate law.

Figure 2



As shown in Figure 2, Decision management includes the power to initiate new policies by putting forward new proposals as to how the organization should act. This is the initiation function of decision management. The execution function of decision management on the other hand refers to the task of executing those policies.

Of these two components of decision management, the initiation function has relevance to the study of direct democracy and is the subject of this chapter dealing with the merits of initiatives.¹⁹⁹ While proposals are typically tabled by the management/executive and then deliberated over by the board of directors or parliament, this function can be temporarily

¹⁹⁹ The characterization of decision management and decision control in this discussion is based on the work of Boudreaux and Prichard. See Boudreaux, Donald J., and Adam C. Pritchard. "Rewriting the Constitution: An Economic Analysis of the Constitutional Amendment Process." *Fordham L. Rev.* 62 (1993): 111 for an in-depth discussion of this issue in the context of the process to amend the US constitution.

taken over by the principals. This happens in the case of ballot initiatives and shareholder proposals where a segment of the principals who meet certain requirements can put forward a proposal that must be then be considered by the principals acting together and voted upon.

The execution function of decision management refers to actually carrying out the decisions made. It is carried out by the management in the case of companies and the executive in the case of governments. For example, the execution function of decision management would include actually manufacturing and distributing what the company has decided to manufacture. In the context of constitutional law, it would be actually enforcing the laws adopted by the country by arresting and prosecuting offenders. As this function cannot be carried out directly by the principals in public companies or countries without incurring extraordinary costs due to collective action problems, it is beyond the purview of this discussion.

Decision control includes two functions as well. The evaluation function of decision control refers to the role of “overseeing the progress of execution and assessing how all other rights were exercised.”²⁰⁰ The approval function of decision control is responsible for choosing between all available proposals and then giving the authorization to act upon the policy that is finally chosen. The role of the principals can be seen in both these functions.

Ordinarily, the board of directors and parliament perform the function of evaluating the performance of the management/executive. In order to enable the board and the legislature to effectively evaluate the performance of the executive or the management, corporate and constitutional law allocate to them requisite powers to call for and receive information and provide for the creation and operation of appropriate committees to facilitate this function.²⁰¹

Citizens and shareholders perform a secondary evaluation function. This evaluation is given voice in their behavior during elections for the board of directors and the legislature. In the case of companies, shareholder reaction to the performance of the management is also

²⁰⁰ Boudreaux, Donald J., and Adam C. Pritchard. “Rewriting the Constitution: An Economic Analysis of the Constitutional Amendment Process.” *Fordham L. Rev.* 62 (1993): 111.

²⁰¹ Eisenberg, Melvin A. “Board of Directors and Internal Control, The.” *Cardozo L. Rev.* 19 (1997): 237 at 238. “The board is not itself unflawed, but as an organ that is compact and cohesive, individualized to the corporation, and capable of being made relatively independent of management control, it is well situated to monitor management on an ongoing and close basis on the shareholders' behalf.”

expressed through the supply and demand for shares. This happens because shareholders sell the shares of under-performing companies thereby driving down the price of its shares and making it more vulnerable to a takeover.

The result of the evaluation carried out by the principals is, therefore, seen reflected in election results and in the case of companies, also in its share price. This is the basis of the representative system at the heart of parliamentary and shareholder democracy. This function can even be considered to spill over into the ambit of direct democracy if provisions for recall elections are considered. Recall elections (also called a recall referendum or representative recall) enable citizens to end the term of an elected representative prematurely by proposing and then voting to pass such a resolution. They are specifically excluded from the scope of this dissertation as they do not enable citizens to take decisions on policy. It is indeed an extension of the election process and only allows replacement of agents

The other part of decision control is the approval function. This function is ordinarily carried out by the board of directors and the legislature which sets the policy of the organization on the basis of information and proposals that are supplied by the management/executive. Therefore, the management and the executive propose policies and the board of directors and legislature respectively approve or reject them.

In the case of referendums and binding initiatives,²⁰² the principals step in to directly exercise the approval function as they can veto proposals from the board of directors or the legislature. In this case, it is the principals who take over the approval function.

It is, therefore, clear that initiatives allow the principals to directly participate in the initiation function of decision management, while referendums allow them to take over the approval function of decision control. Binding initiatives transfer both the initiation and the approval function to the principals. However, in the case of non-binding initiatives, the approval power is vested in the legislature or the board of directors with only the power to propose being passed to the principals.

²⁰² This section introduces the idea of binding and non-binding initiatives. In a direct initiative, a citizen initiated proposal becomes law automatically if it receives the required majority of votes when the proposal is voted on. A non-binding or precatory initiative merely results in the result of a popular vote placed before the government for its consideration which is not bound to adopt the proposal.

Professors Fama and Jensen propose that agency cost in corporate law can be minimized by using “decision systems that separate the management (initiation and implementation) and control (ratification and monitoring) of important decisions at all levels of the organization.”²⁰³ The transfer of power to initiate and adopt policy to the principals, therefore, goes against their recommendation. The issue at the heart of the debate over initiatives is that binding initiatives not only transfer the right to initiate policy to the principals but also transfer to them the right to approve those proposals. This issue is, therefore, central to many of the arguments against binding initiatives and shareholder proposals and is discussed at length in the following chapters.

4.1 RULES OF THE GAME DECISIONS & SPECIFIC BUSINESS DECISIONS

Professor Bebchuk has classified corporate decisions as ‘rules of the game’ and ‘specific business decisions’. The latter are further categorized as ‘game-ending’ and ‘scaling down’ decisions. In order to use the arguments both for and against allowing principals to initiate decisions to help to improve constitutional law, it is essential to conceptualize the types of decisions in terms of agency theory. In this discussion, I look at the effect these types of decisions have on the principal-agent relationship and provide a roadmap to translating corporate governance ideas to address the agency problem in constitutional law.

4.1.1 Rules of the Game Decisions

In terms of agency theory, rules of the game decisions are decisions that concern the relationship between principals themselves and their relationship with their agents. They define the rights and duties of the principals and agents and form the basis of the agency contract of the corporation. In the constitutional scheme, rules of the game decisions are decisions that involve amendments to the constitution and to laws that set out the rights of individual citizens and the powers of the government. These types of decisions will be

²⁰³ Fama, Eugene F., and Michael C. Jensen. “Agency Problems and Residual Claims.” *Journal of Law and Economics* 26, no. 2 (1983): 327-349 at 331.

addressed in depth in the discussion regarding the evolution of constitutional and legal provisions later in this chapter.²⁰⁴

4.1.2 *Specific Business Decisions*

Specific business decisions may involve the actual administration of the daily affairs of the corporation. They also include game-ending and scaling down decisions. When specific business decisions involving the day-to-day affairs of the company such as the activities that generate revenue for the company are examined in terms of agency theory, we see that such decisions focus on the relationship between the company and third parties. They do not change in any way the nature of the relationship between the principals themselves and between the principals and their agents.

Similarly, in the constitutional system, there are numerous decisions such as the determination of recipients of government contracts, the appointment of junior officials etc. that can be considered as specific business decisions as they do not affect the relationship between the principals themselves and between the principals and their agents. These types of decisions are addressed in Chapter six which discusses how imperfect information, considerations of consistency and backseat driving and short termism affect initiation of policy directly by principals.

4.1.2.1 *Game-ending Decisions*

The discussion on game-ending decisions deals with the termination of the principal-agent relationship. Unlike corporations which can cease to exist through voluntary winding up, mergers etc., political units like countries rarely cease to exist through a voluntary decision taken by the government or its citizens.

However, the principal-agent relationship in constitutional law may be ended by the exit of government functionaries, i.e. a change of agents. The appointment and termination of government functionaries like legislators and the executive are determined by the outcome of rules of the game decisions like election rules, term limits etc. This means that the conflict of

²⁰⁴ See section 5.6.

interest involved in ‘game-ending’ decisions in constitutional law are largely covered by the discussion on ‘rules of the game’ decisions. Decisions that relate to the end of the constitutional entity itself by means of a popular vote such as the Austrian referendum backing the ‘*Anschluss*’ with Germany in 1938 are extremely rare and are not separately discussed in this dissertation.²⁰⁵

It should be noted that the only decision that principals may be asked to make outside of elections that can end the principal-agent relationship is through the recall. That discussion is expressly outside the scope of this dissertation and, therefore, excluded from the discussion.²⁰⁶ For these reasons, game-ending decisions are given less attention than rules of the game decisions and even scaling down decisions.

4.1.2.2 Scaling Down Decisions

Scaling down decisions involve reducing the scope of the principal-agent relationship. In the case of corporate scaling down, this means that the company returns assets to the principals meaning that less is left for the agents to manage on their behalf. Such decisions are quite contentious since they often create a conflict of interest for the agents as they have an incentive to pursue empire building strategies for career progression,²⁰⁷ to justify greater compensation, ambition etc. The same is a problem at the constitutional level with governments having a tendency to increase in size.²⁰⁸

²⁰⁵ The referendum was held to determine whether Austria should merge with Germany. After it was successful, Austria ceased to exist as an independent nation and therefore the decision can be termed ‘game-ending’. The Austrian citizen’s principal agent relationship with the erstwhile Austrian government had come to an end.

²⁰⁶ See the section titled ‘Scope and Limitations of Research’ in the introduction.

²⁰⁷ See Hope, Ole-Kristian, and Wayne B. Thomas. “Managerial Empire Building and Firm Disclosure.” *Journal of Accounting Research* 46, no. 3 (2008): 591-626. Professors Hope and Thomas’s research empirically verifies that managers who are not monitored by shareholders tend to maximize their own self-interest by aggressively growing the firm even if this destroys firm value and is against the interests of their shareholders. Their conclusion suggests that the adoption of aggressive disclosure requirements can aid monitoring by shareholders. This improved monitoring drives down agency cost.

²⁰⁸ See Levinson, Daryl J. “Empire-Building Government in Constitutional Law.” *Harvard Law Review* (2005): 915-972. On this subject, Professor Milton Friedman suggested that a constitutional initiative with the principals i.e. citizens proposing and adopting a limit on government spending may be the only way to a libertarian society since government agents have the incentives to increase the size of government and government spending. Note that Milton Friedman, together with Friedrich Hayek are two of the most renowned intellectual advocates of limited government.

These decisions are an interesting topic of study in the current context since they deal with a situation very similar to constitutional law where there is a clear conflict of interest between principals and agents.

Both scaling down and game-ending decisions are of particular interest while comparing the utility of referendums and initiatives since the right of principals to initiate decisions is crucial in these types of decisions. Having a provision for referendums without providing for initiatives may not be helpful in scaling down and game-ending decisions. This is because agents have no incentives to initiate policy that leads to an unfavorable outcome for them, in this case reducing the scope of their authority.

Simply put, agents seeking to pursue empire building activities will have no incentives to initiate proposals that restrict the scope of their powers. Principals, therefore, need other tools to express their desire for restricting the scope of the principal-agent relationship. A detailed discussion examining scaling down decisions and game-ending decisions in corporate governance to identify means to restrict the unchecked growth of government is presented in chapter 5.²⁰⁹

See Friedman, Milton, and Rose D. Friedman. *Free to Choose: A Personal Statement*. Harcourt Brace Jovanovich, 1990. See also Kyvig, David E. "Refining or Resisting Modern Government-The Balanced Budget Amendment to the US Constitution." *Akron L. Rev.* 28 (1994): 97 and Stansel, Dean. *Taming Leviathan: Are Tax and Spending Limits the Answer?* Cato Institute, 1994.

²⁰⁹ See section 5.6.

The Influence of Direct Democracy on Agency Costs:
Lessons from Corporate Governance

PART II: THE LAW AND ECONOMICS OF DIRECT DEMOCRACY:
INITIATIVES AND REFERENDUMS

5 THE UTILITY OF HAVING INITIATIVES IN CONSTITUTIONAL LAW

*“Without direct democracy, legislatures have a monopoly over what issues are to be decided, in what order, and in what form. With the initiative, the monopoly is broken, and ordinary people are allowed to make proposals”*²¹⁰

In this chapter, I begin with a positive inquiry to reveal the legal position regarding the rights of principals to veto decisions taken by their agents as well as their power to initiate policy under corporate and constitutional law. I show that corporate law is quite clear and unambiguous in vesting with shareholders the right to veto major corporate decisions while provisions allowing for referendums are nowhere as universal in the constitutional sphere.²¹¹

On the other hand, the power of shareholders to initiate policy is not a settled issue in corporate law or in constitutional law. There exists considerable divergence between the United States and the United Kingdom’s position regarding the rights of shareholders to initiate policy. Moreover, there is an academic debate raging in the United States regarding this issue in the context of shareholder proposals and shareholder-amended bylaws. The constitutional position on the matter is equally unsettled. Mature democracies may provide for ballot initiatives with a wide scope and ambit as seen in the State of California or not provide for initiatives at all as is the case with the United Kingdom, India and the United States at a federal level.

Having pointed out the legal status quo, the chapter turns normative and examines how the corporate experience²¹² can help to educate our understanding of how authority to initiate

²¹⁰ Matsusaka, John G. “The Eclipse of Legislatures: Direct Democracy in the 21st Century.” *Public Choice* 124, no. 1-2 (2005): 157-177 at 170.

²¹¹ Referendums are plebiscites that allow citizens to adopt or reject proposals put forward by their agents. An example of a referendum is the plebiscite required to adopt constitutional amendments in the State of California. Amendments to the constitution proposed by the legislature only become effective if they are approved by a majority of citizens voting in the plebiscite.

²¹² The corporate conception of direct democracy for shareholders can be understood to be a settled position in favor of the right of shareholders to veto major corporate decisions that require shareholder approval and unsettled in respect to the issue of shareholders initiating policy with a raging debate on shareholder proposals and proxy access.

decisions should be divided amongst citizens and their representatives. Of course, the normative criterion remains the minimization of agency cost.²¹³

5.1 THE RIGHT TO VETO – SETTLED IN CORPORATE LAW, VARIED IN CONSTITUTIONAL LAW

The corporate law of important jurisdictions like Delaware, New York and the UK is fairly consistent with the philosophy of requiring shareholders to approve many types of major corporate decisions. This effectively gives the shareholders of a substantial number of the world's largest corporations a veto right over these types of decisions. Some examples of such major corporate decisions are:

- Changes to the charter,²¹⁴
- Mergers and consolidation,²¹⁵
- The sale of all or substantially all the company's assets not in the ordinary course of business,²¹⁶
- Dissolution,²¹⁷
- A non-binding vote is even required on executive pay since the introduction of the Dodd Frank Act.²¹⁸

²¹³ As understood in this discussion, agency cost includes the cost of collective action associated with direct decision-making as a part of monitoring cost.

²¹⁴ § 242(b)(2), Delaware General Corporation Law; § 803(a), New York Business Corporation Law. In the United Kingdom, the memorandum of association (formerly equivalent to the charter) and the articles of association (formerly equivalent to the byelaws) have been consolidated into the articles of association. These can be amended by the shareholders by means of a special resolution giving shareholders not only veto rights but initiation rights as well. For the purpose of this discussion, it suffices to say that the articles cannot be amended without their approval.

²¹⁵ § 251(c), Delaware General Corporation Law; § 903(a), New York Business Corporation Law. Under the (United Kingdom) Companies Act, 2006, mergers and consolidation typically takes place under the aegis of a court order obtained as per part 26 of the act (and also part 27 if the company is a public company). This court order however requires a supermajority of 75% thereby giving shareholders a veto. As in the case of changes to the articles of association, shareholders also have initiation rights in this respect as members, creditors and if applicable, a liquidator or administrator can make an application under part 26 of the act. This takes nothing away from the veto rights of shareholders as a supermajority vote is required just the same.

²¹⁶ § 271(a), Delaware General Corporation Law; § 909(a), New York Business Corporation Law

²¹⁷ § 275, Delaware General Corporation Law; § 1001(a) & (b), New York Business Corporation Law

Similarly, the requirement of shareholder approval for such types of fundamental corporate decisions exists in most major economies.²¹⁹ While these decisions are initiated by the board of directors, the subsequent approval of shareholders is mandatory. It should be noted that not only is the law on this issue largely settled, there is also little academic debate advocating a change from such a position. For example, even advocates of director primacy like Professor Bainbridge do not propose that the board of directors should be empowered to amend the charter, undertake mergers or sell off all the company's assets without approval from shareholders.²²⁰

On the other hand, the right of citizens to approve major decisions such as changes to key laws and even amendments to the constitution is not a settled matter. Amongst mature democracies, there are some that require citizen approval for major decisions initiated and

²¹⁸ §951 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, 2010. This act was passed in response to the global financial recession of the late 2000's. Perceiving that the financial problems of the country were caused by insufficient regulation of financial entities, the US government adopted extensive regulations to control the same. Due to the outcry against perceived excessive executive compensation, regulations were introduced into the Dodd Frank Act that required shareholders to approve the compensation of directors and top managers in a non-binding vote.

In the United Kingdom, s. 439 of the Companies Act, 2006 requires non-binding approval of shareholders for the compensation of directors. Furthermore, provisions under Chapter 4 of the Companies Act, 2006 (ss. 188 to 226) provide a number of conditions whereby shareholder approval is required for directors to benefit from their position at the company.

²¹⁹ The rights of shareholders to participate in and approve fundamental corporate decisions are enshrined in OECD Principles of Corporate Governance.

See Development (OECD). Steering Group on Corporate Governance. *OECD Principles of Corporate Governance 2004*. OECD Publishing, 2004 at 32. "Shareholders' rights to influence the corporation center on certain fundamental issues, such as the election of board members, or other means of influencing the composition of the board, amendments to the company's organic documents, approval of extraordinary transactions, and other basic issues as specified in company law and internal company statutes. This Section can be seen as a statement of the most basic rights of shareholders, which are recognized by law in virtually all OECD countries."

See also page 18 which states, "Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorization of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company."

²²⁰ See Bainbridge, Stephen. "Director Primacy and Shareholder Disempowerment." *Harvard Law Review* 119 (2006): 1735-2644. Professor Bainbridge agrees that the approval of shareholders should be required for fundamental decisions like amendments to the charter of the company.

taken by the legislature²²¹ while many successful democracies give their citizens no such right of veto.²²²

The discussion on the right of citizens' to veto certain types of major decisions is, therefore, simplified by a settled view on the issue in corporate law. This will be reflected in the treatment of the issue in the normative discussion in the following sections.

5.2 THE RIGHT TO INITIATE – UNSETTLED IN CORPORATE AND CONSTITUTIONAL LAW

The positions taken by both corporate and constitutional law on giving principals the right to initiate policy differs considerably across jurisdictions.

In the constitutional system, citizens in many countries are allowed to set the agenda in certain circumstances. The process to do so is called an initiative. Citizens can put forward a proposal in the form of a petition. If the petition is supported by a predetermined proportion of the voters (demonstrated through signatures on the petition), it is then voted upon either in a special poll or included on the ballot in the next election.²²³

On the other hand, there are many mature democracies that have no such provisions for citizens to initiate proposals.²²⁴ They may be purely representative democracies²²⁵ or

²²¹ All American states barring the state of Delaware require amendments to their constitution to be approved by their citizens in a referendum. While no American state requires statutory changes to be approved via referendum, 23 states have provisions in their constitutions that permit the legislature to place proposed statutory amendments or new statutes on the ballot for citizen approval. Some examples of countries that require the approval of citizens (by means of referendums) for major decisions such as constitutional amendments are Australia, Austria, Bolivia, Costa Rica, Croatia, Iceland and Ireland amongst many others

²²² For example, see Mexico, United States, India, Indonesia, Sri Lanka, Turkey etc. These countries do not allow for referendums on any issue at the federal level.

²²³ At the national level, Hungary, Italy, New Zealand, Serbia and Uruguay are examples of countries that allow initiatives giving citizens the power to bypass their representatives and directly initiate policy changes.

²²⁴ Many democracies like the United States, Canada, Denmark, Germany, India, Iceland and Norway have no provisions for initiatives at the national level.

²²⁵ For example, the US and the Indian constitutions do not provide for any form of direct democracy at all. This includes both referendums as well as initiatives.

democracies that provide for referendums but not initiatives.²²⁶ In the latter case, citizens have the right to approve or veto certain proposals from the government (i.e. the right to referendum) but do not have the right to propose policy themselves which they can subsequently vote to approve or reject (i.e. the right to pass initiatives)

When we examine shareholders' rights to (a) initiate policy themselves and (b) approve or veto policy initiated by their agents, a similar difference in legal treatment position and ongoing academic debate is revealed. In particular, the US and the UK corporate laws differ considerably in this regard. This divergence in legal treatment is in sharp contrast to the clarity and consensus in corporate law regarding the empowering of shareholders to veto fundamental corporate decisions. Accordingly, both the different legal positions must be examined in greater detail.

5.2.1 *The US Position*

In the United States, the power to manage the business and affairs of the corporation is traditionally vested with the board of directors.²²⁷ This includes the power to initiate "rules of the game decisions" as well as "specific business decisions" that include "game-ending decisions"²²⁸ and "scaling down decisions".²²⁹

Rules of the game decisions are classified by Professor Bebchuk as those decisions that concern the 'choice of the rules by which corporate actors play'.²³⁰ They are codified in the charter of the company and in the corporate laws of the state of the company's incorporation.

²²⁶ For example, the US state of New Mexico's constitution allows for referendums but has no provisions regarding initiatives.

²²⁷ Delaware General Corporation Law, §141(a); Model Business Corporations Act, §8.01(b) and New York Business Corporation Law §701.

²²⁸ Game-ending decisions include mergers, consolidations, dissolutions and sale of all the company's assets. These types of decisions end the principal-agent relationship and the company no longer remains a going concern.

²²⁹ Scaling down decisions are decisions involving the return of corporate assets to shareholders in the form of cash or stock. They are known as scaling down decisions since they scale down the size of the company and therefore scale down the scope of the principal agent relationship. See Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 844.

²³⁰ Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914.

The board of directors has the exclusive right to initiate changes to both these sources of rules. This is because firstly, the corporate law of Delaware only allows the board of directors to initiate an amendment to the charter.²³¹ Second, only the board of directors can initiate the decision to reincorporate in another state by proposing a merger with a shell company in that state thereby changing the laws applicable to the company.²³²

The shareholder's power to initiate rules of the game decisions is restricted to proposing bylaw amendments – a power they share with the board of directors.²³³ Shareholders are not empowered to initiate amendments to the charter.²³⁴ The charter is the incorporating document of the company and has precedence over the provisions of the bylaws. In many ways, the charter is analogous to the constitution while bylaws are analogous to ordinary legislation. This means that shareholders have no power to initiate policy on fundamental decisions that affect the principal-agent relationship. Furthermore, bylaws are subordinate to the provisions of the charter and they cannot be used to opt out of default provisions of the DGCL and the MBCA.²³⁵

When it comes to specific business decisions, shareholders do not fare any better due to the wide scope of §141(a), Delaware General Corporation Law and identical provisions in other statutes.²³⁶ The power to initiate game-ending decisions involving mergers, consolidations, dissolutions and sale of all the company's assets rests exclusively with the board of directors. The only rights shareholders have regarding rules of the game decisions and game-ending

²³¹ Delaware General Corporation Law, §242(b); Model Business Corporations Act, §10.03 and New York Business Corporation Law §803(a).

²³² *Supra* note 250 at 844.

²³³ Delaware General Corporation Law, §109; Model Business Corporations Act, §10.20 and New York Business Corporation Law §601.

²³⁴ See Delaware General Corporation Law, §242(b); Model Business Corporations Act, §10.03 and New York Business Corporation Law §803(a). Only the board of directors is given the right to initiate charter amendments.

²³⁵ There are certain exceptions to this particularly relating to the election of directors whereby shareholders may initiate and vote upon the decision to opt out of plurality voting. Modifications to the Delaware General Corporation Law in 2006 retained the plurality vote default rule but mandated that the board of directors cannot modify or rescind a shareholder adopted bylaw which requires a greater of votes for director elections. This move was reflected in amendments to the corporate laws of California, Virginia and Washington which had a similar effect. The debate regarding proxy access also relates to the ability of shareholders to initiate changes to the process whereby directors are elected by changing the default rule. The position of law on this issue is under considerable flux and there is no consensus on the optimal situation. See *Supra* note 250 at 845.

²³⁶ See Model Business Corporations Act, §8.01(b) and New York Business Corporation Law §701.

decisions is the power of veto since these decisions have to be approved by shareholders to come into effect.

In the case of scaling down decisions, all authority is vested with the board of directors. These decisions involve ordering a cash or stock distribution to shareholders. This reduces the size of the company and removes excess cash or assets.²³⁷ Shareholders do not have the authority to initiate such decisions nor do they even have the power to veto decisions involving the distribution of cash or stock to shareholders.

Under the provisions of the DGCL, shareholders may make non-binding proposals on a wider range of issues. Such proposals made under Rule 14(a)(8) passed by the SEC must also be included on the proxy of the company. This allows shareholders making the proposal to use company machinery to disseminate their proposal to all the shareholders. These proposals are then voted on in the next annual meeting of the company.²³⁸

Resolutions passed under Rule 14(a)(8) are typically precatory. This means that the board of directors has the discretion to adopt or reject the proposal even after it receives a majority of the votes cast by shareholders in the general meeting. The impact of such precatory shareholder proposals is hotly debated and will be discussed in detail in section 5.8²³⁹

²³⁷ *Supra* note 250 at 845.

²³⁸ As explained in Section 6.6, Rule 14a-8 allows shareholders to put forward proposals to be included on the company's proxy. This allows shareholders to circulate their proposal at the company's expense and the proposals are then put to a shareholder vote at the next Annual General Meeting of the company.

²³⁹ See Brownstein, Andrew R., and Igor Kirman. "Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions." *The Business Lawyer* (2004): 23-77. Professors Brownstein and Kirman argue that precatory resolutions are often responsible for influencing company policy even though it is not formally adopted as the board of directors since back room negotiations are responsible for addressing many of the issues that form the basis of the resolution. They also argue that just because a proposal was not adopted does not mean that it was not duly considered by the board and that the Business Roundtable has noted that "boards take majority-vote shareholder proposals very seriously, in keeping with their fiduciary duties to the company and all of its shareholders".

The debate over the advantages of binding v. precatory proposals will be reserved for chapter eight which deals with exactly that issue.

5.2.2 *The UK Position*

The American approach is not the only way of allocating rights to initiate decisions between the shareholders and the board of directors. Corporate law in the UK gives greater power to initiate decisions to shareholders. Regardless of this, the UK has also had notable success in attracting international investment in a corporate environment known for large numbers of dispersed shareholders. Moreover, the UK is also a leader in attracting talented managers to act as agents in these companies. This suggests that diluted initiation rights for shareholders are not a precondition for an efficient corporate system that can attract both investors and managers effectively.²⁴⁰

Under the Companies Act of 2006, shareholders have the power to initiate and pass amendments to the articles of association.²⁴¹ They can do this by means of a special resolution²⁴² passed by a supermajority of 75% of the votes cast at a shareholder meeting.²⁴³ This gives the shareholders of UK corporations the right to initiate rules of the game decisions.²⁴⁴ While the high supermajority requirement makes initiation and adoption by shareholders difficult, there are further protections for shareholders in the law as well. For example, if shareholders can demonstrate that they control ten percent or more votes, they can compel the board of directors to call a general meeting²⁴⁵ where the shareholders can vote on the special resolution.²⁴⁶ In fact, if the board of directors fails to call such a meeting, the

²⁴⁰ For a detailed study of the differences in English and American corporate law and governance, see Gower, L. C. B. "Some Contrasts Between British and American Corporation Law." *Harvard Law Review* 69, no. 8 (1956): 1369-1402.

²⁴¹ The Companies Act, 2006 merged the memorandum of association and the articles of association (similar to the charter and the byelaws of US companies respectively) to create a unified articles of association that serves the role of both charter and byelaws.

²⁴² s. 21(1), Companies Act, 2006.

²⁴³ See s. 283, Companies Act, 2006. Shareholders wishing to table a special resolution at the annual general meeting of the company must give prior notice to the company and follow the provisions of Part 13 of the statute.

²⁴⁴ The commentary in Davies, Paul L. *Gower & Davies. The Principles of Modern Company Law*. Sweet and Maxwell, 2008 is the basis of this summary of shareholders' right to initiate decisions under English company law.

²⁴⁵ s. 303(1) read with s. 303(3), Companies Act, 2006 and s. 304, Companies Act, 2006.

²⁴⁶ s. 303(5), Companies Act, 2006.

shareholders themselves can call a general meeting at the company's expense²⁴⁷ in order to pass the proposal as long as they have the requisite number of shares.

In the case of specific business decisions, UK law by default provides that the company should be managed by the board of directors. However, the Companies (Model Articles) Regulations adopted by most public companies provide that "[T]he shareholders may, by special resolution, direct the directors to take, or refrain from taking, specified action".²⁴⁸ Furthermore, the shareholders of UK companies can also initiate a proposal to replace members of the board of directors in an ordinary resolution²⁴⁹ as long as special notice is given to the concerned directors.²⁵⁰

These rights clearly demonstrate that English company law grants far greater power to initiate decision-making to shareholders as compared to the company law of Delaware and most other American states.

It is clear, however, that the managers of both US and UK companies have been able to convince their investors that their governance mechanisms and legal obligations will ensure that investments will not be expropriated and that returns will be generated and distributed. Similarly, both jurisdictions have also had success in attracting excellent managers who are convinced that they will have sufficient discretion to operate effectively.

Shareholders around the world have not found the relatively diminished right to initiate policy in US companies to be a signal of substantially higher agency cost. US companies continue to be competitive with respect to UK companies in attracting international investment. In light of this, a detailed normative analysis will be carried out in the following sections to help determine the extent of agenda control citizens must have in order to minimize agency costs.

²⁴⁷ s. 305, Companies Act, 2006.

²⁴⁸ Regulation 4(1), Companies (Model Articles) Regulations, 2008. Note: Regulation 4(2), Companies (Model Articles) Regulations, 2008 prohibits any retrospective application of Regulation 4(1).

²⁴⁹ s. 168(1), Companies Act, 2006.

²⁵⁰ s. 312, Companies Act, 2006.

5.3 WHEN ARE REFERENDUMS NOT ENOUGH?

This sub-section presents three conditions where the right to veto does not help the principals to minimize agency cost. In each case, the only solution is giving principals the right to initiate policy. A discussion into these situations which illustrate the advantages of separating decision management from decision control is used to show why initiatives may indeed be required in addition to referendums.

Shareholders almost universally have the right to approve certain fundamental decisions of the company such as amendments to the charter, mergers, sale of all assets etc.²⁵¹ Citizens, on the other hand, either do not have these rights (in pure representative democracies), or have veto rights over certain specified classes of decisions in jurisdictions that provide for mandatory referendums. Citizens may also have the opportunity to vote on other issues if the government chooses to ask them for their approval as in the case of legislative referendums. Their decision may or may not be binding.²⁵²

By requiring the principal's approval to act, referendums serve as a loss mitigation device by preventing decisions that the principals oppose enough to block by voting against them. However, agency costs can escalate unchecked in a number of circumstances if principals are denied the right to initiate decisions.

With respect to corporate governance, Professor Bebchuk identifies three circumstances in which shareholders will not be able to use the right to veto to compel the board of directors to make the decision most favored by shareholders.²⁵³ The following discussion summarizes these conditions and shows that citizens would similarly be powerless to compel their government to make the decision the citizens favor most if the constitution only provides for referendums and does not provide for initiatives.

²⁵¹ See section 5.1.

²⁵² Mandatory referendums are referendums required by law or by the constitution in order to make certain kinds of decisions or if certain conditions are satisfied. Legislative referendums are referendums held at the discretion of the legislature. Such a referendum is not a precondition for making the decision that is the subject of the referendum. Since the referendum is held at the option of the legislature, in some cases it may choose to ignore its outcome.

²⁵³ Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 862-65

5.3.1 *Agents Prefer the Status Quo*

The power to veto unfavorable decisions is a power that operates very differently from the power to initiate decisions. Unlike the power to initiate change, the veto power only gives the principals the power to maintain the status quo. In the corporate context, this can help shareholders reject unfavorable takeover bids, but does nothing to help remove anti-takeover provisions that the agents may find to be in their own self-interest and thus never put to the shareholder vote.

In the constitutional scenario, this means that veto rights do not help citizens to change laws when it is in the interest of the legislature to maintain the status quo. Initiatives are, therefore, required whenever citizens want to use direct democracy to enact a change that is not in the interests of their agents to provide. Examples of such decisions may be measures that reduce the scope for corruption, make elections more competitive, create stricter sanctions for abuse of power etc.²⁵⁴

5.3.2 *Agents Prefer the Worse of Two Beneficial Options*

In a situation where there is more than one option that increases value for the principals, the right to veto does not help principals to ensure that the best option is chosen. If the agents choose the option that is in their best interest, the principals would rationally approve the measure as long as it is preferable to the status quo, even if better options exist.

Bargaining theory²⁵⁵ suggests that a party in a position to make ‘take it or leave it’ offers to the other will have a substantial advantage over the other. The former will, therefore, be able to capture virtually all the benefit if the other party “does not have reputational or other mechanisms to commit itself to being tough”²⁵⁶ In the constitutional system, the principals are uncoordinated and dispersed citizens who are badly situated to take a tough position and

²⁵⁴ Romer, Thomas, and Howard Rosenthal. “Political Resource Allocation, Controlled Agendas, and the Status Quo.” *Public Choice* 33, no. 4 (1978): 27-43.

²⁵⁵ See Peters, Michael. “Negotiation and Take it or Leave it in Common Agency.” *Journal of Economic Theory* 111, no. 1 (2003): 88-109 and Forsythe, Robert, Joel L. Horowitz, Nathan E. Savin, and Martin Sefton. “Fairness in Simple Bargaining Experiments.” *Games and Economic Behavior* 6, no. 3 (1994): 347-369.

²⁵⁶ *Supra* note 250 at 863.

to make credible commitments. This means that citizens will rarely veto the self-serving plans of the government in order to force it to adopt more citizen friendly policies.

In such a situation, the initiative allows the citizens to propose the option that maximizes their value and to adopt the proposal if they can muster the votes required. Adopting the option that maximizes value for the citizens using an initiative will lead to lower residual loss and a modest increase in monitoring cost.

5.3.3 *Agents Bundle the Good with the Bad*

By virtue of having exclusive rights to set the agenda for decision-making, agents in companies and countries have the ability to force principals to approve measures that are against their interest. This can be done by bundling a proposal that decreases value for principals with another proposal that increases value a little more than the decrease caused by the original proposal.

This power to bundle proposals sharply highlights the importance of allowing agents to initiate proposals on their own. It illustrates that the vesting of initiation rights exclusively with agents has the potential to dilute the utility of referendums as well.²⁵⁷ This is because principals would rationally be forced to approve proposals from their agents that benefit the principals in one way but also hurt their interests in another as long as the net effect is positive. This means that considering a system that provides for referendums as a compromise to allowing citizens the right to initiate proposals has the potential for abuse by opportunistic agents.

5.3.4 *Logrolling and Bundling by Principals*

The legislature typically has the power to bundle various proposals on unrelated subjects into an omnibus bill that is then voted on as a whole and is adopted or rejected as if it were a single bill.²⁵⁸ This political bargaining and compromise, also called logrolling, allows

²⁵⁷ Lupia, Arthur. "Busy Voters, Agenda Control, and the Power of Information." *The American Political Science Review* (1992): 390-403 at 390-91.

²⁵⁸ There are a number of exceptions to this such as the State of Louisiana whose constitution imposes the Single Subject Rule on legislative as well. See art. 3, § 15(A) of the Constitution of the State of Louisiana which reads,

legislators to achieve the outcomes most important to them in exchange for compromising on issues that they find less important.²⁵⁹ For example, a senator from Virginia may support a bill intended to subsidize the producers of wine which is an important source of revenue for California but not important to Virginia. In exchange for this support, a California senator might promise the Virginia senator his support for a bill which subsidizes tobacco farmers, a group central to the economy of Virginia but not California. Needless to say, neither party would agree to logrolling if they perceive it to be to their detriment.

The ability to bundle various proposals to be put to the vote as a single proposal is, however, often denied to citizens when they frame proposals for ballot initiatives.²⁶⁰ This difference in treatment in the ability to bundle multiple proposals into one may be caused by the fact that the legislature is capable of compromise and negotiation on bills. On the other hand, due to their sheer numbers and dispersion, citizens are not capable of such compromise and negotiation.

When the board of directors and the legislature are compared, it becomes clear that both have relatively manageable numbers and the aid of a multiplicity of institutions and procedures such as a plethora of committees, agendas, advisors etc. These institutions enable reasoned discussion that is not possible between all the shareholders and citizens due to the unmanageable number of individuals and the absence of such institutions to help them to coordinate. An attempt by principals to try the sort of compromise and negotiation required for drafting omnibus proposals would, therefore, suffer from transaction costs orders of magnitude higher than that incurred by their agents.²⁶¹

While logrolling has numerous benefits, it leads to opacity in the voting records of representatives that leads to a dilution in the monitoring abilities of voters. The reduced

“Every bill, except the general appropriation bill and bills for the enactment, rearrangement, codification, or revision of a system of laws, shall be confined to one object.”

²⁵⁹ See Buchanan, James MacGill, and Gordon Tullock. *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Vol. 100. University of Michigan Press, 1965 for an authoritative treatise on the positive impact of logrolling.

²⁶⁰ Gilbert, Michael. “Single Subject Rules and the Legislative Process.” *University of Pittsburgh Law Review* 61 (2006): 803 at 812. “By 1959, some version of the rule had been adopted in forty-three states.”

²⁶¹ Cooter, Robert D., and Michael Gilbert. “A Theory of Direct Democracy and the Single Subject Rule.” *A Theory of Direct Democracy and the Single Subject Rule* 110 (2010): 687 at 697-8, 689.

ability to monitor risks an escalation of agency costs and also increases the likelihood capture by special interests. In both corporations and political democracies, direct democracy presents an alternative for voters to correct the activities of representatives when faced with the inability to hold individual agents responsible. It allows principals to “empower democratic majorities, weaken special interests, and enhance political transparency.”²⁶²

Although direct democracy may serve as a partial solution to some of the negative consequences of logrolling and bundling by representatives, voters themselves are less effective in compromising and bargaining due to prohibitively high transaction costs.²⁶³ This may lead to an inability to accommodate the interests of outlying groups such as ethnic and racial minorities while framing proposals for ballot initiatives.

This is a serious problem since bundling can be misused by groups of principals while framing the initiative proposal just as agents can misuse it. As explained earlier, they can do through actions such as selecting the worse of two options or bundling a regressive proposal with an important and beneficial one.

The problem of bundling by principals has been addressed by the SEC which prohibited shareholders from bundling several proposals into a single shareholder proposal as per Rule 14a-8(c).²⁶⁴ In the following chapters, these corporate insights are used to examine provisions such as the ‘single subject rule’ that already exists in certain constitutions and to argue that principals, unlike agents, should not be permitted to bundle proposals.²⁶⁵

²⁶² See *Infra* note 283 at 699 and Buchanan, James MacGill, and Gordon Tullock. *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Vol. 100. University of Michigan Press, 1965.

²⁶³ Cooter, Robert D., and Michael Gilbert. “A Theory of Direct Democracy and the Single Subject Rule.” *A Theory of Direct Democracy and the Single Subject Rule* 110 (2010): 687 at 700.

²⁶⁴ 17 C.F.R. § 240.14a-8(c). As explained in Section 3.4.1, Rule 14a-8 allows shareholders to put forward proposals to be included on the company’s proxy. This allows shareholders to circulate their proposal at the company’s expense and the proposals are then put to a shareholder vote at the next Annual General Meeting of the company. Rule 14a-8(c) is a limitation on this right which stipulates that several proposals may not be bundled into a single proposal for the purposes of Rule 14a-8.

²⁶⁵ See for example Art. II, Sec. 8 (d) of the Constitution of the State of California, Art. XXI, Sec.1 & Art. IV, Pt. 2, Sec. 13 of the Constitution of the State of Arizona, Art. XI Sec. 3 of the Constitution of the State of Florida and similar provisions in Colorado, Missouri, Montana, Nebraska, Nevada, Ohio, Oklahoma, Oregon, Utah, Washington and Wyoming.

To resist the introduction of initiatives to the constitutional system due to the danger of bundling of proposals would be to throw out the baby with the bathwater. If clear provisions prohibiting the bundling of proposals are introduced, there is no reason why such proposals would not be rejected or separated and meritorious single subject proposals accepted.

5.4 SEPARATING SPECIFIC DECISIONS FROM ELECTIONS

Chapter 3 discussed in detail the different impact elections have on agency problems in the corporate and constitutional systems. To summarize, the relatively lower competition in director elections has the potential to increase entrenchment thereby increasing agency cost. On the other hand, this effect is expected to be at least partially neutralized by the comparatively greater monitoring influence of the Wall Street Rule and the market for corporate control in the corporate system. This can be expected to offset, to an extent, the relative increase in agency cost.²⁶⁶

This section examines whether it is efficient to replace the agent if all that the principals' want is a change of policy on a specific issue. The standard type of bundling in agency theory scholarship refers to a situation where the agents bundle a value increasing and a value decreasing proposal which may make it rational for principals to approve such a plan as they are unable to separate the two.²⁶⁷ Professor Bebchuk identifies the need to replace agents to change policy as a *second type* of bundling problem in the corporate model. It is this second type of bundling problem that is addressed here.

If shareholders are not empowered to initiate decisions and the directors do not respect their demands, a situation is created where the only way to change policy even on a minor point is to replace the board of directors through an election. This means that a particular decision becomes bundled with the need to have fresh elections. This leads to a situation where

²⁶⁶ See sections 3.1 and 3.4.

²⁶⁷ See Section 5.3. See also Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 864-65. This issue is discussed in detail subsequently in this chapter.

shareholders may end up shying away from seeking value enhancing changes due to the cost of electing new directors.²⁶⁸

This second type of bundling problem holds equally true in the constitutional system. The problem remains that in a pure representative democracy, citizens will only adopt a choice opposed by the legislature if the benefits it provides are greater than the cost of replacing the legislature. Furthermore, the uncertainty that accompanies political change adds to the cost of replacing the legislature for the same reasons that make shareholders wary of replacing the board of directors.²⁶⁹

The need to replace the legislature to effect a change in policy translates to an increase in residual loss and also an increase in monitoring cost. This is because principals will be discouraged from bringing policy into line with their preferences if the cost of changing the representatives is prohibitively high. Since elections and the uncertainty behind their outcomes are costly, citizens will accept value-decreasing policies rather than bear the cost of replacing the legislature. This compromise can lead to a divergence in the preferences of the principals and the actions of their agents. This divergence increases residual loss and, therefore, agency cost.

The need to replace the agents to change their policy also increases monitoring cost since the cost of changing agents through elections and the associated uncertainty is extraordinarily high. If we add the uncertainty of the actions of the new legislature, even a possible increase in residual loss can be avoided by making use of the initiative process.

An initiative is assumed to be cheaper and to require less information and effort than an election since voters only have to inform themselves regarding the subject matter of the initiative (and some key alternatives). This is in contrast to all issues related to social, political and economic policy that a change of government would entail. Furthermore, unlike general elections, initiatives do not require voters to expend resources to evaluate the performance of individual legislators and opposition candidates for every seat in the legislature.

²⁶⁸ See Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 857.

²⁶⁹ Bebchuk, Lucian, and Oliver Hart. *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*. No. w8633. National Bureau of Economic Research, 2001.

By unbundling elections from the initiation of proposals, citizens can bring policy more into alignment with their preferences by expending lesser resources. This can be accomplished by pushing through a ballot initiative rather than expending far more resources in order to replace the legislature via election. ‘Unbundling’ elections from individual policies by allowing citizens the right to propose and adopt certain proposals can, therefore, lead to a reduction of both residual loss and monitoring cost.

5.4.1 *Loss of Accountability and Responsibility*

As shown above, giving citizens the power to directly make certain decisions saves the cost of having to replace the majority of the legislature just because citizens are insistent on changing one particular decision. This sub-section examines whether letting citizens share responsibility for decision-making with legislators would dilute the accountability of the legislators for the consequences of government policy per se.

With respect to the issue of representatives’ responsibility to inform themselves regarding issues required for effective decision-making, the well-cited paper by Professor Kessler proves instructive.²⁷⁰ She argues that representatives have incentives to inform themselves of issues necessary to make good decisions only if they have the discretionary power to make those decisions.²⁷¹ This means that the incentives of the agents to inform themselves will be reduced if citizens share the right to make decisions (through initiatives or referendums) because the discretionary power of the agents to make decisions would be reduced.

A greater problem is that of dilution of responsibility. The premise of this argument is that by encroaching on the turf of delegated decision-making, direct democratic action runs the risk of relieving the agents of the responsibility of policy making and may hence lead to reduced accountability for them.²⁷² A criticism of direct democracy provisions that applies primarily to

²⁷⁰ Kessler, Anke S. “Representative versus Direct Democracy: The Role of Informational Asymmetries.” *Public Choice* 122, no. 1-2 (2005): 9-38.

²⁷¹ *Id* at 10.

²⁷² See Grant, Ruth W., and Robert O. Keohane. “Accountability and Abuses of Power in World Politics.” *American Political Science Review* 99, no. 1 (2005): 29-43 at 29. Professors Grant and Keohane define accountability as the right of principals to hold their agents to “a set of standards, to judge whether they have fulfilled their responsibilities in light of these standards, and to impose sanctions if they determine that these responsibilities have not been met”. Since the use of direct democracy blurs the line between the efforts of the

referendums is that it allows the agents to relieve themselves off the responsibility for the outcomes of policies they adopt.²⁷³ Professor Setälä examines this possibility in great depth and concludes that legislators can effectively avoid accountability for their actions if they are able to abuse their right to initiate decisions and then have them rubber stamped through a referendum often by framing the issue in a misleading manner.²⁷⁴

This argument can be demonstrated anecdotally through the furor over former Greek President Papadopoulos' quickly overturned decision to put an urgent but unpopular bailout to a referendum.²⁷⁵ In this instance, the Greek President was criticized for failing to take an urgent decision regarding whether or not to accept a critical bailout that was conditional on tough austerity measures. Since both options available to him were unpopular (bankruptcy or harsh austerity), President Papadopoulos declared that the decision would be taken by referendum. This action was widely condemned as an attempt by the president to absolve himself of the responsibility and the political backlash for making either of the two unpopular choices.²⁷⁶

Another example of a government passing on unpopular decisions to its voters is the 2010 Israeli decision to require a referendum in order to return occupied territories in the absence of a 2/3rd majority in the Knesset.²⁷⁷ This allows the Israeli government to argue that it is the

agents and the results of policy (due to intervention by direct democracy), its use is considered to have a detrimental impact on the accountability of the agents. See also Professor Breuer's analysis of how direct democracy has impacted accountability in Latin America in Breuer, Anita. "The Problematic Relation between Direct Democracy and Accountability in Latin America: Evidence from the Bolivian Case." *Bulletin of Latin American Research* 27, no. 1 (2008): 1-23 and Breuer, Anita. "Institutions of Direct Democracy and Accountability in Latin America's Presidential Democracies." *Democratisation* 14, no. 4 (2007): 554-579.

²⁷³ See Breuer, Anita. "Policymaking by Referendum in Presidential Systems: Evidence from the Bolivian and Colombian Cases." *Latin American Politics and Society* 50, no. 4 (2008): 59-89. This paper analyses the impact of government initiated referendums on the Presidential elections in two South American countries.

²⁷⁴ Setälä, Maija. "On the Problems of Responsibility and Accountability in Referendums." *European Journal of Political Research* 45, no. 4 (2006): 699-721. Please see a complete discussion on the consequences of framing in section 3.4.2.

²⁷⁵ See Donadio, Rache and Kitsantonis, Niki. "Greek Leader Calls Off Referendum on Bailout Plan." *New York Times* (November 3, 2011).

²⁷⁶ See for example "Fresh Trouble for Euro: EU Shocked and Furious at Greek Referendum Plan", *Spiegel Online (International edition)*, November 1, 2011 available at <http://www.spiegel.de/international/europe/fresh-trouble-for-euro-eu-shocked-and-furious-at-greek-referendum-plan-a-795176.html> (visited on February 5, 2012)

²⁷⁷ The Israeli Parliament is known as The Knesset. See the J'lem-Golan National Referendum Law, 2010. For details, see <http://www.haaretz.com/news/national/knesset-passes-bill-conditioning-land-concessions->

Israeli citizens rather than the Israeli legislature which is responsible for failing to resolve the Israel-Palestine dispute thereby allowing the legislature to sidestep their obligations under international law.

A less obvious, but more common use of direct democracy that, in effect, shielded governments from responsibility for controversial decisions was seen in the widespread use of referendums by various European countries to determine their level of involvement with the European Communities and later the European Union.²⁷⁸

A similar situation can be contemplated in corporate law. Directors may pass on tough decisions to shareholders and shirk responsibility for tough choices and their consequences. An example of such a situation may be the shareholder approval of executive compensation. The US and the UK have introduced provisions requiring the non-binding approval of executive compensation since the financial crisis of 2008.²⁷⁹ Since then, shareholders have typically approved the compensation plans of most companies. Professor Myers has argued that by getting the approval of shareholders, managers have been freed from the risk of sparking an outrage against compensation policies that are excessive or not suitably linked to performance. In other words, managers are able to pass on the responsibility for the policy to

[with-popular-referendums-1.326172](#) and <http://www.bbc.co.uk/news/world-middle-east-11817445> (visited on March 14, 2012).

²⁷⁸ For example, France (1972), Ireland (1973), Norway (1973; chose not to join) and Denmark (1973) held referendums to join the European Communities. The UK held a referendum in 1974 to decide whether or not to remain a member. Ireland (1992), France (1992) and Denmark (1992 and 1993) held referendums to decide whether or not to ratify the Maastricht Treaty. In 1995, Austria, Finland, Sweden and Norway held referendums on joining the EU. In 1998, Ireland and Denmark held referendums to decide whether to ratify the Treaty of Amsterdam. In 2001, Ireland refused to ratify and in 2002 agreed to ratify the Treaty of Nice through referendums. In 2004, Malta, Hungary, Lithuania, Slovakia, Poland, Czech Republic, Estonia and Latvia all held referendums to decide whether or not to join the EU. In 2000 and 2003, Denmark and Sweden respectively held referendums to decide whether or not to join the Eurozone. In 2005, Spain, France, The Netherlands and Luxembourg held referendum to decide whether or not to ratify the Treaty establishing a Constitution for Europe. Ireland had a referendum as late as 2008 to decide on the ratification of the Treaty of Lisbon.

²⁷⁹ §951 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, 2010. This act was passed in response to the global financial recession of the late 2000's. Perceiving that the financial problems of the country were caused by insufficient regulation of financial entities, the US government adopted extensive regulations to control the same. Due to the outcry against perceived excessive executive compensation, regulations were introduced into the Dodd Frank Act that required shareholders to approve the compensation of directors and top managers in a non-binding vote.

In the United Kingdom, s. 439 of the Companies Act, 2006 requires non-binding approval of shareholders for the compensation of directors. Furthermore, provisions under Chapter 4 of the Companies Act, 2006 (ss. 188 to 226) provide a number of conditions whereby shareholder approval is required for directors to benefit from their position at the company.

the shareholders even though the managers themselves are largely responsible for the outcome.²⁸⁰

In both these scenarios, the accountability of the agents is diluted as it becomes increasingly difficult to assign credit and blame for the failures and successes of policy. As more and more decisions are taken by the principals and the agents jointly, the diluted accountability of the agents cannot come without a related increase in agency cost in the relevant company or country.

In light of these findings, it must be said that direct democracy can have a detrimental effect because they give the legislators greater plausible deniability for their involvement in the adoption of a controversial law. However, it is precisely this sort of controversial and critical decision-making where the legitimacy of direct decision-making can be critical. In such instances, failure to effectively monitor the actions of the agents can lead to unusually high agency costs.

To conclude, direct democracy can reduce accountability of legislators in certain cases and it seems difficult to establish a process whereby this tendency can be controlled or eliminated. This adverse effect on agency cost must, therefore, be balanced against the benefits that initiatives may provide.

5.5 BYPASSING A BIASED EXECUTIVE

This section argues that initiatives allow the legislature to get informed about issues that the ordinary working of representative democracy may otherwise stifle. In this discussion, the breakdown in the information cycle necessary for effective decision-making occurs not at the stage of the legislature but rather at the executive level. Accordingly, the discussion examines how the board of directors and the legislature, whose responsibility it is to monitor the management and the executive respectively, are reliant upon these very organs to provide them with the information needed to judge their performance.

²⁸⁰ See Myers, Minor. "Perils of Shareholder Voting on Executive Compensation, The." *Del. J. Corp. L.* 36 (2011): 417 for a detailed discussion on the impact of 'say on pay' provisions on the accountability of the board of directors.

The interests of the management and the executive are not perfectly aligned with the interests of the shareholders and the citizens respectively. This means that the information the management and the executive pass on to the board and the legislature has the potential to be biased. It stands to reason that the board and the legislature will not be able to effectively monitor the management and the executive based on such biased information. This section, therefore, argues that initiatives provide a secondary source of information to the legislature making their oversight and policies more responsive to the preferences of the citizens.

The constitutional structure of modern democracies and the complexity of governance involved means that legislators, are dependent upon the executive for information upon which to base their decisions. Similarly, the board of directors has to rely upon the managers of the company to provide them with the information required to make reasoned decisions. This creates an information asymmetry between the legislature and the executive and between the board of directors and the management.

In the corporate context, Professors Milgrom and Roberts explain that this information asymmetry will be exploited by the management because it has the greater information. They explain that even if the management does not misuse the information asymmetry to advance their own interests over those of their principals, it will still lead to inefficient decision-making by the board of directors.²⁸¹

Professors Milgrom and Roberts argues that under such conditions of information asymmetry, even the most well-intentioned managers will selectively pass on information.²⁸² They will do this in order to influence the board to do what the managers think is in the best interests of the company and to influence the board to promote and retain the managers who control the information.²⁸³ As it happens, most managers tend believe these two interests

²⁸¹ Milgrom, Paul, and John Roberts. "An Economic Approach to Influence Activities in Organizations." *American Journal of Sociology* (1988): S154-S179.

²⁸² *Id.* at S156. "Such manipulation can take many forms, ranging from conscious lies concerning facts, through suppression of unfavorable information, to simply presenting the information in a way that accentuates the points supporting the interested party's preferred decision and then insisting on these points at every opportunity."

²⁸³ Eisenberg, Melvin A. "Board of Directors and Internal Control, The." *Cardozo L. Rev.* 19 (1997): 237 at 245.

always converge. After all, most managers believe that their own promotion and retention will be in the best interests of their employers.²⁸⁴

This seemingly innocuous information asymmetry has major significance regarding the exercise of decision-making authority. The very core of both corporate and constitutional law is the separation of decision management and decision control. If the board of directors or legislature is entirely dependent upon the management/executive for information on which to base their approval of policies and their evaluation of performance, the board and the legislature can only be said to serve a nominal role with real power passing to the management/executive.

Professors Milgrom and Roberts provide the following example: While the board of directors has the ultimate responsibility to decide if a plant is to be constructed or not, only the management in charge of the division that will make use of the plant can provide critical information regarding the viability and profitability of the plant.²⁸⁵ In the case of government, this situation is doubly true because the volume and complexity of information is so great that the legislature has to rely almost exclusively on information gathered and vetted by the executive. As in the case of the company in the example, all legislative decision-making is in reality predicated on the accuracy and unbiased nature of information provided by the executive.

For example, the US government relies on the DEA (Drug Enforcement Authority) to inform it regarding the ill effects and prevalence of marijuana use. However, should marijuana ever be legalized, a huge number of DEA officials will be downsized and the organization's budget will be slashed. This is perhaps one of the reasons the DEA maintains that marijuana should be classified along with heroin, cocaine and other far more harmful drugs in opposition to the opinion of numerous public health experts worldwide.²⁸⁶

²⁸⁴ *Supra* note 301.

²⁸⁵ *Id.* at S154.

²⁸⁶ For more information on the drug legalization debate, see Kleiman, Mark AR, and Aaron J. Saiger. "Drug Legalization: The Importance of Asking the Right Question." *Hofstra L. Rev.* 18 (1989): 527; Goode, Erich. *Between Politics and Reason: The Drug Legalization Debate*. New York: St. Martin's Press, 1997; Inciardi, James A., ed. *The Drug Legalization Debate*. Sage, 1999; Ostrowski, J., and Cato Institute. "Thinking About Drug Legalization." (1989) and Ostrowski, James. "Moral and Practical Case for Drug Legalization, The." *Hofstra L. Rev.* 18 (1989): 607.

There are two solutions to this problem. The first solution is to adopt a skeptical posture to the information received from biased sources. The second option is to develop parallel, competing sources of information.²⁸⁷ The first solution is not effective in the corporate system. This is because corporate managers do not have a “known monotonic agenda, such as maximizing sales to the decision maker, so that the information he supplies can always be evaluated in terms of that agenda.”²⁸⁸ To put it simply, since the biases of corporate managers are complex and not decipherable in the context of individual decisions and issues, it is difficult for the board of directors to discount for that bias and ascertain what the real facts are.

This argument also holds true in the constitutional system. The diversity of information supplied by the executive to enable decision-making by the legislature as well as the disparity of interests that motivate and guide the executive makes it impossible for the legislature to factor in a known bias. This means that the legislature cannot easily decipher the truth from information colored by executive bias even if it knows that a bias exists.

The second option of opening parallel channels of information is where shareholder proposals and initiatives come in. By creating a parallel channel for information to reach the legislature, even non-binding initiatives²⁸⁹ can promote informed and responsive decision-making by the legislature by providing a signal of the preferences of the citizens. This is because the outcome of an initiative actually represents the preferences of the citizens on the subject matter of the proposal as directly expressed by them.

Therefore, by enhancing the information available to the legislature, initiatives can reduce agency cost by improving the monitoring of the executive and reducing residual loss by passing on accurate information about citizens’ preferences to the decision-making agents.

²⁸⁷ Milgrom, Paul, and John Roberts. “Relying on the Information of Interested Parties.” *The RAND Journal of Economics* (1986): 18-32 at 19-20, 24-25, 30-31.

²⁸⁸ Eisenberg, Melvin A. “Board of Directors and Internal Control, The.” *Cardozo L. Rev.* 19 (1997): 237 at 246.

²⁸⁹ Non-binding initiatives allow citizens to propose and then vote to adopt a proposal just as in the case of binding initiatives. The key difference is that the proposal, once adopted by the citizens does not automatically become law. Rather, it is up to the government whether to adopt the proposal or not.

5.6 PREVENTING DISTORTIONS IN CONSTITUTIONAL AND LEGAL EVOLUTION

This section considers whether the advantage agents have by virtue of having exclusive control over the agenda in corporate and constitutional law is magnified by the longevity of these organizations. The question it seeks to answer is whether a constitution that gives exclusive control of the agenda to the legislature would result in high agency costs over the long run.

Corporations, like countries, have an indefinite lifespan and both can exist for hundreds of years. Due to this, they both need their governance arrangements to evolve to keep up with the changes in conditions and in order to adopt new ideas as they develop. In the case of companies, this requires that the corporate charters and bylaws be amended at appropriate times. Since many rules of the game provisions²⁹⁰ are codified in the corporate and securities laws of the state rather than in the charter and the bylaws, it is clear that these sources also need to be modified regularly.

In fact, the need to update governance arrangements is much greater in the constitution realm. In the case of companies, changes to the company law of the state of incorporation automatically keeps the governance arrangements updated on some of the most important issues that arise.²⁹¹ In the case of countries, however, all changes required to keep the governance arrangements up to date require action either by the principals or the agents. There is no third party to help them since even international law typically takes force in a country only if it is ratified and adopted internally.²⁹²

It has been demonstrated that giving exclusive control to the management over the right to initiate changes to the charter dramatically swings the policy agenda in their favor due to the following problems it creates:

²⁹⁰ Rules of the game provisions govern the relationship between agents and principals and the relationship between the various principals themselves. See Section 2.5 and 2.5.1 for further information.

²⁹¹ Hansmann, Henry. "Corporation and Contract." *American Law and Economics Review* 8, no. 1 (2006): 1-19.

²⁹² For example, the UK is now bound by the rulings of the European Court of Human Rights (ECHR) only because it took the steps to subject itself to them. Only prohibitions against genocide, war crimes, crimes against humanity etc. have come to be part of the relationship between citizens themselves and their government without being actively adopted. The selective application of these rules in different parts of the world and the conflict of sovereignty with foreign interference underscore the difficulty in 'automatically' updating constitutional law.

- Managers will not initiate proposals that increase value for shareholder but will decrease value for the managers.²⁹³
- When two options exist that will increase value for shareholders, management will choose the option that creates the most value for them rather than the option that creates most value for shareholders.²⁹⁴
- Managers can bundle proposals that increase their value but decrease shareholder value with critical proposals that actually do increase shareholder value. If the benefit to shareholders from the critical proposal exceeds the loss caused by the first proposal, shareholders will be forced to approve the value decreasing proposal as well. This way, managers can even get shareholder approval for proposals that reduce shareholder value.²⁹⁵

In addition to these factors, giving management control over the agenda as well as control over the timing of referendums magnifies the dangers of pro-management distortion over time. Management initiated shareholder votes (typically related to executive compensation) have a remarkable disparity between the large number of proposals that narrowly pass the 50% mark and the unusually small number of such proposals that fall just short of the mark. This is in contrast to ballot questions initiated by outside shareholders where no such anomaly is detected. The reasons for the anomaly in the case of management originated proposals could be strategic timing, strategic lobbying when the management sees the count is falling short, and withdrawal of proposals when they see that they would narrowly lose.²⁹⁶

These imbalances can lead to considerable distortions in favor of the management over time.²⁹⁷ Professor Bebchuk argues that the longevity of corporations and the “pro-management bias in the evolution of corporate charters” means that corporate law needs to be

²⁹³ See Section 5.3.1.

²⁹⁴ See Section 5.3.2.

²⁹⁵ See Section 5.3.3.

²⁹⁶ Listokin, Yair. “Management Always Wins the Close Ones.” *American Law and Economics Review* 10, no. 2 (2008): 159-184.

²⁹⁷ Bebchuk, Lucian Arye. “The Case for Increasing Shareholder Power.” *Harvard Law Review* (2005): 833-914 at 865.

designed “in a way that counters these distortions”.²⁹⁸ A lot of work on corporate governance has, therefore, led to a focus on mandatory legal rules and reversible defaults with this method being championed by Professor Bebchuk himself. The issue of choosing the optimal default is the subject of the following section.

Another important reason for encouraging the balanced evolution of both corporate and constitutional law is that corporations and countries operate in situations very different from those that existed at the time of their founding or incorporation. Corporate charters are adopted at a time where conditions can be very different from those that companies are faced with every day. This is for two reasons:

- The charter was adopted a very long time ago and conditions and ideas have changed since then.
- The priorities of the company at IPO are very different from those during regular operation. (for example, being competitive in the IPO market v. being competitive in the business activity the company is involved in)

A comparison of this with constitutional law shows that the changes in conditions are very similar. The constitutions of most existing Parliamentary democracies existing today were adopted at the time they became Parliamentary democracies and are difficult to amend. More importantly, the political environment in most countries when the constitutions were written was highly chaotic with rampant civil and political unrest in many, if not most instances.²⁹⁹

At the time of drafting the constitution, the priority of the framers of the constitution is to get very disparate groups to agree to adopt the constitution and abide by it rather than to establish the most desirable system possible. A good example of this can be found in the Directive Principles of State Policy that form part of the Constitution of India. At the time of its adoption by the Constituent Assembly, the Constitution of India had to make a compromise against its secular fabric in order to win support from the Hindu and Muslim hardliners in the aftermath of the horrors of partition. The drafters of the Indian Constitution had to allow for

²⁹⁸ *Id.* at 866-67.

²⁹⁹ The constitutions of the US, India, and indeed almost all post-colonial countries as well as the post-Soviet states are examples of constitutions written and adopted during times of enormous political and economic problems. The French constitution is another excellent example of a constitution framed under extra-ordinary social and political circumstances.

different religions to have different personal laws in contravention of the spirit of Article 14 which mandates equal treatment under law for all citizens. Foreseeing that the political and social climate of the nation would be more stable in the future, they beseeched future governments to try and adopt a uniform civil code when conditions were more conducive at a later date.³⁰⁰

Since it is clear that constitutions need to reflect changed realities, it is also clear that they need to be amended at reasonable intervals. As demonstrated with the help of Professor Bebchuk's arguments, if agents are given the exclusive right to initiate these changes, the end result will be constitutional evolution that is biased in favor of the agents. Putting these arguments together, it may be argued that citizens must share initiation rights with legislators if constitutional evolution is to move in a balanced direction.

This issue is central to the work of Milton Friedman who has criticized the continuous growth in the size of government. He argued that the only way to reverse the expanding scope of government authority is to have a constitutional initiative to cap government spending to a percentage of national income.³⁰¹ This argument relates to a specific, singular initiative to cap government spending rather than the effect of the availability of the initiative to the public in general.

Research by Professors Feld and Matsusaka on government spending in Switzerland suggests that provision for initiatives cuts combined state and local spending by about 5% and state spending by over 10% controlling for political and demographic factors.³⁰² The correlation of

³⁰⁰ See Elster, Jon. "Arguing and Bargaining in Two Constituent Assemblies." *U. Pa. J. Const. L.* 2 (1999): 345 at 347. "Constitutions are often written in times of crisis that invite extraordinary and dramatic measures." Professor Elster argues that several American states refused to join the Union if slavery was abolished and if the senate did not have proportional representation ultimately getting their way on the issue of slavery. As it is well known, the US constitution ended up with a perverse compromise which condoned slavery while at the same time declaring every man to be equal. Professor Elster also argues that the French constitution was influenced by threats of violence from the Parisian mob.

³⁰¹ Friedman, Milton, and Rose D. Friedman. *Free to Choose: A Personal Statement*. Harcourt Brace Jovanovich, 1990. According to Professor Friedman, this trend towards big government ostensibly fueled by pro-management bias is well borne out statistically. Note that American federal government spending as a percentage of GDP has increased from 2.38% in 1902 to 23.87% in 2011.

³⁰² See Feld, Lars P., and John G. Matsusaka. "Budget Referendums and Government Spending: Evidence from Swiss Cantons." *Journal of Public Economics* 87, no. 12 (2003): 2703-2724. This research suggests that provision for initiatives cuts combined state and local spending by about 5% and state spending by over 10% controlling for political and demographic factors (See Matsusaka, John G. "Direct Democracy Works." *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206 at 195). Though the US is not a Parliamentary democracy, it is noted that a relationship between the use of the initiative and government spending is also

the availability of the initiative with reduced per capita government spending in the latter half of the 20th century amongst American states is also consistent with empirical evidence that shows that states which provide for initiatives spend less per capita than states that do not have such provisions.

There is however evidence to suggest that referendums can also serve to limit government spending and that “the people themselves appear to care more about fiscal discipline than their elected representatives”.³⁰³ It should also be noted that there is research that shows that initiatives can lead to increased government spending.³⁰⁴ This shows that institutional specificities influence the ability of initiatives to limit the tendency of representatives to increase their influence. This finding must be tempered by the argument that citizens may want a greater role for government and initiatives might be the means by which they ensure greater public services.

This data suggests that the legislature and the executive are averse to initiating measures that reduce the scope of their own authority and that under certain institutional environments, initiatives can help to reign in the role of the state. This issue is discussed in more detail in the following sub-section on empire building.³⁰⁵

This discussion has shown that giving principals the right to set the agenda may allow them to restrict the undesirable expansion of the powers of their agents. Therefore, the provision for initiatives can be an effective tool to restrict the tendency of government to expand its powers and its spending. The details of how this would work are discussed in the following sub-section on ‘empire building’.

identified amongst its states. See Matsusaka, John G. “Fiscal Effects of the Voter Initiative: Evidence from the Last 30 Years.” *Journal of Political Economy* (1995): 587-623; Zax, Jeffrey S. “Initiatives and Government Expenditures.” *Public Choice* 63, no. 3 (1989): 267-277; Matsusaka, John G. “Fiscal Effects of the Voter Initiative in the First Half of the Twentieth Century.” *JL & Econ.* 43 (2000): 619; Matsusaka, John G. “Direct Democracy Works.” *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206.

³⁰³ Feld, Lars P., and Gebhard Kirchgässner. “Does Direct Democracy Reduce Public Debt Evidence from Swiss Municipalities.” *Public Choice* 109, no. 3-4 (2001): 347-370 at 365.

³⁰⁴ Blume, Lorenz, Jens Müller, and Stefan Voigt. “The Economic Effects of Direct Democracy—A First Global Assessment.” *Public Choice* 140, no. 3-4 (2009): 431-461.

³⁰⁵ See section 5.6.1

5.6.1 Comparison with 'Empire-building'

Under Delaware law, decisions involving the transfer of assets (through dividends in cash or kind) from the company to the shareholders are made solely at the discretion of the board of directors.³⁰⁶ Shareholders may not initiate such decisions. This situation results in an imbalance in power in favor of the agents that might lead to an 'empire building problem' for the company.

Empire building refers to the tendency of management to retain excess assets that may be more efficiently managed if they were returned to shareholders. Managers may retain these assets because they are incentivized to make the firm ever larger. The incentive comes from the increased pecuniary and non-pecuniary personal benefits connected with managing a larger corporation.³⁰⁷ The resultant lack of alignment in the preferences of shareholders and managers creates a conflict of interest. The tendency for empire building and the conflict of interest it creates has been described by Professors Henry Hansmann and Michael Jensen as the most significant agency problem facing large public companies.³⁰⁸

Similarly, the trend of governments starting to manage an ever-increasing sphere of social and economic functions has been described by Professors Milton Friedman and Friedrich Hayek as the most significant threat to freedom and liberty itself.³⁰⁹ In the case of the constitutional system, legislators and administrators have an incentive to grow the government ever larger for greater prestige and influence.³¹⁰ After all, the prestige and

³⁰⁶ The decision to issue dividends is covered by the wide authority conferred to the board of directors under s. 141 of the Delaware General Corporation Law and is exercised at the discretion of the board of directors. "Such decisions transfer assets from company control into shareholder hands, in effect reducing the size of the empire under management's control."

³⁰⁷ Kanninen, Vesa. "Empire Building by Corporate Managers: The Corporation as a Savings Instrument." *Journal of Economic Dynamics and Control* 24, no. 1 (2000): 127-142.

³⁰⁸ Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 903. See Hansmann, Henry. *The Ownership of Enterprise*. Belknap Press, 2000 at 38 and Jensen, Michael. "Eclipse of the Public Corporation." *Harvard Business Review* (Sept.-Oct. 1989), revised (1997) at 61, 66.

³⁰⁹ See Friedman, Milton. *Capitalism and Freedom*. University of Chicago Press, 2009. and Hayek, Friedrich August. *The Road to Serfdom: Text and Documents--The Definitive Edition*. University of Chicago Press, 2009. See also Boudreaux, Donald J., and Adam C. Pritchard. "Rewriting the Constitution: An Economic Analysis of the Constitutional Amendment Process." *Fordham L. Rev.* 62 (1993): 111 for a discussion into the relationship between constitutional amendments and agency cost.

³¹⁰ Levinson, Daryl J. "Empire-Building Government in Constitutional Law." *Harvard Law Review* (2005): 915-972.

influence of the legislators depends on the social and economic influence that their actions have on the lives of the citizens.

This is all fine if the citizens also want big government. However, if citizens want to restrict the scope of the government's activities, they will find it hard to convince their representatives to do so due to the reasons explained above. If the citizens are unable to reduce the scope of government to bring it in line with their preferences, there will be an increase in residual loss and, therefore, an increase in agency cost.³¹¹

In the context of corporate governance, Professor Bebchuk suggests a solution to address this sort of agency problem leading to 'empire building' problems.³¹² He suggests that shareholders should be permitted to initiate and adopt binding shareholder resolutions forcing the management to pay dividends in cash or assets such as the stock of subsidiaries. Furthermore, he argues that these shareholder resolutions should also be allowed to set dividend policy for the future. This means that scaling down decisions would be subject to initiation by both directors and shareholders.

A similar solution is given for the similar agency problem that arises in game-ending decisions.³¹³ In game-ending decisions, the conflict of interest arises when shareholder value will be maximized by the winding up the company or by the exit of senior executives or board members.³¹⁴ In such circumstances, the interests of the agents conflict with those of their shareholders because the agents stand to lose the private benefits they accrue from managing the company. Professor Bebchuk has argued that decisions regarding the sale of the business's assets and its dissolution must also be amenable to initiation by both directors and shareholders.³¹⁵ This way the shareholders can initiate game-ending decisions when such a

³¹¹ See section 2.2. Note that Agency cost = Monitoring cost + bonding cost + residual loss.

³¹² Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 902.

³¹³ See section 4.1.2. Game-ending decisions are decisions that terminate the principal agent relationship.

³¹⁴ *Unocal corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

³¹⁵ *Supra* note 337 at 897. "Under current rules, shareholders may not initiate an auction of the company or of its assets or a process of dissolution. Under the proposed regime, however, shareholders will have the option to adopt arrangements that will give them the power to initiate such processes."

decision would maximize shareholder wealth but the directors are hesitant to do so because they would lose their compensation, benefits and prestige.

In the constitutional system, an example of a decision that dramatically and directly impacts the future career prospects of agents is the issue of term limits. Intuitively, one would expect that states where only legislators are allowed to initiate policy would not adopt term limits. This is because the legislators would not initiate a policy that severely restricts the length of their political careers. On the other hand, states where citizens can also initiate policy (through ballot initiatives) would be more likely to have such laws to reduce entrenchment.

In fact, this is borne out empirically. Even though this dissertation concerns itself with the Parliamentary system, the clear evidence from the term limits for congressmen and state legislators in the US is instructive. Out of 24 American states that allow for initiatives, 22 have term limits for congressmen or state legislators. On the other hand, only 2 out of the 26 states that do not provide for initiatives provide for such limits.³¹⁶ While this is a limited sample, the sharp contrast in the adoption of term limits in states that allow for initiatives versus states that do not supports the argument that agenda control is a valuable tool for citizens seeking to reduce ‘empire building’ concerns.

Another example of such a situation is one where citizens want the government to stop regulating an activity. This is, of course, against the interests of the regulators who oversee that activity since they have a private interest to continue regulating the activity in order to keep their jobs. For example, as mentioned before, it is in the private interest of police forces that enforce narcotics laws to ensure that marijuana is not decriminalized since that would result in huge downsizing of their organizations and lead to budget cuts. The solution that emerges from corporate governance is that principals must have the power to initiate and pass resolutions allowing them to scale down the scope of the principal-agent relationship. It is interesting to note that the movement to legalize marijuana is driven by ballot initiatives at the state level and has received far less support through representative democracy.³¹⁷

³¹⁶ Matsusaka, John G. “The Eclipse of Legislatures: Direct Democracy in the 21st Century.” *Public Choice* 124, no. 1-2 (2005): 157-177 at 166.

³¹⁷ Ostrowski, J., and Cato Institute. “Thinking About Drug Legalization.” (1989).

Initiatives are, therefore, a powerful tool to optimize agency cost. Direct democracy cannot be entirely effective by only allowing for referendums and not providing for initiatives. One solution is to make the availability or unavailability of initiatives a default rule (i.e. a rule that can later be changed) rather than a mandatory rule. This way, initiatives can be suspended if they are found to be undesirable or introduced at a later time if their need is felt in the future. The following section looks at what the optimal default rule should be. The answer is predicated on finding the default that will most easily get reversed if it is later found to be inefficient.

5.7 SETTING DEFAULTS

The previous section argued that granting the right to propose key decisions exclusively to the legislature can lead to distorted constitutional evolution. This distortion may lead to an unchecked growth of the powers of government and cause excessive government spending. Similarly, the vesting of agenda control for key decisions solely with the board of directors can lead to excessive expansion of the agency relationship causing an empire building problem.³¹⁸ Therefore, it is seen that the asymmetrical distribution of initiation rights can lead to excessive agency cost.

Since agency theory looks at the relationship between principals and agents as a contract,³¹⁹ principals and agents are free to renegotiate the distribution of agenda control at a later date.³²⁰ This means that agents can expand the scope of their authority beyond what is desired by the principals because of the default rule that gives them the exclusive power to initiate policy. In other words, agents are able to acquire excessive authority merely because they were given exclusive initiation rights at the time of incorporation of the company or the adoption of the constitution. This is so even if the corporate charter or country's constitution does not prohibit principals from being granted the right to initiate policy at a later time. It is, therefore, not enough that the agency contract allows for a possibility to change the allocation

³¹⁸ See Hansmann, Henry. *The Ownership of Enterprise*. Belknap Press, 2000 at 38 and Jensen, Michael. "Eclipse of the Public Corporation." *Harvard Business Review* (Sept.-Oct. 1989), revised (1997) at 61, 66.

³¹⁹ Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3.4 (1976): 305-360.

³²⁰ Ayres, Ian, and Robert Gertner. "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules." *The Yale Law Journal* 99, no. 1 (1989): 87-130 at 87. The rules governing contracts and corporations are of two types. Immutable rules that cannot be altered by the parties and default rules that 'fill in the gaps in incomplete contracts' which can be contracted around by the parties

of initiation rights at a later date. In fact, the charter or constitution must begin with an arrangement that makes it easy to change the default if it is found to be unsatisfactory later.

This section tries to answer the following question: Is it better to adopt a constitution that does not provide for initiatives at the time of ratification (but allows for the use of initiatives to be adopted through a constitutional amendment at a later time)? This option would create a default state of no initiatives. Or, on the other hand, is it better to start off by allowing the use of initiatives which can then be done away with at a future date through a constitutional amendment if they are found to be unpopular? This would be termed a default state allowing for initiatives.

One solution to this problem is to adopt Professors Easterbrook and Fischel's suggestion (also supported by Justice Posner) to choose as a default those rules that the parties would have negotiated in conditions of full information and low negotiation costs.³²¹ This solution, however, is not perfectly workable under the circumstances.

As explained before, constitutions are typically adopted at time of great civil and political unrest. This means that considerations of efficiency often have to give way to considerations of political expediency when constitutions are framed and adopted. When the political and social conditions have stabilized, there is often room for improvement to make the agency contract established more efficient. Furthermore, Professors Easterbrook and Fischel's suggestion does not take into account empire building problems. After all, there is a strong incentive for agents not to initiate changes to arrangements that later become inefficient if doing so would reduce the scope of their authority or their benefits.

This means that even default rules "negotiated in conditions of full information and low negotiation costs" which create a monopoly on the power to initiate decisions in favor of the agents might prove to be a liability in the future. This can happen if conditions change and it is later found desirable to do away with this monopoly and for principals to share initiation rights with agents. Under such situations, principals will find that their agents have little incentive to put forward a proposal to grant them such rights. Since the principals have no

³²¹ Easterbrook, Frank H. *The Economic Structure of Corporate Law*. Harvard University Press, 1996; Posner, Richard A. *Economic Analysis of Law*. Vol. 5. New York: Aspen Law & Business, 1998 at 372. See also Barnett, Randy E. "Sound of Silence: Default Rules and Contractual Consent, The." *Va. L. Rev.* 78 (1992): 821.

means to initiate the decision-making process to give themselves the right to initiate decisions, they will be left with an inefficient principal-agent relationship.

Professors Easterbrook and Fischel have considered this problem and proposed the concept of penalty defaults which give one party to the contract an incentive to opt out of the default arrangement.³²² This concept of penalty defaults has been tailored to address the problem of empire building in corporate governance by Professors Bebchuk and Hamdani in their recommendation of mandatory rules and reversible defaults.³²³ Their proposal suggests that whenever there is a possible choice between two default arrangements, the arrangement that is more restrictive on management should be chosen. This is because if such a choice is later found to be inefficient, both the shareholders and the management, who control the agenda, will have the incentives to opt out of such an arrangement. On the other hand, if the option less restrictive on management is chosen and later found to be inefficient, managers may not have the incentives to opt out of it due to the problem of empire building.

In light of this statement, it would be rational to allow for initiatives as a default. If they are later found to be inefficient in reducing agency cost, citizens and legislators will both have the incentives to end the practice. However, if the constitution does not provide for initiatives and the government has the sole control over the agenda, it is unlikely that the legislators will give up such a monopoly over the agenda even if it is later found that allowing for initiatives would be more efficient.

Since the existing constitutions of many countries vest sole control of the agenda with the government, a Catch 22 situation is created since the agents have no incentive to adopt a reversible default that is more restrictive on them than the existing situation. However, for states that are yet to adopt new constitutions, the suggestion by Professors Bebchuk and Hamdani to introduce, as a reversible default, the option more restrictive on management seems to be the optimal solution. This means that allowing for initiatives with the option of doing away with them in the future seems to be an excellent idea in light of this analysis.

³²² Ayres, Ian, and Robert Gertner. "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules." *The Yale Law Journal* 99, no. 1 (1989): 87-130 at 97.

³²³ Bebchuk, Lucian Arye, and Assaf Hamdani. *Optimal Defaults for Corporate Law Evolution*. No. w8703. National Bureau of Economic Research, 2002.

5.8 INDIRECT BENEFITS

This section deals with the impact of direct democracy when the provisions are not actually utilized. In other words, this section discusses how provisions mandating or allowing for shareholder proposals, shareholder approval of fundamental corporate decisions, initiatives and referendums affect agency cost regardless of whether or not they are actually used to make decisions. It examines the impact that the *threat* of such action by the principals has on their agents and how that in turn affects agency cost.

In corporate governance, the benefits of shareholders having a veto over fundamental corporate decisions are felt both directly and indirectly. This is because directors know that decisions that only benefit them or proposals that do not create value for shareholders will be rejected by the shareholders.³²⁴ This causes directors to not bother putting exploitative proposals before shareholders in the first place. This works the same way in the case of constitutional referendums. The threat of rejection by citizens causes legislators to only put forward proposals that they think will be approved by citizens.

Similarly, the primary benefits of initiatives will also be indirect. Rather than waiting for initiatives to be passed on issues that are popular with the citizens, legislators will choose to preempt such initiatives and pass the laws in question themselves. This will happen because legislators will want to take the credit for passing popular laws. In fact, legislators may even pass laws opposed by powerful lobbying groups if they know that such a law would get passed through the initiative process anyway. It should, therefore, be noted that the impact of the initiative process cannot be measured effectively by looking at the number of successful initiatives or even the number of initiatives that reach the ballot. In other words, direct democracy has an impact on representative decision-making by virtue of the credible threat of its use.³²⁵

It must be noted Professors Blume, Müller and Voigt have shown empirically that the indirect effect of initiatives is found to be significantly less pronounced than its direct effects in the

³²⁴ Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 878.

³²⁵ See Lupia, Arthur, and John G. Matsusaka. "Direct Democracy: New Approaches to Old Questions." *Annu. Rev. Polit. Sci.* 7 (2004): 463-482 and Matsusaka, John G. "Direct Democracy Works." *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206 at 192.

constitutional system.³²⁶ However, this research also shows that the indirect effect of initiatives is more pronounced in ‘weak’ democracies than more developed and sophisticated ‘strong’ ones. This lends some credence to the idea that initiatives have a limited but not insignificant indirect monitoring effect. This is because the legislatures of ‘strong’ democracies would be more aligned with the preferences of the citizens and would require lesser deviation in policy to reflect the preferences of the citizens in the countries where they are faced with the possible threat of an initiative. On the other hand, the legislatures of ‘weak’ democracies would tend to poorly represent the preferences of the citizens. They would, therefore, be expected to show a greater deviation from their policies in countries where they are subject to the possibility of monitoring by direct intervention through the initiative process.

The indirect effect of initiatives is not without its risks. If legislators are not aware of voters’ preferences, they might move policy away from the preferences of the majority of their voters when faced with the chance that an extreme initiative might be passed by a special interest group.³²⁷ However, precisely these pressures are also created by the competitive effects of regular elections so initiatives do not introduce an entirely new problem.

The next indirect effect of direct democracy is to increase the information and political engagement in the citizenry. Since direct democracy requires the support of a majority of voters, the opponents and proponents of proposals ensure that information concerning the decision is widely dispersed and is understood by the public at large. Information disseminated in the context of referendums and initiatives helps to increase political awareness, increases voter turnout and also increases citizen engagement with interest groups.³²⁸

³²⁶ Blume, Lorenz, Jens Müller, and Stefan Voigt. "The Economic Effects of Direct Democracy—A First Global Assessment." *Public Choice* 140, no. 3-4 (2009): 431-461.

³²⁷ Matsusaka, John G. "Direct Democracy Works." *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206 at 192-93. One way to mitigate the threat of government responding to threats of extreme initiatives is to require initiatives to be passed twice in consecutive ballots to be effective. This relieves the government from the threat of extreme initiatives where they are unsure about the possible result. Under this sort of system, the government can ignore extreme initiatives and only worry about measures that came close to the vote requirements to get adopted the first time.

³²⁸ Tolbert, Caroline J., Ramona S. McNeal, and Daniel A. Smith. "Enhancing Civic Engagement: The Effect of Direct Democracy on Political Participation and Knowledge." *State Politics & Policy Quarterly* 3, no. 1 (2003): 23-41. These findings are based on American National Election Studies data for 1996, 1998, and 2000. The

The existence of direct democracy provisions also has an impact on the way interest groups are organized and how they operate. When decisions are made via representative democracy, interest groups with narrow and well-defined interests and limited numbers of influential members have an advantage in influencing policy over interest groups with wider, more general interests.³²⁹ This is because groups with small memberships representing narrow economic interests are better able to manage the free rider problem and because there is minimal divergence in interest amongst the members.³³⁰

Since direct democracy revolves around public opinion, the influence of broad based interest groups that champion causes of general public interest gains importance relative to the lobbying power of special economic interests.³³¹ Therefore, direct democracy can have the happy consequence of encouraging citizen groups and civic engagement over the influence of the lobbying by narrow economic interests.

This analysis shows that the indirect effects of direct democracy are well understood in both corporate and constitutional law scholarship. Both fields of study converge in how they understand the impact of the credible threat of direct decision-making by principals on the actions of their agents. The agency theory based analysis can, therefore, effectively factor in the indirect effect of direct decision-making since it has a similar impact on the motivations of both directors and legislators.

5.9 FINDINGS

Chapter five has shown that the corporate laws of most jurisdictions require the approval of shareholders before the board of directors can take certain major corporate decisions such as

authors attribute this to the argument that voting directly to make decisions makes citizens feel empowered and responsible for the governance of the country.

³²⁹ Scarrow, Susan E. "Direct Democracy and Institutional Change A Comparative Investigation." *Comparative Political Studies* 34, no. 6 (2001): 651-665.

³³⁰ Interest groups with small memberships and a narrow interest find it easier to ensure that all the members who benefit from the interest group's activities pay for its work as compared to groups with numerous members which have trouble ensuring that all the individuals who benefit from its activities pay a fair share to fund its activities.

³³¹ Boehmke, Frederick J. *The Indirect Effect of Direct Legislation: How Institutions Shape Interest Group Systems*. Ohio State University Press, 2005.

mergers, dissolutions etc. On the other hand, corporate laws differ significantly regarding the rights of shareholders to initiate decisions. When direct democracy in constitutional systems is considered, insights from corporate law strongly favor referendums for major decisions such as amending the constitution, joining the European Union etc. This is because referendums can minimize agency cost by separating decision management from decision control. The status of initiatives which allow citizens to share control of the agenda with legislators is more controversial.

There are situations where agents prefer the status quo, the worse of two positive outcomes or where they bundle a self-serving but shareholder value decreasing decision with one that increases shareholder value more than the first decreases it. In such situations, it is shown that the right to veto enshrined in referendums proves to be of no help at all. This leads to an examination of the initiative to see if it fares better at advancing citizen interest.

Initiatives can help to separate individual decisions from periodic elections. This lets citizens take action immediately instead of having to wait for the next election. It also saves them the need to deal with the uncertainty that would accompany the replacement of representatives just because of a conflict on a single issue. This sharing of decision-making authority by citizens can, however, reduce the accountability and the responsibility of the legislature.

Initiatives also allow citizens to bypass the executive wing of government and express their preferences directly to the legislature. This creates a far more effective means for the legislature to gauge public preferences than information provided by the executive and from the results of periodic elections.

Initiatives also help to check the gradual yet steady move towards greater agency costs that giving sole control of the agenda to agents might entail as the agents seek to increase their powers and position. Borrowing from the debate on proxy access, it is proposed that the optimal default rule for constitutional law is to provide for referendums and initiatives with the option to opt out at a later date. That way, if initiatives are found to have a negative influence, they can easily be done away with because both the principals and the agents will support such a move. However, if the default does not allow for initiatives when the constitution is framed, it is far more difficult for initiatives to be introduced to the constitution later if the legislature has sole control of the agenda and is jealous of sharing this power with the public.

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This problem can be solved by introducing penalty defaults. By choosing as the default rule the option that is more restrictive on the legislature, the constitution can ensure that legislators will have the incentives to propose doing away with the default if it is found to be problematic and the citizens will support that proposal. This means that initiatives should be provided by default and legislatures charged with reversing this default if it is found that initiatives are not reducing agency cost. This is better than starting with a default that does not provide for initiatives and finding that the legislators have no incentives to introduce them later if the need for initiatives is felt at a later time.

6 CORPORATE GOVERNANCE INSIGHTS FOR IMPLEMENTING INITIATIVES EFFECTIVELY

This chapter examines key issues that are relevant to the success or failure of the initiative process and uses corporate governance arguments to cast light on potential pitfalls that are likely to arise. The first section examines the incentives of voters to inform themselves enough to express their preferences effectively and participate in the initiative process. The incentives of citizens are then compared with the incentives of different types of shareholders and a study of the use of shareholder proposals by various types of shareholders is used to draw insights to improve the use of initiatives in constitutional law.

Section two discusses the potential for nuisance proposals proposed by certain groups of voters (citizens and shareholders) in order to advance their own private interests at the expense of the collective interest of other voters. This is followed by section three which looks at issues pertaining to information to evaluate whether shareholders have the means to get informed about the facts necessary to make informed decisions. This analysis is then extended to constitutional law to see if citizens are adequately informed to effectively express their preferences. Section four examines the problems of consistency in corporate policy and evaluates whether, and to what extent, problems of consistency and long-term planning also exist in constitutional law. It then proposes corporate governance solutions that can be adapted to minimize agency cost through the use of initiatives.

The last section looks at the problems of special interests, short termism and black mail. These are all problems caused by a difference in the interests of different groups of principals. Corporate governance is examined to provide solutions to manage these problems in the context of initiatives in constitutional law.

6.1 PROPER INCENTIVES FOR VALUE INCREASING INITIATIVES

An objection to allowing greater scope for shareholder proposals is that shareholders do not have the incentives to bring forth desirable proposals. Unlike a successful proxy contest for control of the company that yields monetary and non-monetary rewards in the form of control

for the acquiring shareholder, a shareholder proposal does not.³³² This is because the benefits of a shareholder proposal, if successful, accrue to the company and are distributed amongst all shareholders in proportion to their shareholding in the company.

Furthermore, the supporters of a successful shareholder proposal do not gain control of the corporate machinery unlike the winners of a successful proxy battle for seats on the board of directors. This means that the supporters of a successful shareholder proposal cannot reimburse their expenses *ex post*.³³³ This leads to a situation where the costs of the proposal are concentrated while the benefits are dispersed. Theoretically, this can lead to a free rider problem where no party will make proposals.³³⁴ Another reason why shareholder proposals may not work is because of the behavior of institutional investors. Besides the free rider problem mentioned earlier, institutional investors have incentives to stay on good terms with the management and are, therefore, reluctant to interfere with their policies and decisions.³³⁵

Both these problems can also be found in constitutional law. Citizens who propose and work to pass initiatives need to expend their own resources to do so. On the other hand, the perceived benefits of the initiative are distributed across the population. Unlike political elections for the legislature, the proponents of the initiative also have no hope of getting direct or indirect monetary or non-monetary windfalls that membership of Parliament might bring. There is also no provision in any major democracy known that provides for

³³² See section 3.1.1. In short, a proxy is an authorization from a shareholder to the holder of the proxy enabling the holder to exercise the voting rights the shareholder is entitled to in a shareholder meeting.

³³³ The free rider problem is not automatically eliminated in the context of takeovers. Other shareholders have an incentive to let the acquirer expend resources to gain control of the company and improve shareholder value while reaping the benefits of the acquirers actions at no cost to themselves. For a detailed discussion, please see Grossman, Sanford J., and Oliver D. Hart. "Takeover Bids, the Free-rider Problem, and the Theory of the Corporation." *The Bell Journal of Economics* (1980): 42-64; Holmström, Bengt, and Barry Nalebuff. "To The Raider Goes The Surplus? A Reexamination of the Free-Rider Problem." *Journal of Economics & Management Strategy* 1, no. 1 (1992): 37-62; Harrington, Joseph E., and Jacek Prokop. "The Dynamics of the Free-rider Problem in Takeovers." *Review of Financial Studies* 6, no. 4 (1993): 851-882 and Cohen, Lloyd. "Holdouts and Free Riders." *The Journal of Legal Studies* 20, no. 2 (1991): 351-362.

³³⁴ Bainbridge, Stephen. "Case for Limited Shareholder Voting Rights, The." *UCLA L. Rev.* 53 (2005): 601 at 633. See Bebchuk, Lucian Arye, and Marcel Kahan. "A Framework for Analyzing Legal Policy Towards Proxy Contests." *California Law Review* (1990): 1071-1135 at 1127 for a discussion on the incentives of shareholder to make useful proposals in issue contests (not related to particular director elections).

³³⁵ Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 876. See also Bainbridge, Stephen. "Case for Limited Shareholder Voting Rights, The." *UCLA L. Rev.* 53 (2005): 601 at 632-33.

reimbursement of expenses even in the case of successful initiatives, let alone unsuccessful ones.

Furthermore, just as institutional investors are wary of conflict with the management and, therefore, conservative in their opposition, super agents like labor unions, organizations for ethnic minorities etc. may also have much to lose by antagonizing the government by interfering through initiatives. For example, large institutional investors like insurance companies and banks may be hesitant to oppose the management of a company they hold shares in due to fear of losing insurance or banking business from the firm. Similarly, super agents like Non-Governmental Organizations (NGOs) who get part or all of their funding from the government might be hesitant to propose initiatives that seriously upset the government and may result in a retaliatory budget cuts.

“Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success.”³³⁶ This argument of Professor Arrow stipulates that using a cost benefit analysis, shareholders and citizens can only be expected to gather information required to make informed decisions if the perceived benefits exceed the effort. According to Professor Bainbridge, the costs of collecting and understanding this information will be especially high. This is due to the large number of complex disclosures, which are the source of most publically available corporate information and the cost of acquiring the specialist skills required to analyze them. On the other hand, the perceived benefits are likely to be low because there is a chance that the proposal will not be adopted. Even if the proposal is adopted, the benefits, unlike the costs, will be distributed amongst all the shareholders.³³⁷ This will lead to shareholders delegating decision-making authority to the board of directors to ensure the long term maximization of shareholder value.³³⁸

The argument for increasing shareholder decision-making presupposes that shareholders seek more information than is made available to them and that they want to be more involved with

³³⁶ Arrow, K. E. *The Limits of Organization*. Norton, 1974 at 69.

³³⁷ Bainbridge, Stephen. “Director Primacy and Shareholder Disempowerment.” *Harvard Law Review* 119 (2006): 1735-2644 at 1745.

³³⁸ Bainbridge, Stephen. “Case for Limited Shareholder Voting Rights, The.” *UCIA l. reV.* 53 (2005): 601 at 624.

the decision-making of the company.³³⁹ This is countered by advocates of the director centric approach who argue that shareholders do not have the time, the skills or the incentives required to analyze relevant information. Furthermore, the director centric approach argues that shareholders can be misled into voting against their interests if the information available to them is not carefully regulated.³⁴⁰

This dilemma is addressed by Professor Bebchuk in the context of corporate governance. He argues that the cost of initiating proposals that are clearly value enhancing and enjoy widespread support amongst shareholders will be low because they would require relatively little effort in the form of campaigning and soliciting proxies. Since these are exactly the sort of proposals that are desired for minimizing agency cost, the objection that shareholders will not bear the cost of initiating proposals loses some ground.

Additionally, even though shareholder proposals are mostly precatory i.e. non-binding, and are often ignored, they are still regularly put forward in a large number of companies showing that shareholders do have an interest in direct decision-making.³⁴¹ If shareholders expend energy and resources to put forward resolutions that are not binding and are often ignored year after year, it can be reasoned that there will be even greater support for an even greater number of resolutions if they were binding and shareholders were convinced of their efficacy. This argument, however, does not answer all the criticism of shareholder decision-making and further analysis is required.

The information condition in Professor Arrow's analysis also merits further comment. The information required for making business decisions is indeed highly specialized and difficult for the common man to understand as far as it applies to a specific company, the business it

³³⁹ See Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 and Bebchuk, Lucian Arye. "Case for Shareholder Access: A Response to the Business Roundtable, The." *Case W. Res. L. Rev.* 55 (2004): 557.

³⁴⁰ Strine, Leo E. "Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America." *Harvard Law Review* 119, no. 6 (2006): 1759-1783; Bainbridge, Stephen. "Case for Limited Shareholder Voting Rights, The." *UCLA l. rev.* 53 (2005): 601; Bainbridge, Stephen. "Director Primacy and Shareholder Disempowerment." *Harvard Law Review* 119 (2006): 1735-2644; Bainbridge, Stephen M. "Why a Board-Group Decision-making in Corporate Governance." *Vand. L. Rev.* 55 (2002): 1.

³⁴¹ *Supra* note 361 at 877. "In 2003, 427 precatory resolutions took place, with an average participation rate of more than eighty percent of all outstanding shares."

pursues and the market conditions affecting its business.³⁴² However, when a proposal is tabled as a ballot initiative in the political context, it is likely to receive wide media attention, be directly related to the lives of voters and is sure to receive endorsement and disapproval from various trusted sources. This has a dramatic effect on both the quantity and veracity of the information available to the voters and must be considered when addressing the information condition in Professor Arrow's analysis.

Till now, this section has looked at whether or not shareholders have the proper incentives to get informed in order to propose, vote on and adopt value-enhancing shareholder proposals to minimize agency cost and how this translates to the constitutional context. This argument, however, needs to be substantiated by a look at how shareholders respond to shareholder proposals in the real world. The following discussion examines how US investors have responded to their ability to mount shareholder proposals. In particular, the following sub-sections examine different types of shareholders, their varying interests and look at how they react to shareholder proposals.

6.1.1 Individual Shareholder Activists

Historically, the most visible exercise of direct decision-making by shareholders has been by individual shareholders. These wealthy individuals acquire a sizable stake in a company and then lobby for value enhancing changes by means of direct democracy provisions and other means.³⁴³ Good examples of such shareholders in recent years are investors like Carl Icahn and Kirk Kerkorian.³⁴⁴ The relatively small proportion of stock owned by individuals in light of the trend towards ever increasing institutional ownership has made this sort of activism less important in recent years. However, a considerable exercise of direct democracy by

³⁴² Arrow, K. E. *The Limits of Organization*. Norton, 1974.

³⁴³ Yermack, David. "Shareholder Voting and Corporate Governance." *Annu. Rev. Financ. Econ.* 2, no. 1 (2010): 103-125.

³⁴⁴ Both Carl Icahn and Kirk Kerkorian are famous 'corporate raiders' known for heavily leveraged buyouts (taking lots of debt to buy control of the target company) and accusations of asset stripping (selling assets of the acquired company to repay the debt taken on to acquire the company). Mr. Icahn and Kerkorian are now increasingly being regarded as activist investors rather than being the corporate raiders they became famous for in the 1980's. See Katelouzou, Dionysia. "Myths and Realities of Hedge Fund Activism: Some Empirical Evidence." *Va. L. & Bus. Rev.* 7 (2013): 459-561.

individual shareholders can be seen empirically in data collected by Professors Gillan and Starks for a somewhat earlier period.

Between 1987 to 1994, a total of 2,042 shareholder proposals were put forward by shareholders out of which 1,277 proposals were initiated by individual shareholders with institutional shareholders following with 463 proposals.³⁴⁵ It is, therefore, noted that individual investors are very important users of direct decision-making provisions in corporate law. Later analysis will show how this, together with the behavior of other types of shareholders, can help to understand the behavior of citizens in initiatives.

6.1.2 *Mutual Funds and Pension Funds*

According to Professor Jensen, the downturn in takeover activity in the 1990's has diminished the effect of the market for corporate control in reducing agency costs.³⁴⁶ Due to this, a number of shareholders have demonstrated an interest in influencing the strategy of the companies they hold stock in. Since large shareholders are able to capture a large share of the value generated by positive changes to the company's strategy through shareholder action, they suffer the least from the free rider problem inherent in such activity.³⁴⁷

However, mutual funds and corporate pension funds have had limited involvement in shareholder activism.³⁴⁸ As in the case of individual activist shareholders like Carl Icahn and Kirk Kerkorian, institutional investors are not free from the free rider problem which is a natural consequence of owning less than 100% ownership of stock. Similarly, they also have

³⁴⁵ See Table 2 in Gillan, Stuart L., and Laura T. Starks. "Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors." *Journal of Financial Economics* 57, no. 2 (2000): 275-305 at 283. Of the 1366 proposals credited to individual shareholders in this table, 54 were initiated by religious groups and 35 by unidentified shareholders. Accordingly, the actual figure is lower and is actually 1277.

³⁴⁶ See Jensen, Michael C. "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems." *The Journal of Finance* 48, no. 3 (1993): 831-880.

³⁴⁷ Gillan, Stuart L., and Laura T. Starks. "Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors." *Journal of Financial Economics* 57, no. 2 (2000): 275-305 at 279. Shareholder activists have to bear the entire cost of activism. However, being a large investor reduces the free rider problem since a large shareholder gets a correspondingly large proportion of the benefits which might be big enough to offset the requirement of internalizing the entire cost of activism.

³⁴⁸ *Supra* note 369 at 117.

no means of compensating themselves even if successful unlike the case involving a contest for control.

One reason for this and the consequent lack of enthusiasm for shareholder activism by mutual funds and corporate pension funds are legally mandated diversification requirements. This means that the law ensures that such investors can only get a small proportion of the benefit in case of successful shareholder activism while bearing all of the costs. In other words, laws requiring diversification do not permit mutual funds and corporate pension funds to acquire holding large enough that their pro rata share of the benefit would be sufficient to offset the cost of activism.

The case of public pension funds is somewhat different. Public pension funds like CalPERS have been active since 1987 in sponsoring proposals that call for improved corporate governance.³⁴⁹ This move has picked up since 1992 when the SEC made coordination between institutional investors easier and public pension funds have subsequently emerged as key activist shareholders.³⁵⁰ Research by Professor Wahal also shows that public pension funds have moved from supporting takeover related proxy proposals in the late 1980's to supporting governance related proposals in the 1990's.³⁵¹

What is the reason for this? Why do public pension funds buck the trend prevalent amongst other shareholders of being deterred by the free rider problem? Professors Gillan and Stark offer an answer. They argue that pension funds often find it difficult to sell underperforming stocks due to the fact that they are required to index a large proportion of their portfolios. The locking-in of the pension fund's investment into the fortunes and future performance of specific companies gives public pension funds an incentive to pursue activist behavior.³⁵²

³⁴⁹ CalPERS is the organization that manages the pensions funds of California's public employees. See section 6.1.2.

³⁵⁰ *Supra* note 369 at 118; Choi, Stephen J., and Jill E. Fisch. "On Beyond Calpers: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance." *Vand. L. Rev.* 61 (2008): 315.

³⁵¹ See Table 2 in Wahal, Sunil. "Pension Fund Activism and Firm Performance." *Journal of Financial and Quantitative Analysis* 31, no. 01 (1996): 1-23 at 9. This contention is confirmed in Black, Bernard. "Shareholder Activism and Corporate Governance in the United States." *as published in the New Palgrave Dictionary of Economics and the Law* 3 (1998): 459-465.

³⁵² See *Supra* note 373 at 278. "The level of indexing in public pension funds is reflected by their very low turnover. CalPERS has annual turnover in its equity holdings of approximately 10% and the New York Retirement funds have annual turnover of about 7% of total equity."

The other reason offered is that public pension funds face a lower conflict of interest than other institutional investors because they do not need to worry about getting business from the companies they hold stock in.³⁵³ The last reason, of course, is that the leadership of such funds sometimes use shareholder activism to advance their political objectives.³⁵⁴

The activities of public pension funds have been notably successful in bringing about governance reforms through negotiations or after gaining considerable shareholder support in terms of votes in the Annual General Meeting.³⁵⁵ However, these reforms have not led to a clear increase in value for the companies targeted in terms of market capitalization.³⁵⁶

6.1.3 Hedge Funds

As demonstrated above, the track record of large shareholders with diversified investment is not very encouraging. Even in the case of public pension funds, the results are mixed at best. In order to advocate the use of principal initiated proposals for the constitutional setup, an example of its successful use in the corporate context seems important. The case of hedge funds provides such an example.³⁵⁷

³⁵³ Black, Bernard. "Shareholder Activism and Corporate Governance in the United States." *as published in the New Palgrave Dictionary of Economics and the Law* 3 (1998): 459-465.

³⁵⁴ Romano, Roberta. "Public Pension Fund Activism in Corporate Governance Reconsidered." *Columbia Law Review* 93, no. 4 (1993): 795-853. See the controversy surrounding the alleged misuse of CalPERS (California's public employees' pension fund) by its chief executive, Mr. Phil Angelides to advance his political ambitions.

³⁵⁵ English II, Philip C., Thomas I. Smythe, and Chris R. McNeil. "The "CalPERS effect" Revisited." *Journal of Corporate Finance* 10, no. 1 (2004): 157-174; Wahal, Sunil. "Pension Fund Activism and Firm Performance." *Journal of Financial and Quantitative Analysis* 31, no. 01 (1996): 1-23; Ertimur, Yonca, Fabrizio Ferri, and Stephen R. Stubben. "Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals." *Journal of Corporate Finance* 16, no. 1 (2010): 53-72.

³⁵⁶ Crutchley, Claire E., Carl D. Hudson, and Marlin RH Jensen. "Shareholder Wealth Effects of CalPERS' Activism." *Financial Services Review* 7, no. 1 (1998): 1-10; Nesbitt, Stephen L. "Long-term Rewards from Shareholder Activism: A Study of the "CalPERS Effect"." *Journal of Applied Corporate Finance* 6, no. 4 (1994): 75-80; Barber, Brad M. "Monitoring the Monitor: Evaluating CalPERS' Activism." *The Journal of Investing* 16, no. 4 (2007): 66-80; Karpoff, Jonathan. "The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings." *Available at SSRN 885365* (2001).

³⁵⁷ See Brav, Alon, Wei Jiang, Frank Partnoy, and Randall Thomas. "Hedge Fund Activism, Corporate Governance, and Firm Performance." *The Journal of Finance* 63, no. 4 (2008): 1729-1775. The authors posit that hedge funds can generally be said to have four characteristics: (1) they are pooled, privately organized investment vehicles; (2) they are administered by professional investment managers with performance-based compensation and significant investments in the fund; (3) they are not widely available to the public; and (4) they operate outside of securities regulation and registration requirements. More specifically, hedge funds avoid the Investment Company Act of 1940 by having a relatively small number of sophisticated investors.

A series of empirical studies report very high success rates for hedge fund sponsored shareholder proposals that have allowed hedge funds to have their reforms adopted by the targeted companies.³⁵⁸ Moreover, these reforms often lead to permanent improvements in shareholder value.³⁵⁹

The key factors responsible for the success of hedge funds to effectively use shareholder proposals are the lack of diversification requirements, higher performance expectations of investors from hedge fund managers and the ability to invest in illiquid securities that allow greater secrecy and flexibility. Other factors identified as being responsible are high leverage and empty voting strategies³⁶⁰ as well as the eventual takeovers of targeted companies.³⁶¹

³⁵⁸ See Klein, April, and Emanuel Zur. *Hedge Fund Activism*. (2006); Brav, Alon, Wei Jiang, Frank Partnoy, and Randall Thomas. "Hedge Fund Activism, Corporate Governance, and Firm Performance." *The Journal of Finance* 63, no. 4 (2008): 1729-1775. (looking at data from Schedule 13D filings from 2001 to 2006); Clifford, Christopher Patrick. *Hedge Fund Activism*. ProQuest, 2008. (looking at data from Schedule 13D filings from 1998 to 2005); Brav, Alon, Wei Jiang, Frank Partnoy, and Randall Thomas. "Hedge Fund Activism, Corporate Governance, and Firm Performance." *The Journal of Finance* 63, no. 4 (2008): 1729-1775 (looking at data from Schedule 13D filings from 2001 to 2005)

NOTE: SEC Schedule 13D filings are used to measure hedge fund activism since they indicate when the hedge fund acquires 5% or greater shareholding in the company and may also indicate specific goals behind the acquisition of shares and proposed future actions.

³⁵⁹ Brav, Alon, Wei Jiang, Frank Partnoy, and Randall S. Thomas. "The Returns to Hedge Fund Activism." *Financial Analysts Journal* (2008): 45-61. (looking at data from 2001 to 2006); Brav, Alon, Wei Jiang, and Hyunseob Kim. "Hedge Fund Activism: A Review." *Foundations and Trends in Finance* 4, no. 3 (2009); Yermack, David. "Shareholder Voting and Corporate Governance." *Annu. Rev. Financ. Econ.* 2, no. 1 (2010): 103-125 at 119. It should be noted that while Professor Klein's many papers suggest a positive impact of hedge fund activism on shareholder value (especially around the time of the filing of SEC Schedule 13D (when the hedge fund acquires 5% of voting rights), he shows that it has a negative impact on bond holder's wealth. See Klein, April, and Emanuel Zur. "The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders." *Review of Financial Studies* 24, no. 5 (2011): 1735-1771. Since only shareholders are considered principals within the framework of this dissertation, this is not immediately relevant but must be considered when examining the impact of direct democracy on non-voting constituents such as foreign trading partners, neighboring countries, disenfranchised felons etc.

³⁶⁰ See Ringe, Georg. "Empty Voting Revisited: The Telus Saga." *Butterworths Journal of International Banking and Financial Law* (2013): 154-156. Empty voting strategies refer to a process by which activist shareholders separate their economic risk from the value of their shares. This is done through different types of hedging arrangements, for example. Once the risk and voting rights have been separated, the activist shareholders can use their voting rights to further their agenda free from the risk of loss if share prices were to go down as a result.

³⁶¹ *Infra* note 390 at 119. See also Kahan, Marcel, and Rock, Edward B., "Hedge Funds in Corporate Governance and Corporate Control", *University of Pennsylvania Law Review* (2007): 1021-1093 and Klein, April, and Emanuel Zur. *Hedge Fund Activism*. (2006).

Professors Kahan and Rock identify two objections to the role of hedge funds.³⁶² First, that hedge funds' interests may differ from those of other shareholders and second, that their intense activism may overburden the regulatory system.³⁶³ However, the analysis rightly concludes as follows: "The resulting concerns, however, are relatively isolated and narrow, do not undermine the value of hedge fund activism as a whole, and do not warrant major additional regulatory interventions." Similarly, these concerns are not sufficient to meaningfully impact the comparative analysis that forms the basis of this dissertation. This is because appropriate threshold requirements for signatures in support of petitions for initiatives can keep the number of proposals to a manageable number as explained later in this chapter.

6.1.4 Social Activists

Social activists have used shareholder proposals to raise social, environmental and political issues receiving an average of 15.4% voting support as of 2007.³⁶⁴ Many of the proposals tabled by such shareholders have nothing to do with increasing shareholder value and in some cases would have the opposite effect if adopted.³⁶⁵ As such, they serve as means of gaining publicity for a certain cause and for putting the issue on the agenda of the company's shareholders and board of directors.

³⁶² Kahan, Marcel, and Edward B. Rock. "Hedge Funds in Corporate Governance and Corporate Control." *University of Pennsylvania Law Review* (2007): 1021-1093 at 1022.

³⁶³ See Black Jr, Lewis S., and A. Gilchrist Sparks III. "SEC as Referee-Shareholder Proposals and Rule 14a-8, The." *J. Corp. L.* 2 (1976): 1. A large number of shareholder proposals has the potential to swamp the SEC because the SEC must determine whether or not to issue no-objection letters regarding the decisions of various companies not to include the shareholder proposals in the board's proxy.

³⁶⁴ Yermack, David. "Shareholder Voting and Corporate Governance." *Annu. Rev. Financ. Econ.* 2, no. 1 (2010): 103-125.

³⁶⁵ See Guay, Terrence, Jonathan P. Doh, and Graham Sinclair. "Non-governmental Organizations, Shareholder Activism, and Socially Responsible Investments: Ethical, Strategic, and Governance Implications." *Journal of Business Ethics* 52, no. 1 (2004): 125-139 and Tkac, Paula. "One Proxy at a Time: Pursuing Social Change Through Shareholder Proposals." *Economic Review-Federal Reserve Bank of Atlanta* 91, no. 3 (2006): 1. A large number of socially motivated shareholder proposals want the company to cease a profitable but socially harmful activity or want the company to pursue a socially useful activity at the cost of shareholder value. See for example *State of Minnesota ex rel. Charles A. Pillsbury v. Honeywell Inc.* 191 N.W.2d 406 (1971). In this case, the plaintiff shareholders put forward a shareholder proposal asking Honeywell Inc. to cease the manufacture of napalm which was being used by the US military against civilians in Vietnam. While this was a socially well motivated proposal, it proposed social benefit at the cost of corporate profits.

These proposals are usually withdrawn after negotiations and compromise with the board and very rarely receive majority support in the shareholders meeting.³⁶⁶

6.1.5 Analysis

An examination of the different results of shareholder activism by different types of investors presents important findings for constitutional law. It is clear that shareholders who are relatively less diversified such as hedge funds and individual shareholder activists are more successful in countering the free rider problem which is responsible for the disappointing use of shareholder proposals by other types of shareholders such as mutual funds. Diversified investors like mutual funds are not only discouraged by the pro-rata distribution of the benefits of reform but by the fact that their investment in individual companies is too small a portion of their portfolio to warrant the attention and effort. This shows that if shareholders are able to concentrate their portfolio to just a few companies, their high stake and high returns will allow them to overcome the free rider problem as is seen in the case of hedge funds and sometimes with individual shareholder activists.

In the constitutional scenario, all citizens can be assumed to be entirely non-diversified. This is because the vast majority of citizens have their freedom and fortune linked to the conditions in their country. After all, the average citizen cannot hedge the risk of poor economic, social and political performance by getting the citizenship of multiple countries or owning property internationally. As discussed earlier, citizens find it much harder to 'vote with their feet' since immigration is exponentially harder than selling shares in a large public company for the vast majority of people.³⁶⁷

It is much easier to hedge company risk by investing in multiple companies than it is to hedging the risk of bad governance by getting multiple citizenships. In fact, many countries do not allow their citizens to accept the citizenship of another country without giving up their original citizenship. Accordingly, citizens can be expected to behave more like hedge funds as compared to mutual funds which only have a few percentage points of their portfolio

³⁶⁶ David, Parthiban, Matt Bloom, and Amy J. Hillman. "Investor Activism, Managerial Responsiveness, and Corporate Social Performance." *Strategic Management Journal* 28, no. 1 (2007): 91-100.

³⁶⁷ See section 3.4.2.

linked to the fortunes of any one company. This means that citizens and ‘super agents’,³⁶⁸ such as political parties, civic action groups, environmental groups, religious groups etc. which only operate in a single country can be expected to have incentives akin to hedge funds or individual investor activists such as Carl Icahn. In fact, they can be considered to be relatively even less diversified than hedge funds or individual investor activists and treated as entirely undiversified in most circumstances. Accordingly, citizens and their super agents can be expected to have even stronger incentives than hedge funds or big individual investors in taking beneficial direct democratic action. Furthermore, since citizens, political parties, civic groups etc. all have their interests permanently intertwined with the fortunes of their country, the criticism of hedge funds as being short term result oriented also does not apply in the constitutional setup.³⁶⁹

The publicity issue is not without importance to this discussion. While corporate governance scholars have criticized social activism through shareholder proposals as a means of using company funds to publicize private concerns, this is not as much of a problem in the constitutional space. Sufficiently high requirements in terms of signatures for a petition to be placed on the ballot along with other such checks and measures can ensure that fringe ideas would be excluded. On the other hand, a successful democracy needs to ensure that all issues dear to a significant portion of the population are debated and publicized even if they are not acted upon by the majority. Accordingly, the use of public funds to place these proposals on the ballot and at the same time requiring that private funds are used for actively canvassing the proposal seems to be a fair compromise.

For example, two of the most publicized instances of social activism through shareholder proposals were to stop companies from manufacturing napalm for use on Vietnamese citizens and doing business with apartheid South Africa.³⁷⁰ While the merit of using corporate funds

³⁶⁸ See section 1.7 for a discussion on the role of super agents on direct as well as delegated decision-making.

³⁶⁹ See section 6.5 for a discussion about dealing with short term versus long term planning in corporate and constitutional law.

³⁷⁰ See *State of Minnesota ex rel. Charles A. Pillsbury v. Honeywell Inc.* 191 N.W.2d 406 (1971) regarding the shareholder proposal against continuing to manufacture and supply napalm to the US military. For examples of shareholder proposals being used to boycott the apartheid regime in South Africa, see O’Rourke, Anastasia. “A New Politics of Engagement: Shareholder Activism for Corporate Social Responsibility.” *Business Strategy and the Environment* 12, no. 4 (2003): 227-239; Proffitt, W. Trexler, and Andrew Spicer. “Shaping the Shareholder Activism Agenda: Institutional Investors and Global Social Issues.” *Strategic Organization* 4, no. 2 (2006): 165-190 and Ryan, Patrick J. “Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy.” *Ga. L. Rev.* 23 (1988): 97.

to gain publicity for such activities remains controversial, few objections can be raised against spending public money to place such proposals on the ballot in political elections especially if the advocates of the initiative bear the cost of campaigning for their adoption. While shareholder proposals are criticized for pushing social, political and environmental agendas, these are precisely the sorts of issues that are suitable for initiatives as provided under constitutional law. Of course, reimbursing the costs of successful initiatives remains an option that would perhaps make the use of ballot initiatives even more effective by improving the incentives for advocating initiatives on popular issues.

This section has demonstrated that citizens, like hedge funds, individual activist shareholders and oftentimes public pension funds have sufficient incentives to engage in direct decision-making even though they have to bear its entire cost. The section also shows that the free rider problem can be overcome if the principals are sufficiently undiversified and have a large stake in the company. Since the citizens of a country have their future wellbeing (and their children's future wellbeing) heavily dependent on the social, economic and political performance of their own country, they can be considered to be entirely undiversified and heavily invested in those countries. Taking a cue from the corporate governance position explained in this section, it is argued that they will have sufficient incentives to engage in direct democracy in an informed fashion. Of course, it should be noted that just like different types of shareholders have different incentives to monitor their agents and engage in direct democracy, different groups of citizens can also have different incentives and differing responses to direct democracy. The arguments made here only apply to the broad class of citizens and there are exceptions to the rule.

6.2 NUISANCE PROPOSALS

Advocates against increased shareholder voting rights argue that shareholder proposals have the potential to waste the time and resources of both shareholders and management by allowing self-serving shareholders to make proposals that do not increase shareholder value. This wastes resources because shareholders will have to vote down such proposals and the management would have to expend resources to campaign against them.³⁷¹ Unlike the free

³⁷¹ Palmiter, Alan R. "Shareholder Proposal Rule: A Failed Experiment in Merit Regulation, The." *Ala. L. Rev.* 45 (1993): 879.

rider problem that might dis-incentivize shareholders from initiating shareholder proposals, they argue that distributing the cost of publicizing proposals and then voting upon them also creates a serious problem.

In such circumstances, shareholders may use corporate machinery to broadcast their private views that do not have the potential to increase shareholder value thereby imposing costs upon the rest of the principals.³⁷² In other words, allowing shareholder activism at no cost to the activist obliges the company to finance the private activism of its shareholders on matters not relevant to corporate performance or related to minimizing agency cost.

These objections may also be raised in the constitutional system. However, while such objections are not baseless, they can be adequately addressed by designing the initiative process appropriately. An examination of solutions to prevent such a problem in corporate governance may prove instructive. Professor Bebchuk provides the following solutions:³⁷³

1. Threshold signature requirements to screen out frivolous proposals that do not enjoy support amongst a sizable proportion of the shareholders.
2. Barring readmission of proposals that failed to garner a specified threshold of support in a previous year.
3. Requiring a majority of outstanding shares to approve proposals rather than a majority of voting shares.
4. Requiring that a proposal be adopted in two successive meeting before it is adopted.

Of these solutions, the first two can be adapted to constitutional initiatives without any problem and they will help to reduce frivolous initiatives. By adopting sufficiently high threshold signature requirements for a petition to be put on the ballot, the problem of nuisance proposals can be alleviated to a significant extent since the nuisance proposals will have a hard time attracting the requisite signatures. Additionally, prohibiting the readmission of proposals that did not receive a specified proportion of votes cast in consecutive years ensures that even fringe proposals that can meet the signature requirement do not have to be voted on every year.

³⁷² Liebler, Susan W. "Proposal to Rescind the Shareholder Proposal Rule, A." *Ga. L. Rev.* 18 (1983): 425 at 425-26.

³⁷³ Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 879-80.

Adapting the last two proposals to fit constitutional law is a little more complicated. Since voter turnout differs vastly across jurisdictions, a requirement of approval by a majority of registered voters might make any initiative impossible to adopt. Professor Bebchuk's idea does, however, have applicability in countries that have compulsory voting for legislative elections like Brazil and Australia.

In such jurisdictions, initiative proposals are often bundled together with the elections for choosing legislators in order to save time and money. This way the same election infrastructure can serve both ends because voters cast their vote for their choice of representative as well as their vote on the initiative proposal during the same visit to the polling booth. Requiring a majority of votes cast in the legislative election in support of the ballot initiative has the benefit of allowing citizens who oppose the initiative to express their disapproval by not voting yes or no for the initiative when they vote for their representatives. This solution negates the claim that a burden will be placed on citizens since the only people who have to do anything are the people who support the proposal. The citizens who do not support the initiative can oppose it by doing nothing with respect to it. It should be noted that for this solution to work, voting for the legislative election must be mandatory but voting for the ballot initiative bundled with that election must be optional.

The idea of requiring approval in two successive votes before an initiative takes effect is also worth considering in the constitutional setting. This requirement has the advantage of helping the government to save time and resources that would otherwise be spent campaigning against a detrimental proposal just because there is a small chance that it might get passed. In fact, Professor Matsusaka has suggested exactly the same solution for constitutional law.³⁷⁴ This allows the government to gauge the will of the electorate and gives it ample time to campaign against the proposal's adoption till the second vote takes place. Consequently, a two-step approval requirement prevents the government and indeed the citizens from being taken by surprise. It also introduces a measure of caution and consideration into the initiative process. This has a positive effect as minimum resources have to be expended to defeat fringe proposals.

³⁷⁴ Matsusaka, John G. "Direct Democracy Works." *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206 at 192-93. One way to mitigate the threat of government responding to threats of extreme initiatives is to require initiatives to be passed twice in consecutive ballots to be effective. This relieves the government from the threat of extreme initiatives where they are unsure about the possible result. Under this sort of system, the government can ignore extreme initiatives and only worry about measures that came close to the vote requirements to get adopted the first time.

In conclusion, this section advocates that initiative proposals must be required to meet threshold signature requirements to screen out frivolous proposals that are not supported by a sizable proportion of the citizens. Proposals that do not meet a specified threshold of support when voted on as an initiative should be barred from being readmitted the next year. And lastly, nuisance proposals can be greatly deterred by mandating that proposals must be adopted twice, in successive initiatives in order to take effect.

6.3 IMPERFECT INFORMATION

This section discusses the relationship between the information available with principals and the effectiveness of direct democracy.

One of the primary challenges for direct democracy is the free rider problem which suggests that voters will remain rationally ignorant of the vast and oftentimes complex and technical information required for educated and effective policy making. The natural corollary of this statement is that direct democracy would lead to less efficient outcomes than delegated decision-making by representatives. This is because representatives have access to the specialized human capital required to analyze the specialized information necessary to make those decisions which is absent amongst the principals.³⁷⁵

It is conceded that principals (shareholders and citizens) lack some of the specialized and complex information that may be important to informed decision-making. Furthermore, principals also lack the appropriate incentives to inform themselves since they bear the cost of information gathering and processing but do not capture the perceived benefits which are distributed to the company or country as a whole.³⁷⁶

There are, however, notable exceptions to this. It is argued that this perceived information asymmetry does not hamper the ability of citizens to make ‘rules of the game’ decisions because such decisions often do not require specialized information. For example, referendums on issues like religion, gay rights, euthanasia etc. are issues of collective social

³⁷⁵ *Id* at 193; See also Maskin, Eric, and Jean Tirole. “The Politician and the Judge: Accountability in Government.” *The American Economic Review* 94, no. 4 (2004): 1034-1054.

³⁷⁶ Bebchuk, Lucian Arye. “Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments.” *Harvard Law Review* (1989): 1820-1860 at 1836-40.

conscience and may not require much specialized information.³⁷⁷ According to Professor Matsusaka, the liberal use of referendums on European integration is a result of this approach because the consequences of consolidation of authority in Europe are widely dispersed and difficult for the legislature to fully capture in its analysis.³⁷⁸

Furthermore, there is no bar on the legislature disseminating the specialized information that it has while arguing either for or against the initiative. In fact, this may lead to situations where citizen are faced with an initiative where the legislature, having better information but worse incentives, faces off against a citizen group with worse information but better incentives. In such a situation, initiatives allow citizens to weight between these two options and to make a considered choice.³⁷⁹

If for some reasons the required information is sensitive or secret, the legislature can express this to the electorate and give its recommendations without disclosing the information. How much consideration the citizens will have for such recommendations depends upon the trust the citizens have in the legislature. If the legislators are not trusted by the citizens, depriving the citizens of the right to initiate policy will concentrate power with untrusted agents leading to increased agency costs not to mention an erosion of democracy. Since few rules of the game decisions require secret information, leaving it up to the government to release suitable information and to ask the citizens to trust them as far as protected information is concerned will enable informed decision-making and be suitable for dealing with such issues.

³⁷⁷ Matsusaka, John G. "The Eclipse of Legislatures: Direct Democracy in the 21st Century." *Public Choice* 124, no. 1-2 (2005): 157-177 at 163.

³⁷⁸ Matsusaka, John G. "Direct Democracy Works." *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206 at 193. For example, France (1972), Ireland (1973), Norway (1973) and Denmark (1973) held referendums to decide whether to join the European Communities. The UK held a referendum in 1974 to decide whether or not to remain a member. Ireland (1992), France (1992) and Denmark (1992 and 1993) held referendums to decide whether or not to ratify the Maastricht Treaty. In 1995, Austria, Finland, Sweden and Norway held referendums on joining the EU. In 1998, Ireland and Denmark held referendums to decide whether to ratify the Treaty of Amsterdam. In 2001, Ireland refused to ratify and in 2002 agreed to ratify the Treaty of Nice through referendums. In 2004, Malta, Hungary, Lithuania, Slovakia, Poland, Czech Republic, Estonia and Latvia all held referendums to decide whether or not to join the EU. In 2000 and 2003, Denmark and Sweden respectively held referendums to decide whether or not to join the Eurozone. In 2005, Spain, France, The Netherlands and Luxembourg held referendum to decide whether or not to ratify the Treaty establishing a Constitution for Europe. Ireland had a referendum as late as 2008 to decide on the ratification of the Treaty of Lisbon.

³⁷⁹ Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 881-82.

When specialized and esoteric rather than secret information is involved, citizens, like shareholders can rely on cues to vote on issues on which they are inadequately informed.³⁸⁰ For example, proxy advisory services like ISS and Glass, Lewis & Co. provide recommendations for director elections and also give recommendations regarding which way to vote on shareholder proposals.³⁸¹ The same can be said of organizations like political parties, which help citizens select representatives and also provide cues for referendums and initiatives by their endorsement or criticism. In fact, empirical research has shown that voters in California can accept or reject esoteric insurance-related propositions based on whether or not they are in their best interests with a great deal of accuracy by just looking at the endorsement or criticism given by trusted individuals or organizations.³⁸²

It can even be argued that voting to select a candidate while unaware of his or her position on a vast range of complex matters in regular elections requires more information if the citizens are to make an informed decision. Voters rely on the use of cues from reliable sources to make their choice in all elections for the legislature. In this respect, direct democracy will work similarly to representative democracy.

In addition to the use of cues for voting intelligently even when uninformed of the specific information behind a proposal, the numerous and dispersed voters of corporate and constitutional democracies alike also benefit from the influence of the Condorcet Jury Theorem³⁸³ to give voice to the majority view. The Condorcet Jury Theorem operates as follows: Voters must choose between choices A and B where one choice is better than the other. Each individual voter has a chance just marginally higher than 50% of making the correct decision based on the information available to him. In such a case, the Condorcet Jury

³⁸⁰ 'Cues' refers to signals voters receive from their super agents such as political parties, civic groups, NGOs etc. These signals usually in the form of support or criticism of a certain policy enables voters to vote to further their interests without having to understand all the issues required to make an informed decision by themselves.

³⁸¹ Verdam, Albert. "An Exploration of the Role of Proxy Advisors in Proxy Voting." *Available at SSRN 978835* (2006) and Rose, Paul. "On the Role and Regulation of Proxy Advisors." *Michigan Law Review First Impressions* 109 (2010): 62. See also <http://www.issgovernance.com/> and <http://www.glasslewis.com/> for a list of their activities.

³⁸² Lupia, Arthur. "Shortcuts versus Encyclopedias: Information and Voting Behavior in California Insurance Reform Elections." *American Political Science Review* (1994): 63-76.

³⁸³ See de Caritat, Marie Jean Antoine Nicolas. *Essai sur l'application de l'analyse à la probabilité des décisions rendues à la pluralité des voix*. L'imprimerie royale, 1785. Note: Marie Jean Antoine Nicolas de Caritat was the Marquis of Condorcet (Marquis de Condorcet), France. He was also known as Nicolas de Condorcet.

Theorem states that as the number of voters increase, the probability of the correct option being chosen in the election approaches 100%. Adapting the theorem for the purposes of the issue at hand, it can be said that a multitude of voters receiving some information instructive to making a decision optimal for them will be able to do so. This is because “aggregating the opinions of a million voters can be highly accurate by the law of large numbers even if each person's chance of being right is small”. This is true as long as the policy disagreements are caused by differing information being available to them rather than different underlying preferences.³⁸⁴

Accordingly, even if informational problems do not allow voters to make fully informed decisions, the law of large numbers will guide the majority decision towards the median preferences of the body politic in both companies and in countries. However, some decisions that require specialized and technical information like food and water safety standards should be left to experts. Interestingly, evidence suggests that in jurisdictions with provisions for initiatives, representative decision-making by legislators focuses on technical issues while initiatives are largely restricted to issues which are decided on the basis of dispersed information and social and personal values.³⁸⁵

Corporate governance researchers have also recognized the importance of the Internet in informing principals in a manner not previously possible. “Increased access to the internet for investors and shareholder activists has coincided with liberalized proxy rules for communicating amongst shareholders.”³⁸⁶ This is no accident. The rapid proliferation of the Internet has allowed the cheap and instantaneous transfer of information amongst various shareholders and between the management and the shareholders. This enhanced communication is expected to further strengthen the scope for shareholder democracy in the coming years. In the constitutional system, the role of the Internet should also be recognized in encouraging political direct democracy. This is especially true for countries with

³⁸⁴ Matsusaka, John G. “Direct Democracy Works.” *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206 at 193.

³⁸⁵ *Id.* at 193-94.

³⁸⁶ Brownstein, Andrew R., and Igor Kirman. “Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions.” *The Business Lawyer* (2004): 23-77 at 31.

substantial internet penetration where citizens can be expected to gather information and make more informed decisions due to it.³⁸⁷

As in the case of corporate governance, the impact of modern communication networks and of the Internet in particular, has been recognized by constitutional law and public choice scholars.³⁸⁸ This literature not only maintains that the internet allows citizens to inform themselves regarding key issues but that it also allows deliberation on those issues to a certain extent. In light of this, the increasing penetration of the Internet and hundreds of millions of people getting access to Internet-connected mobile phones every year makes the argument about citizens not being able to adequately inform themselves weaker with each passing day.

It can, therefore, be argued that the use of cues and the influence of the Condorset Jury Theorem can alleviate many of the informational problems with direct democracy in constitutional law as it does in corporate governance. Accordingly, the lack of information is not a complete argument against giving citizens the right to use direct democracy to make decisions. In fact, lessons from corporate governance suggest that citizens will be able to make decisions that further their interests even when they individually may not be suitably informed. These arguments, along with the rapid inroads being made by the Internet and digital communications suggest that citizens will have sufficient information to allow effective decision-making via direct democracy.

³⁸⁷ Ferdinand, Peter. "The Internet, Democracy and Democratization." *Democratization* 7, no. 1 (2000): 1-17; Buchstein, Hubertus. "Bytes that Bite: The Internet and Deliberative Democracy." *Constellations* 4, no. 2 (1997): 248-263; Morris, Dick. "Direct Democracy and the Internet." *Loy. LAL Rev.* 34 (2000): 1033; Gimmler, Antje. "Deliberative Democracy, The Public Sphere and the Internet." *Philosophy & Social Criticism* 27, no. 4 (2001): 21-39. The internet also has the potential to spread disinformation that may mislead the voters. However, it is argued that the net effect of Internet access amongst voters is greater levels of awareness about the issues to be decided.

³⁸⁸ See Morris, Dick. "Direct Democracy and the Internet." *Loy. LAL Rev.* 34 (2000); Buchstein, Hubertus. "Bytes that Bite: The Internet and Deliberative Democracy." *Constellations* 4, no. 2 (1997): 248-263; Ferdinand, Peter. "The Internet, Democracy and Democratization." *Democratization* 7, no. 1 (2000): 1-17; Tolbert, Caroline J., Ramona S. McNeal, and Daniel A. Smith. "Enhancing Civic Engagement: The Effect of Direct Democracy on Political Participation and Knowledge." *State Politics & Policy Quarterly* 3, no. 1 (2003): 23-41 and Gimmler, Antje. "Deliberative Democracy, The Public Sphere and the Internet." *Philosophy & Social Criticism* 27, no. 4 (2001): 21-39.

6.4 THE NEED FOR LONG TERM PLANNING AND CONSISTENCY IN DECISION-MAKING

This sub-section discusses the impact of direct decision-making on the continuity and long-term planning that is essential for success in both companies and countries.

An important concern in corporate governance against increasing shareholder voting rights is that it will disrupt a coherent and long-term corporate strategy.³⁸⁹ This issue has also been identified as a problem for constitutional law due to the use of initiatives. An example of myopic direct democracy is Proposition 13 passed by California voters in 1978 which amended Article 13A of the state constitution. It placed a cap of 1% on the taxation of real property and required that all future tax increases be passed by no less than 2/3rd of both houses of the state legislature. This initiative, later upheld by the US Supreme Court in *Nordlinger v. Hahn*³⁹⁰ has been criticized for its potential to make spending choices inconsistent with financing strategy.³⁹¹

In the context of corporate governance, Professor Bebchuk has argued that while inconsistency can indeed arise due to initiation of policy by shareholders, shareholders will not blindly adopt the short-term or simplistic solution that would disrupt corporate strategy. Just like in the case of specialized information, the board of directors is expected to explain its long-term view to the shareholders and to point out how a shareholder proposal or bylaw amendment might disrupt it. At the end of the day, it is up to the shareholders to decide whether to believe the management's claims about possible disruption, which is arguably based on better information, after carefully considering possible conflicts of interests that the managers might have.³⁹²

This system means that shareholders can start adopting policies inconsistent with the position of the board of directors if shareholders have lost faith in the board without having to wait to

³⁸⁹ See Bainbridge, Stephen M. "Why a Board-Group Decisionmaking in Corporate Governance." *Vand. L. Rev.* 55 (2002): 1 and Bainbridge, Stephen. "Case for Limited Shareholder Voting Rights, The." *UCLA L. REV.* 53 (2005): 601. These arguments are also accepted as having merit by Professor Bebchuk, an ardent advocate of increased shareholder rights in *Infra* note 418 at 882.

³⁹⁰ *Nordlinger v. Hahn*, 505 U.S. 1 (1992).

³⁹¹ Whalen, Bill. "Who's Afraid of the Big Bad Initiative." *Hoover Digest* (2000) 3.

³⁹² Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 883.

replace it through elections. Moreover, shareholders might be satisfied with the performance of the company but they may not trust the managers to put the interests of the shareholders ahead of their own interests in a particular transaction that poses a serious conflict of interest.³⁹³

This line of argument can be extended to constitutional law. For example, citizens might be quite satisfied with their government's performance but may not trust their legislators to objectively decide special cases where the agents have a particularly serious conflict of interest. An example of a decision that creates a uniquely serious conflict of interest for the legislators is a decision to introduce or repeal term-limits for the legislature. Since this decision directly and drastically impacts the political future of legislators, it may be better off being decided through direct democracy. An initiative may, therefore, be the least disruptive means of providing for term limits, while also keeping the incumbent government.

Regarding both the issue of information and consistency, it is important to note that there is no single solution to the problem. Since some issues both involve a conflict of interest and concerns relating to consistency and information, it is best that citizens be allowed to weigh the matter and decide which factor is more important in the particular case. For example, in an initiative concerning the compensation of legislators, citizens will pay less heed to the opinion of the legislature. This is because the decision requires little specialized knowledge to evaluate the living expenses of parliamentarians, poses few problems of disrupting government strategy but creates a very great conflict of interest for the legislators.

On the other hand, an initiative that affects military matters will be driven more by the advice of the legislature. This is because such decisions require a large amount of specialized and often secret information, they might disrupt long term strategy and the legislators have a very small chance of having a conflict of interest. In such cases, even if the government does not divulge the secret information that forms the basis of its recommendation, the citizens are likely to go along with the government because the absence of a conflict of interest makes misdirection less likely.

³⁹³ Bebchuk, Lucian Arye. "The Case for Empowering Shareholders." *Berkeley Program in Law and Economics*. (2003).

This argument is perhaps best borne out by the fact that the government of the United States had little trouble in convincing its population to support a war against Iraq based on its fictitious involvement in the 9/11 attacks and its non-existent weapons of mass destruction.³⁹⁴ This shows that even a government with widely publicized links to the military industrial complex would have little difficulty in maintaining consistency in terms of military matters.³⁹⁵ On the other hand, if legislators have lost the faith of its citizens to such a degree that citizens are not willing to trust it even on matters of national security, the country needs an immediate change in policy (and probably even a change in government). Consistency can, therefore, not be held out to be a valid argument to perpetuate the policies of such an unpopular and untrusted legislature.

It can, therefore, be said that agents can preserve long term planning and consistency in policy even when citizens have the right to use initiatives. This can be done by providing citizens with the relevant information explaining why a short-term decision proposed through an initiative may be against their interests. This shows that corporate law can give insights into how interests of consistency can be balanced with interests of transparency and trust in constitutional law using direct democracy.

6.5 SPECIAL INTERESTS, SHORT-TERMISM AND BLACKMAIL

Traditionally, institutional investors have aimed to maximize their returns, to stay competitive and to satisfy their investor's demands for greater returns by minimizing their costs. This has led institutions to shy away from investing the time and money involved in

³⁹⁴ See Isikoff, Michael, and David Corn. *Hubris: The Inside Story of Spin, Scandal, and the Selling of the Iraq War*. Random House Digital, Inc., 2006; Kaufmann, Chaim. "Threat Inflation and the Failure of the Marketplace of Ideas: The Selling of the Iraq War." *International Security* 29, no. 1 (2004): 5-48 and Foyle, Douglas C. "Leading the Public to War? The Influence of American Public Opinion on the Bush Administration's Decision to go to War in Iraq." *International Journal of Public Opinion Research* 16, no. 3 (2004): 269-294.

³⁹⁵ The United States government is widely seen as suffering from uncomfortably close ties to the military industrial complex that affects the interests of legislators and government possibly creating a conflict of interest. See Adams, Walter. "The Military-Industrial Complex and the New Industrial State." *The American Economic Review* 58, no. 2 (1968): 652-665. While there was no direct democracy involved with the Iraq War, the fact that the government was so easily able to build up support with no real evidence shows that the public will typically back the government when relevant information is secret and specialized and the chances of disrupting long term strategy are high.

shareholder democracy, both in term of monitoring costs and the cost associated with actively opposing the board.³⁹⁶

The tendency to avoid activism is further reinforced because several institutional investors have parent or subsidiary companies that seek business and investment from the very companies they hold stock in. This means that engaging in activism can lead to reduced business and lost profits for the parent or subsidiary companies if the board of the target company chooses to retaliate.

These disincentives to engage in activism only add to the fact that shareholder activism nets only pro-rata benefits for the activist and requires them to bear the entire cost. This leads to a free rider problem that discourages the institution from proceeding with such plans in the first place. Direct-decision-making by shareholders is, therefore, threatened by a concern that institutional shareholders will seek to curry favor with the management of companies they invest in by avoiding activist measures.³⁹⁷

While these factors usually deter activism by shareholders who have an interest in the company other than their interest as shareholders, activism by such institutions could also result in them being bought off by the management. Large investors such as insurance companies and mutual funds which have divisions that also manage private pension funds for companies have a strong incentive to remain on good terms with the management of companies that they invest in. This relationship can help to get more business from the company for their associated concerns or to be allowed to retain their existing business and not be punished by the company taking its business elsewhere.³⁹⁸ Due to this power that the managers have over certain institutional investors, the latter may have incentives to withdraw from shareholder proposals if pressured and may, therefore, be susceptible to being bought off by the management.

³⁹⁶ Bainbridge, Stephen. "Director Primacy and Shareholder Disempowerment." *Harvard Law Review* 119 (2006): 1735-2644 at 1753.

³⁹⁷ See Section 6.1 for a detailed discussion into how different types of shareholders are incentivized to participate in shareholder direct decision-making. See also *Id* at 1754.

³⁹⁸ See Roe, Mark J. *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*. Princeton University Press, 1996 at 62 and *Supra* note 422 at 1754.

The role of private interests such as seeking rewards in a capacity other than as a shareholder or seeking greater than pro-rata returns have also been identified as the drivers of shareholder activism by union and public employee pension funds.³⁹⁹ These groups are active participants in shareholder democracy.⁴⁰⁰ One example of the potential misuse of the right to initiate decisions is the upsurge of shareholder activism by CalPERS allegedly driven by the political ambition of Phil Angelides.⁴⁰¹ In this instance, Phil Angelides was accused of misusing his control over California's public employee pension fund when he was the state's Treasurer in order to further his ambition of becoming the state's governor by pursuing corporate activism.

As in corporate governance, there exist similar concerns in constitutional law that the initiative process might be used to pursue special interests and short-term goals over the long-term health of the company or country. The objection that special interests might capture the process has to be addressed by the design of the initiative. Since a majority vote is required to pass a proposal, the requirement of the support of an extremely large number of voters means that a special interest proposal will have little chance of being adopted. As discussed earlier, a system requiring a majority of registered voters could be introduced to make doubly sure that special interest proposals are defeated in countries with very high voter turnout and in countries with compulsory voting for legislative elections.⁴⁰² This argument is supported by the corporate governance experience where "the only resolutions that systematically obtain majority support are ones calling for changes that are viewed as value enhancing by a wide

³⁹⁹ Union and public employee pension funds manage investments to finance the payouts of union and public employees' pensions respectively. They are important institutional investors due to the large amounts of money they have under management. For example, the largest public employee pension fund in the US known as the Civil Service Retirement System has a projected balance of an astonishing \$832 billion as of September 30, 2013. Note that Japan's public pension fund is worth about \$1.37 trillion. This makes it clear that public pension funds are major stockholders with relevance to the study of direct decisions making.

⁴⁰⁰ See Brownstein, Andrew R., and Igor Kirman. "Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions." *The Business Lawyer* (2004): 23-77 and Thomas, Randall, and Kenneth Martin. "Should Labor be Allowed to Make Shareholder Proposals?" *Washington Law Review* 73, no. 1 (1998). See also the discussion in Section 6.1.2.

⁴⁰¹ Barber, Brad M. "Monitoring the Monitor: Evaluating CalPERS' Activism." *The Journal of Investing* 16, no. 4 (2007).

⁴⁰² See Section 6.1. This requires a system where voters are required to vote in legislative elections and the initiative proposals are voted upon at the same time. Here citizens can reject the initiative by not voting on the initiative or voting against it. However, they must actively vote for the proposal to register their support for it.

range of financial institutions... In contrast, proposals that focus on social or special interest issues uniformly fall far short of a majority".⁴⁰³

However, this might not be the case in the constitutional system where powerful and well-funded super agents⁴⁰⁴ like chambers of commerce, large unions etc. may be able to have their proposals placed on the ballot even if they serve narrow goals of special interest groups. Getting the approval of the majority of the voting population is a different matter but some danger inevitably remains. Additionally, the scope for damage is also much greater in the case of initiatives than it is with shareholder proposals due to the vast scope of political power. After all, bad corporate decisions can only lead to financial loss and even that can be hedged against. On the other hand, bad decisions at the constitutional level threaten life, liberty and every aspect of human life.

The risk of short-term thinking trumping long-term considerations is, however, less of a problem in constitutional law than it is in corporate law. Since almost all citizens live and die in the same country and more importantly, most citizens have children whose interests are very dear to them, there is no identifiable group of voters who have an unambiguous short-term interest that outweighing their long-term interests. As long as the government is there to inform the voters about the long-term impact of an initiative and the checks and balances discussed in this chapter are introduced, there is little fear that the majority of citizens will deliberately vote to damage their own future and their children's future.

This inherent long term interest is, however, not true for the special interest groups that fund and frame the proposal. After all, the leaders of political parties, labor unions etc. might sacrifice the long-term good of the country in favor of measures that give results in the short-term in order to win elections. They may do this, for example, by supporting an initiative that cuts taxes or raises the minimum wage before the elections even if it is economically unfeasible in the long term. This means that the ultimate check on the abuse of initiatives by special interests is the ability of citizens to vote to further the long term interest of the citizenry at large. A problem that arises is that special interest groups can coordinate and

⁴⁰³ Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 884.

⁴⁰⁴ See section 2.3. See also Issacharoff, Samuel, and Daniel R. Ortiz. "Governing Through Intermediaries." *Virginia Law Review* (1999): 1627-1670.

work together to combine their forces. This might result in an omnibus proposal that is supported by several special interest groups which furthers all their agenda's at the expense of everyone else. For example, racists, misogynists and homophobes could come together and draft a terrible proposal that encompasses all their biases and thus gain support from all these groups.

This problem can be addresses by introducing a requirement that proposals for initiatives may only address a single issue and no more. This rule would make it impossible for special interest groups to coordinate with each other thereby preventing omnibus bills that benefit a number of powerful and narrow interests at the expense of the others. This is an imperfect solution but no better one seems to be available besides judicial remedies if the proposal adopts or amends a statute and that statute falls foul of the constitution.⁴⁰⁵

In fact, the only institution in this discussion that has a short term interest is the legislature itself. Legislators may indeed sacrifice their long-term interest in favor of short-term gains (particularly before elections).⁴⁰⁶ If anything, the initiative, in some circumstances, may be an instrument against the short termism of legislators rather than a source of short term benefit at the expense of long term prosperity.

A concern regarding shareholder proposals is that they can be abused by certain shareholders to extract private benefit from management by bringing or threatening to bring a proposal.⁴⁰⁷ As in corporate law, this objection is a serious impediment to the use of initiatives in constitutional law. If the proposal is value decreasing in nature, the government has to campaign against the measure and prevent it from being adopted by the citizens.⁴⁰⁸

⁴⁰⁵ Eule, Julian N. "Judicial Review of Direct Democracy." *The Yale Law Journal* 99, no. 7 (1990): 1503-1590 and Tushnet, Mark. "Fear of Voting: Differential Standards of Judicial Review of Direct Legislation." *Ann. Surv. Am. L.* (1996): 373.

⁴⁰⁶ Albertazzi, Daniele, and Duncan McDonnell. *Twenty-first Century Populism*. Palgrave Macmillan, 2007.

⁴⁰⁷ *Supra* note 429.

⁴⁰⁸ In such a situation, the government is in a privileged position as it can use public funds to pay for research on the proposal as well as publicizing its support or objections to a proposed initiative. As should be the case, citizens can weigh the persuasiveness of the governments' recommendations against the conflict of interest their legislators may have before the citizens make their decision.

Campaigning against every fringe proposal that may be value decreasing would still lead to resources being wasted and, therefore, Professors Matsusaka's proposal of requiring initiatives to be approved in two widely spaced, consecutive ballots gains some traction.⁴⁰⁹ This solution of requiring principals to adopt twice, in consecutive polls, any proposals initiated by them has also been proposed by Professor Bebchuk in the context of corporate governance.

Requiring approval in consecutive ballots also takes care of Professor Bainbridge's objection that even if managers believe that shareholders would not adopt a value reducing proposal, the managers, being risk averse,⁴¹⁰ will still be susceptible to blackmail.⁴¹¹ Simply put, the agents might negotiate with the proponents of a value-reducing proposal because they do not want to take any risk of the proposal getting adopted if it is voted on by principals. If approval of proposals in consecutive ballots is required to adopt initiatives, the legislature has far fewer concerns that a value reducing initiative may get adopted. This is because a proposal will not become law until it is reapproved in another vote. This gives the legislature ample time to educate the public about proposals that actually stand a chance of being adopted rather than worrying about fringe proposals surprising them.

On the other hand, if a proposal is value enhancing and the legislature wants to avoid it for selfish reasons, compromising with the proponents of the proposal will be of little use. This is because any value enhancing proposal that the legislature thinks has a good chance of being adopted by the voters will just be proposed by other parties thereby making payoffs to the original proponents pointless.⁴¹²

⁴⁰⁹ Matsusaka, John G. "Direct Democracy Works." *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206 at 192-93. One way to mitigate the threat of government responding to threats of extreme initiatives is to require initiatives to be passed twice in consecutive ballots to be effective. This relieves the government from the threat of extreme initiatives where they are unsure about the possible result. Under this sort of system, the government can ignore extreme initiatives and only worry about measures that came close to the vote requirements to get adopted the first time.

⁴¹⁰ Bebchuk, Lucian Arye. "Federalism and the Corporation: the Desirable Limits on State Competition in Corporate Law." *Harvard Law Review* (1992): 1435-1510 at 1464.

⁴¹¹ Bainbridge, Stephen. "Director Primacy and Shareholder Disempowerment." *Harvard Law Review* 119 (2006): 1735-2644 at 1756.

⁴¹² *Supra* note 429 at 884-86. These payoffs may include favoring the interests of the group that brought forward to proposal in a particular government decision or in future government decisions as well as illegal bribes.

It is clear that the problems of special interest, short termism and back seat driving stem primarily from a double agency problem.⁴¹³ This is a situation where the second order agents such as political parties, civic groups, NGOs etc. increase agency problems by advancing the interest of their constituents at the expense of others. The managers of such second order agents may also abuse the power exercised by these organizations to seek private rents. The important thing to note is that with appropriate checks and balances such as requiring the adoption of a proposal in two successive ballots, legislatures can rely upon the rationality and self-interest of their citizens and not have to strike deals with special interest groups. This should insure that the problems of special interest, short termism and blackmail do not undermine the savings in agency cost brought about by the use of initiatives.

6.6 THE SUBJECT MATTER OF INITIATIVES

This section examines what is the appropriate subject matter for initiatives in order for their use to reduce agency cost. When corporate governance literature is examined for answers, Rule 14a-8 of the Securities Exchange Act, 1934 appears in the vast majority of papers. This rule gives shareholders the right to initiate a proposal and to have it included in the company's proxy.⁴¹⁴ Key to the discussion here is that Rule 14a-8 mandates that shareholder proposals must be consistent with the law of the company's state of incorporation.⁴¹⁵ This means that shareholder proposals can only deal with subject matter that shareholders are empowered to decide under the corporate law of the state of incorporation. This section examines Delaware law in particular to get insights into what issues should be amenable to direct decision-making.

The analysis of Rule 14a-8 must be done mindful of the difference in the way voting is carried out in companies and in countries. The centrality of the proxy system in corporate voting means that this rule determines what can and cannot effectively be put to the vote of the shareholders. This is because placing the proposal on the company's proxy significantly

⁴¹³ See section 3.3. See also Issacharoff, Samuel, and Daniel R. Ortiz. "Governing Through Intermediaries." *Virginia Law Review* (1999): 1627-1670.

⁴¹⁴ See section 3.1.1. In short, a proxy is an authorization from a shareholder to the holder of the proxy enabling the holder to exercise the voting rights the shareholder is entitled to in a shareholder meeting.

⁴¹⁵ See *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947). See also Ledes, John G. "Review of Proper Subject under the Proxy Rules, A." *U. Det. LJ* 34 (1956): 520.

alleviates the free rider problem by causing the company to bear a large part of the cost of publicizing the proposal. Since the company now pays for the proposal and also gets the benefits of such proposals, the proposing shareholder does not have to spend more than he can hope to gain if the proposal is successful. Because Rule 14a-8 requirements effectively determine what can and cannot be put to the shareholders' vote unless the proponent cares to assume the entire expense himself, these requirements are examined to identify lessons for constitutional law.

The origins of Rule 14a-8 can be traced to the "Summary of Proposed Revision of Proxy Rules" released in August 19, 1942. This document opened the debate on shareholder democracy by providing for shareholders to have almost any matter placed on the company's proxy. From then onwards, the rule has seen an evolution to prevent shareholder proposals from becoming "an all-purpose forum for malcontented shareholders to vent their spleen about irrelevant matters."⁴¹⁶

As expected, the original approach needed to be balanced and the first objection was received by the Chairman of the SEC less than 2 months later in the form of a letter dated October 12, 1942 from an industry committee. It argued that such an arrangement could lead to companies faced with a shareholder's demand to place libelous and malicious matter in their proxies thereby putting the board in a no-win legal position. They would either be guilty of violating the proxy rules for not including such material in their proxy or suffer prosecution for libel and slander. Accordingly, the proposal that was adopted by the Commission on December 18, 1942 required that the proposal must be a "proper subject for action" and also that it would be the shareholder and not the company and its agents who would be legally liable for the contents of the proposal.⁴¹⁷

This shows that the evolution of the SEC's position on the suitability of the subject matter of a shareholder proposal began from an extreme position where almost anything could be included and an almost instant move towards systematically restraining this power.

⁴¹⁶ *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659, 678 (D.C. Cir.1970), vacated, 404 U.S. 403 (1972). Cited from Palmiter, Alan R. "Shareholder Proposal Rule: A Failed Experiment in Merit Regulation, The." *Ala. L. Rev.* 45 (1993): 879. at 888.

⁴¹⁷ Ledes, John G. "Review of Proper Subject under the Proxy Rules, A." *U. Det. LJ* 34 (1956): 520 at 520-21.

In 1945, Rule 14a-8 was given further definition by the SEC. From then onwards, a shareholder could only ask for a proposal to be included in a company's proxy if the subject matter of the proposal was considered open to shareholder action under the law of the company's state of incorporation. Furthermore, shareholder proposals relating to general social, political and economic issues could be excluded from the company's proxy.⁴¹⁸ This provision was finally withdrawn in 1972 and replaced with a more "objective standard"⁴¹⁹ with the inclusion of subsection (c)(5) to Rule 14a-8 which restricts proposals to matters of significance and interest to the company.

Per subsection (c)(5), proposals must relate to activities that account for a minimum of 5 percent of the company's total assets, gross annual sales or net annual earnings OR be "otherwise significantly related to the company's business".⁴²⁰ This change has allowed shareholder to move proposals that are of political and social import when they meet the conditions laid down above. As exemplified by *Lovenheim v. Iroquois Brands Ltd.*⁴²¹, the SEC has used this change to allow for a wider range of proposals. This has allowed shareholder proposals to be used to ask management to submit a report on force feeding geese to produce pate even though it accounted for less than 0.05% of the firm's assets as the SEC held that to be an issue "significantly related to issuer's business."

This situation can be compared to the 2002 amendment to the constitution of the State of Florida that gave pregnant pigs the right to a cage in which they could turn around.⁴²² While animal rights legislation is important and may well be a suitable area for the use of the initiative, the constitution is definitely not the best place to put animal rights legislation such as this. This shows that the initiative process works but can be messy in its results.

Subsequently, the exclusion of proposals of social and political import mandated by SEC Exchange Act Release 3638, 1945 was removed and retained only as an example of an issue

⁴¹⁸ SEC Exchange Act Release 3638, 1945. Opinion Dir. Corp. Fin. Div. Cited from *Id.* at 521.

⁴¹⁹ Solicitation of Proxies, Exchange Act Release No. 9784, 37 Fed. Reg. 23,178,23,179 (Sept. 22, 1972). Cited from *Infra* note 449 at 891.

⁴²⁰ Proposals of Security Holders, 17 C.F.R. § 240.14a-8(cX5) (1993). Cited from *Infra* note 449 at 891.

⁴²¹ *Lovenheim v. Iroquois Brands, Ltd.*, 618 F. Supp. 554 (D.D.C. 1985).

⁴²² Matsusaka, John G. "Direct Democracy Works." *The Journal of Economic Perspectives* 19, no. 2 (2005): 185-206 at 202.

that may be a “matter[s]... Not significantly related to the business of the issuer... not within the control of the issuer”.⁴²³ This language was then further changed so that the reference to ‘social and political cause’ was entirely removed⁴²⁴ which led a spurt of such proposals being tabled by shareholders. While this may have been a debatable move, the inclusion of the “significantly related” and “ordinary business” exclusions in Rule 14a-8(c)(5) created a near-perfect bureaucratic Catch-22. A proposal can be neither so general that it is unrelated to the firm's business nor so specific that it is a matter of ordinary business.⁴²⁵

This is an important issue that needs to be addressed before a provision like Rule 14a-8(c)(5) can be adopted in the constitutional setting. In other words, if citizens are to be allowed to table ballot initiatives that are significantly related to the function of the government but not related to the ordinary business or functioning of the government, clear guidelines will have to be provided to ensure that a deadlock does not occur.

An analysis of these restrictions introduced over time shows that similar concerns arise when direct democracy is considered at the constitutional level. One important issue is how to deal with situations where the subject matter of an initiative conflicts with a more fundamental set of laws. This may be a conflict with the constitution in cases where an initiative seeks to enact or amend a statutory provision. Ballot initiatives may also conflict with basic human rights or with fundamental provisions of the constitution when citizens try to amend the constitution through an initiative.

It should be noted that allowing citizens to initiate constitutional amendments is not inherently a bad idea and has successfully been in place in jurisdictions like California. However, if this seems like too great a risk to take, the ‘basic structure doctrine’ as propounded by the Indian Supreme Court may be considered.⁴²⁶ While the Indian constitution

⁴²³ Palmiter, Alan R. “Shareholder Proposal Rule: A Failed Experiment in Merit Regulation, The.” *Ala. L. Rev.* 45 (1993): 879 at 911.

⁴²⁴ Adoption of Amendments Relating to Proposals by Security Holders, Investment Act Release No. 9539, 41 Fed. Reg. 52,994, at 52,9977 (Nov. 22, 1976). Cited from *Ibid.*

⁴²⁵ *Supra* note 429 at 892.

⁴²⁶ For a detailed discussion on the “basic structure doctrine” see *His Holiness Kesavananda Bharati v. The State of Kerala and Others* (AIR 1973 SC 1461). The Supreme Court of India noted that while the government has the power to amend the constitution, it may not alter the basic structure of the constitution. What constitutes the basic structure is to be decided on a case to case basis by the courts. This is the only case to ever be

does not provide for initiatives, the ‘basis structure doctrine’ mandates that the legislature may not change the basic structure of the constitution. Whether or not a constitutional amendment changes the basic structure of the constitution is determined by the courts. It is proposed that such a limitation can also be imposed on initiatives to protect basic rights and liberties.

When corporate governance is examined for other rules that exclude shareholder proposals, it becomes clear that shareholders are not allowed to champion personal claims or grievances through this mechanism.⁴²⁷ Shareholders are also not allowed to put forward proposals that cannot be acted upon by the company,⁴²⁸ proposals that are moot⁴²⁹ and proposals that require the company to break the law.⁴³⁰ Rule 14a-9 contains anti-fraud provisions which prohibit false and misleading solicitations which have been interpreted by the SEC to also include “vague and indefinite” proposals.⁴³¹

It is argued that all these provisions can help to make the initiative process more efficient in constitutional law. Not allowing personal claims and grievances to be included in proposals for ballot initiatives will ensure that only issues of general interest are voted upon. It will also ensure that the initiative process is not swamped with proposals that do not affect a sizable proportion of the population. It should be noted that threshold requirement for signatures that petitions must receive before they are considered for inclusion as an initiative also resolve this problem to a large extent.

Not admitting proposals that cannot be acted upon by the government and not allowing initiatives that are moot is also a sensible idea to borrow from corporate governance. The analysis in this dissertation is based on the ability of principals to act directly and on the basis

considered by a 13 judge bench of the Indian Supreme Court and as such has precedence over all other Indian judicial decisions.

⁴²⁷ Proposals of Security Holders, 17 C.F.R. § 240.14a-8(cX4) (1993). This paragraph draws from the analysis of SEC exclusions for shareholder proposals in *Supra* note 429 at 889.

⁴²⁸ Proposals of Security Holders, 17 C.F.R. § 240.14a-8(cX6) (1993).

⁴²⁹ Proposals of Security Holders, 17 C.F.R. § 240.14a-8(cX10) (1993).

⁴³⁰ Proposals of Security Holders, 17 C.F.R. § 240.14a-8(cX2) (1993).

⁴³¹ False or Misleading Statements, 17 C.F.R. § 240.14a-9 (1993).

of a credible threat of such intervention by direct decision-making by the agents. This is the basis of the monitoring role served by direct democracy and decisions that cannot be acted upon do not serve such a purpose. It can, therefore, be said that initiatives should not be used to pass symbolic resolutions that cannot be acted upon. For example, a proposal that citizens should strive to be more patriotic may have good chances of receiving many votes but is a bad subject for an initiative since it serves no monitoring function and does not minimize agency cost.

The corporate governance rule banning proposals that require the company to violate the law also convert well to the constitutional model. Just as the directors are bound by state and national laws that their principals cannot force them to violate, legislators are bound by the constitution. Accordingly, citizens must be barred from proposing initiatives to adopt laws that violate the constitution. If citizens are allowed to amend the constitution, they must explicitly frame such a proposal as a constitutional amendment and not as an unconstitutional statutory amendment.

Similarly, constitutional law would also benefit from barring “false and misleading” as well as less malicious “vague and indefinite” proposals from being voted upon. If such proposals are voted upon, citizens may be misled into voting against their interests and agents may get an erroneous impression of the citizen’s preferences from the results. This will lead to an escalation in residual loss and therefore an increase in agency cost. Accordingly, this corporate governance solution for regulating the subject matter of initiatives can also be adopted to reduce agency cost through direct democracy.

The bar on proposals dealing with matters of general social, economic or political interest, however, cannot be excluded as these are the very matters on which laws are made at the constitutional level. As such, these ‘rules of the game’ decisions must remain within the scope of the initiative.

This discussion shows that Rule 14a-8 adopted by the SEC to govern shareholder proposals can provide many useful insights to help reduce agency cost in constitutional law by determining what the appropriate subject matter to be decided via initiatives is.

6.7 FINDINGS

This chapter analyzed corporate governance literature to identify what conditions and rules are required for initiatives to be implemented efficiently. The first issue analyzed is whether citizens have the proper incentives to bring value increasing proposals. This is compared with the participation of individual shareholder activists, mutual funds, pension funds, hedge funds and social activists in shareholder proposals. This comparison reveals that shareholder activism is strongest amongst social activists and amongst shareholders who have a substantial stake in the company which significantly alleviates the free rider problem.

Just like shareholders with substantial shareholding in a company, citizens can be considered to have a large and undiversified stake in the fortunes of their country. Accordingly, initiatives are expected from super-agents acting on behalf of a sizable part of the population, from special-interest groups that are able to capture enough of the benefits to justify the costs of the initiative and from social activists. This seems to reflect reality in constitutional law quite accurately.

Corporate governance literature and, in particular, Rule 14a-9 along with sub-section (c)(5) of Rule 14a-8 passed under the Securities Exchange Act, 1934 are then used to identify methods by which nuisance proposals can be kept off the ballot if initiatives are provided for. Other solutions from corporate governance literature offered in this chapter are to require a minimum number of signatures for the petition, rejection of proposals that got a poor response in previous votes and using a variation of the 'proper purpose'⁴³² test from proxy access literature.

Citizens are found to be rationally uninformed but are still able to vote intelligently on both representative elections and ballot initiatives through the use of cues. In addition to this, a representative result can be arrived at even if citizens have imperfect information due to the

⁴³² Rule 14-8(i)(1) determines whether or not a shareholder proposal relates to subject matter deemed suitable to be circulated to shareholders under Rule 14a-8. As per Rule 14-8(i)(1), shareholder proposals must comply with the law of the state of incorporation. The company laws of most states provide that companies are free to determine what types of proposals shareholders can put forward and vote on in shareholder meetings. However, because state law typically vests authority to manage the business and affairs of the corporation, the SEC has created a rule of thumb:

If a shareholder proposal is precatory does not bind the board of directors, it is presumed to fall within the 'proper purpose' of shareholder action and may be circulated and voted upon. In such cases, the onus shifts to the board of directors to prove that the subject matter of the proposal is not suitable if they wish to exclude the proposal from the company's proxy statement and stop it from being voted upon by shareholders.

influence of the Condorcet jury theorem.⁴³³ This discussion concludes that citizens are capable of directly deciding matters relating to social values or where information is widely dispersed amongst the population and that they should be allowed to do so. On the other hand, legislature should make decisions requiring specialized and technical information. In fact, it is seen that this is exactly what happens in jurisdictions with provisions for ballot initiatives.

The next issue examined is the threat of inconsistent policy. This threat is determined to be real with California's budget woes being a good example. The solution on offer is for the government to explain to the population how their choice may create such problems and thereby convince them to vote differently. This is related to issues of special interests, short-termism and the scope for blackmail. Firstly, citizens are all considered to have long-term horizons while deciding laws and therefore have the incentives to oppose the short-term interests of special interest groups. The self-interest of citizens is also presented as a partial cure to the threat of blackmail since the legislature can explain its criticism of a harmful proposal to the people and be assured that it will fail without having to compromise with its proponents. Additionally, initiatives may be required to be approved in two consecutive meetings. This gives the legislators far more breathing space as they can wait to see if a detrimental proposal passes the first vote before having to expend time and resources campaigning against it.

The chapter concludes by examining the evolution of Rule 14a-8 to identify suggestions for keeping the subject matter of initiatives relevant to the needs of the voters and the democratic process. As in the case of companies and their shareholders, citizens should not decide matters that are related to the 'ordinary business' of governing the polity nor should they be allowed to make proposals that are not 'substantially related' to the work of government. For example, initiatives relating to whom government departments should buy pencils from and who should be the captain of the national football team are both inappropriate for those reasons respectively.

⁴³³ See section 6.3. The Condorcet Jury Theorem operates as follows: Voters must choose between choices A and B where one choice is better than the other. Each individual voter has a chance just marginally higher than 50% of making the correct decision based on the information available to him. In such a case, the Condorcet Jury Theorem states that as the number of voters increase, the probability of the correct option being chosen in the election approaches 100%.

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The last word on the chapter is that while there are disadvantages as well as advantages to allowing for initiatives, the advantages seem to be greater on a number of counts. This is, at the very least, sufficient to advocate for constitutions to include a reversible default in favor of initiatives.

7 SHOULD REFERENDUMS BE BINDING?

This chapter examines whether referendums should be binding or non-binding in order to minimize agency cost. This does not refer to whether or not a referendum must be held to decide a particular issue.⁴³⁴ Rather, whether or not a referendum is binding refers to whether a negative vote by citizens in the referendum bars the government from pursuing the policy rejected in that referendum. This is referred to as the finality of the veto and this chapter considers how this impacts agency cost. This analysis is used to determine what decisions should be subject to a final, binding veto by principals and when the veto should be non-binding in order for agency cost to be minimized.

The first issue alluded to above is the difference between mandatory referendums, as opposed to legislative or referred referendums. Mandatory referendums are referendums required by the constitution (and sometimes by statutory provisions) in order for the government to make certain types of decisions. For example, a provision requiring all constitutional amendments be adopted only after they are approved via a referendum gives rise to mandatory referendums. On the other hand, referendums held by the government when there is no legal obligation to seek the approval of the citizens for deciding an issue lead to legislative referendums (also known as optional or referred referendums). The proposals that are the subject matter of legislative or referred referendums are, therefore, within the authority of the legislature to decide even without holding a referendum.⁴³⁵

Legislative referendums are conducted the same way as the mandatory referendums. The rules for the actual conduct of the referendum may or may not be specified by the constitution or by statute. If the process is not specified, the referendum is held as per rules set by the legislative decree that called for the referendum. Such referendums are known as ad hoc optional or legislative referendums. Since the rules governing how they are conducted are often set by the act of the legislature that calls for the referendum, whether or not they are

⁴³⁴ Referendums that are required to ratify certain decisions as per the constitution are called mandatory referendums. Referendums called at the discretion of the government are called optional referendums. This chapter deals with whether or not the results of a referendum can be ignored by the legislature once the referendum has been held. It does not focus on whether or not a referendum is required to be held in the first place.

⁴³⁵ See J.G. Matsusaka, "Direct Democracy", *Encyclopedia of Public Choice*, at 1.

binding varies. Such referendums are typically called by governments to push through legislation that might fail to get adopted by parliament and they may even be votes of confidence in the government itself.⁴³⁶

This chapter examines whether or not referendums need to be binding in order to minimize agency cost. First, the chapter carries out a positive analysis looking at what types of referendums around the world are binding and in what circumstances. This is then compared to the finality of shareholder vetoes in corporate governance when shareholder approval is needed or asked for by the board of directors. The chapter then carries out a normative analysis to look at whether the decisions that require binding shareholder approval in corporate governance are correctly identified in order to actually minimize agency cost. This is contrasted with the choice of decisions that mandatorily require the approval of citizens in constitutional law. This analysis is used to identify how agency cost can be minimized by properly designing the laws that govern the use of referendums in constitutional law.

7.1 REFERENDUMS AROUND THE WORLD: BINDING OR NON-BINDING?

Referendums have received very different treatment in the constitutions of the nations of the world. They are used with different procedures to settle different types of questions in various countries and states. This varied treatment of the referendum around the world has resulted in a divergence in the finality of the decisions reached by such processes. In some countries, a rejection of a proposal in a referendum is binding and the proposal cannot become law. In others, the result of a referendum is merely advisory and it is up to the government whether or not to enact the proposal into law regardless of the outcome of the referendum.

⁴³⁶ See Beramendi, Virginia, Andrew Ellis, Bruno Kaufman, Miriam Kornblith, Larry LeDuc, Paddy McGuire, Theo Schiller, and Palle Svensson. *Direct Democracy: The International IDEA Handbook*. International Idea, 2009 at 45-49.

Regarding the use of legislative referendums to push through policy that might fail to get adopted by parliament or as votes of confidence in the government, the handbook gives the following examples. France held an optional referendum in 1988 on the issue of New Caledonia, Denmark held one in 1986 regarding the ratification of the Single European Act and Bolivia held one in 2004 to help pass a law to regulate its natural gas reserves. These were held because there was insufficient support for government policy in the legislature. Optional referendums may also be held to resolve a difference in opinion between two houses of Parliament. Examples of this are the 1950 referendum in Belgium to decide the issue of the return of King Leopold III from exile and Sweden's 1957 referendum on supplementary pension plans. Optional referendums can also be held to demonstrate the public's confidence in the government or its leader(s). The failed French referendum of 1969, the Chilean referendum of 1978 and the Russian referendum of 1993 are all examples of referendums used not to settle a policy question but rather to ask the citizens whether they support the government or not.

In fact, some countries have provisions for both binding and non-binding referendums. For example, the October 1972 referendum held under Article 20 of the Danish Constitution regarding Denmark's membership of the European Economic Community was binding. On the other hand, the Danish referendum in February 1986 called by the government regarding Denmark's acceptance of the Single European Act was merely advisory and could be rejected by the government.⁴³⁷ This diversity in the treatment of referendums can have other criterion as well. For example, the results of local referenda in Poland and Macedonia are binding if they are adopted in votes with participation rates greater than 30% and 50% respectively. If the participation rate is lower, the referendum is still valid but its results are only advisory and can be rejected by the government.⁴³⁸

As this is a positive examination looking at the circumstances under which referendums are binding in constitutional law, an empirical overview is called for. From an examination of the data from 214 countries and territories surveyed in 2008, it can be seen that 108 countries and territories provide for mandatory referendums while 120 provide for legislative referendums.⁴³⁹ Further analysis shows that out of the 108 countries that provide for mandatory referendums and 120 countries that provide for legislative referendums, 34 countries only provide for mandatory referendums, 46 countries only provide for legislative referendums and 74 countries provide for both.

Of the 34 countries that have only mandatory referendums, 22 are confirmed to treat their result as binding; the status of 10 countries is unclear and only 2 countries, namely Nigeria and Palau can be identified where a mandatory referendum can, under some circumstances, be disregarded by the government. When the 46 countries that only provide for legislative referendums are considered, the picture is different. While 20 countries provide for binding legislative referendums, 7 specifically require that the outcome of legislative referendums must be precatory. Of the remaining countries, 10 countries mandate that the result is binding only in certain circumstances and the position of the remaining 9 countries is unknown.

⁴³⁷ Siune, Karen, and Palle Svensson. "The Danes and the Maastricht Treaty: The Danish EC Referendum of June 1992." *Electoral Studies* 12, no. 2 (1993): 99-111 at 101.

⁴³⁸ Búcek, Jan, and Brian Smith. "New Approaches to Local Democracy: Direct Democracy, Participation and the Third Sector" *Environment and Planning C* 18, no. 1 (2000): 3-16 at 6.

⁴³⁹ See Annex A, Beramendi, Virginia, Andrew Ellis, Bruno Kaufman, Miriam Kornblith, Larry LeDuc, Paddy McGuire, Theo Schiller, and Palle Svensson. *Direct Democracy: The International IDEA Handbook*. International Idea, 2009 at 202-211.

The case of countries that allow for both types of referendums is mixed. Out of 74 such countries, 50 require the results to be binding, in 15 countries the results can be either binding or precatory depending on specified conditions, and the position of 8 countries is unknown. Iceland is the only country that provides for both types of referendums and requires that the outcome of both types be precatory.

It can be concluded that while data on this issue is incomplete mainly due to lack of information on very small countries and some overseas territories, there is clear evidence that mandatory referendums are typically binding. In fact, Iceland is the only country that identified which requires that the results of mandatory referendums be precatory and only Nigeria and Palau allow for a possibility of the results of mandatory referendums to be ignored in certain circumstances.⁴⁴⁰

An examination of the countries where the result of referendums is binding on the government shows that issues that require public approval through referendum are typically decisions with major political significance. Some examples of decisions requiring mandatory referendums that are binding on the government are:⁴⁴¹

1. Constitutional amendments in Australia, Denmark, Japan, Switzerland, Uruguay and Venezuela.
2. Ratification of certain international treaties in Switzerland.
3. Transfer of authority to international bodies and organizations in Denmark (if the decision is not approved by a 5/6th majority in the parliament).
4. Issues touching on sovereignty or national self-determination in the Republic of Ireland as witnessed regarding the decision to join the European Union.

Certain types of decisions are sometimes excluded from the requirement to hold a mandatory referendum even if they are important decisions with major political significance. These may be issues concerning taxes and public expenses where it is felt that the public at large would not decide wisely.⁴⁴² Therefore, a state might require mandatory referendums for

⁴⁴⁰ *Ibid.*

⁴⁴¹ Beramendi, Virginia, Andrew Ellis, Bruno Kaufman, Miriam Kornblith, Larry LeDuc, Paddy McGuire, Theo Schiller, and Palle Svensson. *Direct Democracy: The International IDEA Handbook*. International Idea, 2009 at 43.

⁴⁴² *Id.* at 44-45. See for example Article 42 of the Constitution of Denmark. It reads:

constitutional amendments but might carve out an exception for matters regarding taxes and public expenses. In such a case, a constitutional amendment relating to taxes would be exempt from the requirement for being approved via referendum.

This is a matter of balancing the monitoring effects of referendums with certain special circumstances of tax policy which make it less suitable for resolution through direct democracy. The exclusion of tax and fiscal matters from the purview of referendums is not in any way universal and research suggests that Swiss referendums on tax and fiscal matters may have helped by reducing the centralization of fiscal activities.⁴⁴³

Mandatory and binding referendums may also be required to pass laws that ordinarily do not need to be approved in a referendum, if certain specified procedural conditions arise.⁴⁴⁴ For example, under certain conditions, constitutions may require a referendum if there is a disagreement between the President and the legislature⁴⁴⁵ or as a means of bypassing a strict supermajority requirement in the legislature.⁴⁴⁶

7.2 FUNDAMENTAL CORPORATE DECISIONS

This discussion examines whether or not a failure by management to get shareholder approval for a decision that requires such approval is fatal to the proposal under corporate law. In other words, is the rejection of the board's proposal final and is the management enjoined from pursuing the rejected policy? Looking at the provisions mandating shareholder approval for different classes of decisions shows a uniformity in treatment. Fundamental

"Finance Bills, Supplementary Appropriation Bills, Provisional Appropriation Bills, Government Loan Bills, Civil Servants (Amendment) Bills, Salaries and Pensions Bills, Naturalization Bills, Expropriation Bills, Taxation (Direct and Indirect) Bills, as well as Bills introduced for the purpose of discharging existing treaty obligations shall not be submitted to decision Referendum."

⁴⁴³ Feld, Lars P., Christoph A. Schaltegger, and Jan Schnellenbach. "On Government Centralization and Fiscal Referendums." *European Economic Review* 52, no. 4 (2008): 611-645.

⁴⁴⁴ Supra note 467 at 45.

⁴⁴⁵ See for example the Icelandic constitution that requires that a referendum be held on laws that are passed by the Parliament but then rejected by the President.

⁴⁴⁶ See for example the case of Denmark where a referendum is required on decisions involving transfers of national sovereignty if the measure is not supported by 5/6th of Parliament. Israel takes this a step further and requires a referendum on returning occupied territory if the measure has less than 2/3rd support in the Knesset, the Israeli Parliament.

corporate decisions that have traditionally required shareholder approval cannot go ahead if such approval is denied.

The discussion regarding the power of shareholders to veto fundamental corporate decisions has been examined at some length in Chapter 2.⁴⁴⁷ For the purposes of a concise positive examination of this right, it suffices to point out (a) the types of decisions that are subject to such a veto, (b) how universal is this legal treatment of shareholder rights, and (c) whether this veto is binding or not.

Binding shareholder approval is required for fundamental corporate decisions in almost all jurisdictions.⁴⁴⁸ For example, the US and the UK both require shareholder approval for changes to the charter,⁴⁴⁹ mergers and consolidation,⁴⁵⁰ the sale of all or substantially all the company's assets not in the ordinary course of business⁴⁵¹ and dissolution.⁴⁵² This treatment is widely accepted⁴⁵³ and has been recognized as a crucial right by the OECD and included in its Principles of Corporate Governance as follows:⁴⁵⁴

⁴⁴⁷ See section 2.1

⁴⁴⁸ See the OECD's Principles of Corporate Governance discussed in the following paragraph.

⁴⁴⁹ § 242(b)(2), Delaware General Corporation Law; § 803(a), New York Business Corporation Law. In the United Kingdom, the memorandum of association (formerly equivalent to the charter) and the articles of association (formerly equivalent to the bylaws) have been consolidated into the articles of association. These can be amended by the shareholders by means of a special resolution giving shareholders not only veto rights but initiation rights as well. For the purpose of this discussion, it suffices to say that the articles cannot be amended without their approval.

⁴⁵⁰ § 251(c), Delaware General Corporation Law; § 903(a), New York Business Corporation Law. Under the (United Kingdom) Companies Act, 2006, mergers and consolidation typically takes place under the aegis of a court order obtained as per part 26 of the act (and also part 27 if the company is a public company). This court order however requires a supermajority of 75% thereby giving shareholders a veto. As in the case of changes to the articles of association, shareholders also have initiation rights in this respect as members, creditors and if applicable, a liquidator or administrator can make an application under part 26 of the act. This takes nothing away from the veto rights of shareholders as a supermajority vote is required as the same.

⁴⁵¹ § 271(a), Delaware General Corporation Law; § 909(a), New York Business Corporation Law

⁴⁵² § 275, Delaware General Corporation Law; § 1001(a) & (b), New York Business Corporation Law

⁴⁵³ See Davies, Paul L. *Gower & Davies: The Principles of Modern Company Law*. Sweet and Maxwell, 2008 at 375-76. This reiterates that the UK has an almost identical requirement for shareholder ratification for fundamental decisions.

⁴⁵⁴ *Infra* note 481 at 18.

“Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorization of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.”

This is not just an ideological convergence across all major economies but also a convergence in terms of real world legal treatment. The OECD reports that provisions requiring shareholder approval for fundamental corporate decisions *“can be seen as a statement of the most basic rights of shareholders, which are recognized by law in virtually all OECD countries.”*⁴⁵⁵

This shows that shareholders have the right to ratify or reject certain fundamental corporate decisions in major world economies and that their rejection of such a decision typically bars the management from giving effect to the rejected proposal.

7.3 OTHER IMPORTANT DECISIONS REQUIRING SHAREHOLDER APPROVAL

This sub-section highlights the recent trend towards making executive compensation subject to the approval of shareholders. In recent times, the legislature in both the US and the UK has expanded the realm of the power of shareholders to approve corporate decisions. As per §951 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, 2010, companies are required to put their executive compensation plan to a non-binding vote before the shareholders.

Before October 1, 2013, the UK also required non-binding approval of shareholders for executive compensation plans. Section 439 of the Companies Act, 2006 required the non-binding approval of shareholders for the compensation of directors in the form of a remuneration report as per s. 420 of the same Act.⁴⁵⁶ This non-binding say-on-pay regime has

⁴⁵⁵ Development (OECD). Steering Group on Corporate Governance. *OECD Principles of Corporate Governance 2004*. OECD Publishing, 2004.

⁴⁵⁶ See *Infra* note 483; Gordon, Jeffrey N. ““Say on Pay”: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In.” *Harv. J. on Legis.* 46 (2009): 323-585; Conyon, Martin, and Graham Sadler. “Shareholder Voting and Directors’ Remuneration Report Legislation: Say on Pay in the UK.” *Corporate Governance: An International Review* 18, no. 4 (2010): 296-312.

had unimpressive results with empirical studies showing a very small, although noticeable reduction in what the researchers categorized as excessive compensation (particularly at the CEO level).⁴⁵⁷

The UK witnessed considerable political movement in the direction of introducing a binding say-on-pay vote for executive compensation which saw the light of day on October 1, 2013 in the form of the Enterprise and Regulatory Reform Act. This legislation requires that executive compensation plans be subject to the binding approval of shareholders.⁴⁵⁸

Unlike the nearly universal incidence of binding votes on fundamental corporate decisions, requiring a non-binding shareholder vote to approve a decision of the board is a relatively new concept.⁴⁵⁹ The requirement for shareholder approval with the possibility to ignore a negative outcome is found only a few countries and is narrowly restricted to decisions regarding executive compensation. Agency theory suggests that the compensation contracts of executives should be designed in order to maximize shareholder value.⁴⁶⁰ Since shareholders are numerous and dispersed, they delegate the negotiation of the compensation contracts to the board of directors. The problem is that the top management wields decisive influence on the appointment of directors and this creates a conflict of interest for the board of directors. The managers are instrumental in the appointment of directors and the directors determine the pay and benefits of the managers. This gives both groups an incentive to please each other rather than promoting shareholder value.⁴⁶¹

⁴⁵⁷ Ferri, Fabrizio, and David A. Maber. "Say on Pay Votes and CEO Compensation: Evidence from the UK." *Review of Finance* 17, no. 2 (2013): 527-563.

⁴⁵⁸ The UK's Enterprise and Regulatory Reform Act, 2013 requires the binding approval of shareholders every three years in the form of an ordinary resolution to approve the compensation policy that determines the compensation of the company's directors. Any deviation from this policy must also be approved by the shareholders.

⁴⁵⁹ The novelty of even non-binding 'say on pay' provisions is clear from their recent origin in the aftermath of the last financial crisis. As mentioned, binding 'say on pay' provisions are an even newer trend and as of now are seen only in the UK.

⁴⁶⁰ Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3.4 (1976): 305-360. The compensation contracts for senior executives often include provisions for bonding costs which are designed to minimize agency cost in order to maximize shareholder value.

⁴⁶¹ Cai, Jie, and Ralph A. Walkling. "Shareholders' Say on Pay: Does It Create Value?" *Journal of Financial and Quantitative Analysis* 46, no. 2 (2011): 299 at 300.

This is the root of the agency problem in executive compensation and giving the shareholders a say in the matter is thought to alleviate the problem.⁴⁶² Accordingly, even though executive compensation is not a 'fundamental corporate decision', it is made conditional to shareholder approval due to the large conflict of interest suffered by the board of directors. However, since this is a new practice, the US and the UK have differing opinions as to whether or not such approval must be binding on the directors in order to minimize agency cost and there is insufficient data to reveal a clearly superior strategy.

7.4 INCENTIVE TO GET INFORMED

This discussion looks at how the finality of a referendum impacts the information available to the principals who vote on it. Intuitively, the more important a decision, the more effort a rational person will expend in gathering and understanding the facts required to make an informed decision. This sub-section studies how the binding or precatory nature of a referendum impacts the incentives of principals to inform themselves. This is followed by an examination of how differences in citizens' incentives to get informed may impact the ability of referendums to manage agency cost.

Professor Kessler has argued that representatives will inform themselves of the issues necessary to make good decisions only if they have the discretionary power to make those decisions.⁴⁶³ This means that agents would not have proper incentives to adequately inform themselves if principals have the final say on a particular decision and the agents feel they are not accountable for its consequences.⁴⁶⁴ After all, it stands to reason that directors will have lesser incentives to inform themselves if the decision of shareholders is final rather than if it is the director's decision that will supersede that of the shareholders. This is true because the latter scenario would end with the adoption of the director's proposal and the board would be held responsible for its outcome.

⁴⁶² This contention has its opponents. See Bainbridge, Stephen. "Remarks on Say on Pay: An Unjustified Incursion on Director Authority." *UCLA School of Law, Law-Econ Research Paper* 08-06 (2008) for a discussion into the negative effects of shareholder say on executive pay.

⁴⁶³ Kessler, Anke S. "Representative versus Direct Democracy: The Role of Informational Asymmetries." *Public Choice* 122, no. 1-2 (2005): 9-38 at 10.

⁴⁶⁴ Myers, Minor. "Perils of Shareholder Voting on Executive Compensation, The." *Del. J. Corp. L.* 36 (2011): 417.

In the context of corporate governance, shareholder approval and rejection of management proposals are binding and final insofar as they relate to fundamental corporate decisions.⁴⁶⁵ This would suggest that such types of decisions are considered important enough to risk reducing the incentives of agents. Moreover, greater reductions of agency cost may be possible by directly ascertaining and acting on the preferences of shareholders.

The case of 'say-on-pay' provisions is interesting because such matters are not considered to have sufficient risk of escalating agency cost to require a binding vote by shareholders, at least in countries except the UK. Professor Kessler's argument holds good for shareholders as much as it does for directors. If shareholders know that their decision will be final, they will have a greater incentive to adequately inform themselves than if they know that their decision is not binding and it is the board of directors that will make the final decision.

This means that making 'say on pay' provisions non-binding rather than binding reduces the incentives of shareholders to inform themselves. Conversely, non-binding 'say on pay' provisions provide greater incentives to directors to inform themselves as compared to binding 'say on pay' provisions. 'Say on pay' is, therefore, an issue where binding shareholder veto is found to be excessive but the conflict of interest of the board of directors is considered high enough to merit a non-binding shareholder vote.⁴⁶⁶

Since US 'say on pay' provisions are non-binding, it is important to see how this impacts the information available and understood by shareholders who have less incentive to inform themselves than if the 'say on pay' provisions were binding. The short answer is that 'say on pay' provisions have had very limited success in reducing executive compensation.⁴⁶⁷ Large

⁴⁶⁵ See section 3.1.2.1

⁴⁶⁶ See section 3.1.2.2. As explained there, agency theory suggests that the compensation contract of executives should be designed in order to maximize shareholder value. Since shareholders are dispersed, they delegate the negotiation of the compensation contracts to the board of directors. The problem is that the top management wields decisive influence on the appointment of directors which creates a conflict of interest for the board of directors. The managers appoint the directors and the directors reward the managers giving both groups an incentive to please each other rather than promoting shareholder value. This is the root of the agency problem in executive compensation and giving the shareholders a say in the matter is thought to alleviate the problem.

⁴⁶⁷ See Cheffins, Brian R., and Randall S. Thomas. "Should Shareholders have a Greater Say over Executive Pay: Learning from the US Experience." *J. Corp. L. Stud.* 1 (2001): 277 for the US experience. See Ferri, Fabrizio, and David A. Maber. "Say on Pay Votes and CEO Compensation: Evidence from the UK." *Review of Finance* 17, no. 2 (2013): 527-563; Gordon, Jeffrey N. "'Say on Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In." *Harv. J. on Legis.* 46 (2009): 323-585; Conyon, Martin, and Graham Sadler. "Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK."

institutional shareholders who are instrumental for determining the outcome of shareholder votes can also be expected to be well informed of prevailing trends in executive compensation and to also have detailed knowledge regarding the performance of the company.⁴⁶⁸ Since such well-informed shareholders have shown limited interest in ‘say on pay’ votes, the lack of information caused by the non-binding nature of the vote cannot be blamed.

The ideal case to study here is the recent reform of the ‘say on pay rules’ in the UK to make them binding rather than precatory as they were until the Enterprise and Regulatory Reform Act 2013 went into effect in October 1, 2013. This will allow an analysis of the reasons why ‘say on pay’ should be binding and not precatory while not changing other variables.⁴⁶⁹ The UK’s Department for Business Innovation and Skills proposal behind the enactment of this law suggests that the reason for making shareholder ‘say on pay’ votes binding was that “feedback from shareholders is that many companies are not responding adequately to their concerns”.⁴⁷⁰ A reading of the proposal and the enacted legislation suggests that the non-binding nature of ‘say-on-pay’ provisions has not been found to be the cause of insufficient information amongst shareholders in the UK. Instead, the documents and debates leading to the adoption of the Enterprise and Regulatory Reform Act 2013 have identified the lack of information as a separate issue and addressed it as such. In fact, the proposal from the Department for Business Innovation and Skills is packed with separate requirements for the simplification of the executive compensation plan so shareholders may better understand it. It

Corporate Governance: An International Review 18, no. 4 (2010): 296-312 for the UK experience (not accounting for the forthcoming introduction of binding say on pay provisions).

⁴⁶⁸ Gillan, Stuart, and Laura Starks. “Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective.” *Weinberg Center for Corporate Governance Working Paper* 2003-01 (2003).

⁴⁶⁹ This dissertation was complete at the time the Enterprise and Regulatory Reform Act 2013 came into force on October 1, 2013. The dissertation has been revised to reflect the change in the law. However, it is impossible to include an analysis of the impact that this change will have since no data is yet available.

⁴⁷⁰ See the UK’s Department for Business Innovation and Skills proposal for making say on pay for executive compensation binding at

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31653/12-900-directors-pay-guide-to-reforms.pdf

also includes requirements to provide data that helps shareholders to compare the compensation plan to those of similar companies.⁴⁷¹

This means that making ‘say on pay’ provisions binding is not thought to be a solution to making shareholders more informed by the UK experts involved in the drafting of the Enterprise and Regulatory Reform Act 2013. This in turn suggests that the link between binding vetoes and shareholder’s incentive to inform themselves has not been recognized as crucial by UK lawmakers.

This debate translates well into the constitutional context. Referendums held at the national or regional levels typically deal with well-publicized topics that generate considerable media attention. They are highly publicized and debated which means that the information required to make an informed decision is, by and large, available to the public. The information condition is also different from corporate governance if the referendum concerns issues that are of moral or social import. For example, referendums on issues like gay marriage, euthanasia etc. have a strong moral component where citizens can vote their conscience with the help of information in the public sphere without expending significant time and resources to gather specialized information.⁴⁷²

More importantly, unlike shareholder votes, the rule of one person-one vote and large populations means no citizen can rationally expect his or her vote to decide the outcome of an election. This is a crucial difference because the number of citizens is extremely large and unlike corporate governance, one person cannot accumulate disproportional voting rights. It is, therefore, not unreasonable to argue that citizens would have similar incentives to inform themselves regarding a referendum regardless of whether or not their vote will determine the end outcome. In other words, citizens will vote to express their preferences in a non-binding referendum even if they cannot rationally expect their actions to change the end result. After all, citizens can never rationally expect their single vote to change the outcome of an election, poll or referendum but they inform themselves and vote anyway.

⁴⁷¹ *Ibid.*

⁴⁷² Matsusaka, John G. “The Eclipse of Legislatures: Direct Democracy in the 21st Century.” *Public Choice* 124, no. 1-2 (2005): 157-177 at 163. “Think of moral issues such as whether to allow gay marriage or physician assisted suicide. Many budgetary policies share the same flavor; they are mainly about establishing spending priorities and do not require a great deal of expertise to form an opinion.”

It can, therefore, be said that although there is some added incentive to gather information if a referendum is binding, this connection has been downplayed in corporate governance by the UK government. The legal position in Delaware also gives the same insight. By making the approval of executive compensation non-binding, it assumes that shareholders will have sufficient incentives to inform themselves regarding the issue even when their decision is not final. Put differently, factors other than the principals' incentive to collect and assimilate information must be relied upon to decide whether or not a referendum should be binding.

7.5 FRAMING CONCERNS

Agents can use cleverly framed referendums to represent the wishes of the principals as different from what they really are. This would increase agency cost since it increases residual loss. The residual loss is increased because strategic wording of the proposal can create a gap between the real preferences of the citizens and the perceived preferences of the citizens as will be expressed in the referendum.⁴⁷³ If the agents then act on the basis of a distorted view of citizen's preferences provided by an improperly framed referendum, their actions and policies will naturally not be aligned with the citizen's true preferences.

A good example of framing concerns in referendums is the one called by General Augusto Pinochet in Chile in 1978. The referendum question asked the Chileans to vote yes or no on the following question:

*"In the face of international aggression against the government of our fatherland, I support President Pinochet in his defense of Chile's dignity, and I once again confirm the legitimacy of the government of the republic in its leadership of the institutional proceedings in this country."*⁴⁷⁴

A yes vote would extend General Pinochet's term by another eight years while a no vote would trigger general elections in December 1989.

⁴⁷³ Residual loss is the cost of a difference between the preferences of the principals and the actions of the agents.

⁴⁷⁴ Beramendi, Virginia, Andrew Ellis, Bruno Kaufman, Miriam Kornblith, Larry LeDuc, Paddy McGuire, Theo Schiller, and Palle Svensson. *Direct Democracy: The International IDEA Handbook*. International IDEA, 2009 at 49.

This question reads more like a test of patriotism rather than a referendum on the leadership of General Pinochet. The confusing wording of the referendum question surely led to many people voting yes because they were concerned about the defense of Chile's dignity in the face of international aggression, an argument that is not the subject of the referendum. By framing the referendum this way, General Pinochet was able to avoid calling for general elections, succeeded in entrenching himself in power and heaped on his people the extraordinary agency costs associated with the residual loss brought about by eight more years of military dictatorship.⁴⁷⁵

The tactical framing of referendums can especially escalate residual loss if the referendum is used to bypass a constitutional or legal obstacle that barred the action in the absence of such a referendum. For example, legislators may frame referendums cleverly to convince voters to approve measures that take away certain rights in countries where the constitution requires that such measures be approved through referendum. In such instances, strategic framing may allow agents to defeat safeguards designed to minimize agency cost in the form of the requirement to hold mandatory referendums. From this, it is clear that framing can be a problem and will increase agency cost if abused by the agents to circumvent constitutional checks and balances.

The question here is, however, whether the residual loss component of agency cost would be reduced in such circumstances if the referendum were non-binding or whether the residual loss component of agency cost would increase if it were binding. A strategically worded referendum can allow agents to demonstrate inflated support for a policy or leader. It can also allow them to overcome certain constitutional or legal barriers to the adoption of the policy. In all these circumstances, a non-binding vote would work just as well as a binding one.

If the vote is binding and successfully manipulated by clever framing, agency cost sees an increase in the form of an increase in residual loss. On the other hand, if the vote is non-binding, the authority to make the decision remains with the agents. In such a case, the agents can use the manipulated referendum to show support for their position and then make the decision themselves. Either way, the policy of the country will deviate from the preferences of the principals. Both situations will lead to a similar increase in residual loss and, therefore,

⁴⁷⁵ Panzer, John, and Ricardo D. Paredes. "The Role of Economic Issues in Elections: The Case of the 1988 Chilean Presidential Referendum." *Public Choice* 71, no. 1-2 (1991): 51-59 at 51.

similar increase in agency cost. Therefore, when legislators successfully misguide the citizens into voting for a referendum that is against their interests, it does not matter much whether or not the referendum is binding as far as the impact on agency cost is concerned. The solution to controlling an escalation in agency cost due to improper framing of referendums, therefore, lies in rules governing how referendums can be framed and not by making the referendum non-binding.

7.6 SEPARATION OF DECISION MANAGEMENT AND DECISION CONTROL

Chapter 4 discussed Professors Fama and Jensen's argument that the separation of decision management (initiation and implementation) and decision control (ratification and monitoring) is critical to minimizing agency cost.⁴⁷⁶ This section examines how this axiom applies to the question of whether or not referendums should be binding in order to minimize agency cost.

In the case of referendums, the initiation function of decision management is performed by the government because it creates the proposal that the referendum is supposed to decide.⁴⁷⁷ Therefore, Professors Fama and Jensen's arguments suggest that in order to effectively reduce agency cost, the ratification function of decision control must move to another party. Corporate governance is now examined for pointers as to how this can be done.

Corporate law in all American states, the UK and as per the OECD report,⁴⁷⁸ the corporate laws of all modern economies require that fundamental corporate decisions that are initiated by the board of directors should be subject to the approval of the shareholders.⁴⁷⁹ Therefore, corporate governance uses the principals as a distinct source of ratification for decisions

⁴⁷⁶ See Section 2.4. See also Fama, Eugene F., and Michael C. Jensen. "Agency Problems and Residual Claims." *Journal of Law and Economics* 26, no. 2 (1983): 327-349 at 331 and Klein, Benjamin. "Contracting Costs and Residual Claims: The Separation of Ownership and Control." *Journal of Law and Economics* 26, no. 2 (1983): 367-374 at 372.

⁴⁷⁷ See Matsusaka, John G. "Initiative and Referendum." *The Encyclopedia of Public Choice*. Springer US, 2003 at 624-628. "Referendum" is defined as "a process that allows the electorate to approve or reject a proposal by the legislature."

⁴⁷⁸ Development (OECD). Steering Group on Corporate Governance. *OECD Principles of Corporate Governance 2004*. OECD Publishing, 2004 at 18.

⁴⁷⁹ See Section 5.1.

initiated by the agents. The nearly universal principle of requiring the approval of shareholders for fundamental corporate matters, therefore, effectively separates decision management and decision control for the most important types of decisions.

These types of decisions are often 'rules of the game' decisions that regulate the relations between the agents and the principals and between the principals themselves. Since such decisions have a high propensity for increasing agency costs if the agents were in complete control, the corporate governance approach seems to be conducive to lower agency costs.

Alas, the situation in constitutional law is not as simple. Referendums are called not only when special types of decisions need to be made but also when special circumstances arise. For example, the constitution may require a referendum if there is a disagreement between the President and the legislature⁴⁸⁰ or as a means of bypassing a strict supermajority requirement in the legislature.⁴⁸¹

This means that referendums are not necessarily initiated by a certain majority in the legislature. Therefore, if such a decision is subjected to a non-binding referendum and the final decision is made by the legislature in light of such a referendum, decision management and decision control are not necessarily intermingled. This is because such referendums can be initiated by the President or by a minority in the legislature and then ratified by the complete legislature (with a sufficient majority) with the benefit of knowing the citizens' preferences. This means that, unlike the case of corporate governance where a non-binding vote on fundamental corporate changes would be contrary to Professors Fama and Jensen's argument, the case for binding political referendums is not as straightforward.

It might, therefore, be argued that referendums on issues like constitutional amendments proposed by the legislature should be binding in order to ensure the separation of decision management and decision control in rules of the game decisions. This is because these decisions, like fundamental corporate decisions may seriously impact agency cost by altering the principal-agent relationship itself. Like fundamental corporate decisions proposed by the

⁴⁸⁰ See for example the Icelandic constitution that required a referendum on laws passed by the Parliament but rejected by the President as soon as possible.

⁴⁸¹ See for example the case of Denmark where a referendum is required on decisions involving transfers of national sovereignty if the measure is not supported by 5/6th of Parliament. Israel also requires a referendum on returning occupied territory if the measure has less than 2/3rd support in the Knesset, the Israeli Parliament.

board of directors, most referendums are proposed by the government which enjoys the support of a majority in the legislature. In such situations, if the referendum is non-binding, the same institution would be control both decision management and decision control and lead to high agency cost.

On the other hand, referendums can also be triggered by a difference in opinion between the President and the legislature or on the basis of a motion by a specified minority of legislators. In such cases, the decision cannot be said to have been initiated done by a majority vote in the legislature. However, if such a proposal is approved or rejected by a non-binding referendum, the final decision will be taken by a majority vote in the legislature. In such cases, even a non-binding referendum would satisfy Professor Fama and Professor Jensen's suggestion to avoiding combining decision management and decision control. This is because the approval function is exercised by a majority in the legislature while the initiation of the decision is triggered by causes such as a disagreement of the legislature with the President as provided by the constitution of Iceland or by a resolution by a minority of legislators.

Therefore, as per Professors Fama and Jensen's argument for separating decision management from decision control to reduce agency cost, referendums initiated by a majority of the legislature should be binding in order to effectively reduce agency cost. Here, the legislature initiates the decision thereby assuming the function of decision management. If the referendum is non-binding, once the citizens have approved or rejected the proposal, the legislature would sit in judgment once again to wield the real power of decision control by approving or rejecting the result of the referendum. This can lead to high agency costs.

However, when the referendum is triggered by actors other than a majority in the legislature, even non-binding referendums can separate decisions management and decision control since a majority in the legislature does not initiate the decision but only gives the final approval. Such decisions can, therefore, be subject to non-binding referendums without risking high agency costs.

7.7 THE FINALITY OF BINDING REFERENDUMS

Binding referendums can help to reduce agency cost if they are actually effective in helping principals to block a proposal that is against their interests. This sub-section looks at how

agents can sometimes bypass binding referendums and how this impacts the ability of binding referendums to minimize agency cost.

In 1992, the government of Denmark failed to get the approval of the citizens in a referendum to decide whether to ratify the Maastricht Treaty. So they tried again with a reworded referendum in 1993.⁴⁸² Similarly the Irish government failed to get the approval of the citizens for the ratification of the Nice Treaty 2001. So they tried again in 2002 with somewhat different wording.⁴⁸³ This attempt to keep putting an issue to referendum till it gets accepted was taken to an extreme in Palau, which held seven referendums to allow the passage of nuclear capable warships from the United States through its waters. All of them failed. Eventually, the government reduced the super-majority requirement of 75% required to allow nuclear weapons and platforms in Palau as established by its constitution and the treaty was signed in 1993.⁴⁸⁴ The question then becomes one of how binding a binding referendum really is?

As seen from the previous examples, the results of a binding referendum are final only until the time that they are overturned by another binding referendum. This shows that the need to change policy with changing circumstances is not unduly hindered by binding referendums. Writing about the repeated referendums in Denmark and Ireland, Professors Worre and Hayward concede that circumstances had changed when the second referendums were held from what they were during the first.⁴⁸⁵ The ability of the government to hold repeated referendums on the same issue is, therefore, a positive thing in light of the fluid circumstances facing nations. The question of interest to agency cost, therefore, becomes how often the government should be able to put forward the same measure for referendum? Too often would cause the public to lose faith in the referendum process and too large intervals would reduce the ability of the state to respond to changing circumstances.

⁴⁸² Worre, Torben. "First No, Then Yes: The Danish Referendums on the Maastricht Treaty 1992 and 1993." *JCMS: Journal of Common Market Studies* 33, no. 2 (1995): 235-257.

⁴⁸³ Hayward, Katy. "'If at first you don't succeed...': The Second Referendum on the Treaty of Nice, 2002." *Irish Political Studies* 18, no. 1 (2003): 120-132.

⁴⁸⁴ Hinck, Jon. "The Republic of Palau and the United States: Self-Determination Becomes the Price of Free Association." *California Law Review* (1990): 915-971.

⁴⁸⁵ *Supra* note 508.

In the case of corporate law, it is the notice provisions that force the board of directors to space out the votes on fundamental corporate decisions. This means that every time the board of directors wants to seek the approval of shareholders on a proposal, they need to circulate it afresh which provides a minimum time interval between such votes. Corporate law, therefore, indirectly requires that a period of time elapses between successive shareholder votes on proposals initiated by the board of directors. Since referendums are much more expensive and difficult to organize than shareholder meetings, it is advisable that constitutional law adopt a much larger minimum interval between consecutive referendums. This will help to ensure that the monitoring cost associated with the holding of referendums does not exceed the potential reduction in residual loss provided by the blocking of unpopular actions of the government.

This solution is directly applied in constitutional law in the Constitution of Argentina which requires that no referendum be repeated within two years of its rejection. The requirement for a reasonable period of time to elapse between successive referendums on the same issue seems to be a good compromise to ensure the sanctity of the referendum as well as allow for its review after a reasonable period of time by the principals. This will ensure that the monitoring cost of holding referendums does not exceed potential savings in terms of the reduction in residual loss.

7.8 FINDINGS

This chapter shows that corporate law in the world's major economies almost always provides for shareholders to exercise binding veto power over fundamental corporate decisions initiated by the board of directors. In the US and the UK, shareholders are also required to approve executive compensation plans because directors suffer from a strong conflict of interest while making such decisions. This requirement to get shareholder approval exists even though such decisions cannot be termed as fundamental corporate decisions having an impact on the 'rules of the game'. In the case of such decisions, corporate law is not uniform across jurisdictions as to whether the veto rights of shareholders are binding or non-binding.

Accordingly, the chapter looks deeper in corporate governance literature to identify insights regarding the relative potential of binding and non-binding referendums to minimize agency

cost. The first issue considered is how binding and non-binding referendums influence the incentives of principals and agents to gather and assimilate information. Professor Kessler argues that both shareholder and directors have incentives to gather information relevant to making decisions when they have the discretionary power to make that decision.

Applying this reasoning to constitutional law suggests that citizens would have higher incentives and legislators would have lower incentives to inform themselves when decisions are subject to a binding referendum. The situation is reversed when the decision is subject to a non-binding referendum where citizens' incentives to inform themselves are lowered and the incentives of the legislators are increased. This relationship is made more complicated by other issues that are peculiar to constitutional law and do not arise in corporate law. The information required to vote on a referendum receives widespread media publicity and citizens have the benefit to using cues to understand issues that they would not be able to analyze themselves. Furthermore, many issues raised in referendums may not require any specialized information and be decided on the basis of social and moral norms. Lastly, it is argued that citizens inform themselves sufficiently to vote at elections when they know that the odds of their vote changing the outcome is negligible so it may be assumed that citizens gather information out of a sense of civic participation even when their individual vote may not change outcomes.

Next, the chapter examines the impact of strategic framing of the referendum question on agency cost and compares how binding and non-binding referendums affected by this. The results of this examination are straight forward. Both binding and non-binding referendums have the same effect of rubber stamping and giving legitimacy to the decisions of the legislature if the legislature succeeds in confusing the citizens who vote on it. After all, if the government succeeds in getting the citizens to approve a value decreasing proposal in either a binding or a non-binding referendum, it will lead to an increase in residual loss not to mention the monitoring cost brought about by holding the referendum.

This chapter then looks at how the corporate governance scheme for separating decision management from decision control in order to minimize agency cost can be insightful to understanding binding and non-binding referendums. This scheme suggests that the entity initiating a decision should not also have the power to approve that decision. Based on this principle, corporate governance ensures that directors perform decision management and the shareholders perform decision control while making fundamental corporate decisions by

requiring binding shareholder approval. If the directors were to sit in final judgment and decide whether or not to defer to the decision of the shareholders, it is the directors who would fulfil both roles.

This reasoning also applies to constitutional law when the legislature asks for a referendum by a majority vote. If such a referendum refers to a ‘rules of the game’ decision, agency cost would be minimized by requiring a binding referendum. However, not all referendums are triggered by a majority vote in the legislature. When the constitution permits the President or a minority of the legislators to call a referendum, even a non-binding referendum can serve to minimize agency costs. In such cases, the proposal will be decided by a majority of the legislators if it is adopted in the referendum while the initiation would have been done by the President or a minority of legislators. In such cases, non-binding referendums might also adequately minimize agency cost.

Lastly, the chapter examines whether legislators should be allowed to act contrary to the results of a binding referendum after a certain amount of time has passed and also to determine how subsequent referendums can be held on that subject. A positive examination of constitutions around the world shows that legislatures have in fact adopted policies that their citizens have earlier rejected in binding referendums. This has been done either by ignoring the previous referendum or by holding repeated referendums and manipulating the procedure used until the legislators got the results they desired.

In the case of constitutional law, it would be unwise to prohibit any further action by the legislature merely because a proposal was defeated in a referendum because circumstances might change in the future. On the other hand, it is also important to ensure that legislatures do not keep holding referendums in the hope of getting the outcome that they want until citizens lose faith in the process. Accordingly, the corporate governance solution is to require the agents to wait till the next meeting of the principals to resubmit the defeated proposal. However, keeping in mind the great cost of holding referendums, a reasonable interval such as the period of two years required by Argentina between successive binding referendums on the same issue is recommended.

It is argued that if the suggestions given in this chapter are adopted, binding referendums can be expected to reduce agency cost when ‘rules of the game’ decisions are to be made or when deciding issues that create a conflict of interest for the legislators. On the other hand, non-

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binding referendums can help to minimize agency cost when making specific business decisions and also when referendums are called by means other than a majority vote in the legislature.

8 SHOULD INITIATIVES BE BINDING?

Having discussed the question of whether or not referendums should be binding, this chapter asks the same question with respect to initiatives. The following sections examine how the impact of initiatives on agency cost depends on whether or not the results of the initiative are binding (or non-binding).

8.1 INITIATIVES AROUND THE WORLD: BINDING OR NON-BINDING?

Out of 214 countries and territories surveyed, the citizens of only 37 have the right to propose and pass a citizens' initiative at the national level. However, such initiatives are provided for at the local or provincial level in far more countries. Of the 37 countries that allow for initiatives at the national level, 26 countries allow for citizens' initiatives for amendments to ordinary legislation while 20 countries allow them to amend the constitution.⁴⁸⁶

Most countries that allow for citizens' initiatives to make such constitutional amendments also provide for initiatives on legislative amendments. However, there may be limits on the power of citizens to amend the constitution. For example, the constitution of Slovakia allows citizens to amend the constitution via initiatives but does not allow them to make amendments that affect basic rights and liberties.⁴⁸⁷ On the other hand, countries like Switzerland allow for initiatives on constitutional amendments, but not on regular legislative matters at the national level.⁴⁸⁸

Therefore, when initiatives are allowed, some constitutions allow initiatives only for fundamental questions like constitutional amendments, while reserving regular legislative

⁴⁸⁶ Beramendi, Virginia, Andrew Ellis, Bruno Kaufman, Miriam Kornblith, Larry LeDuc, Paddy McGuire, Theo Schiller, and Palle Svensson. *Direct Democracy: The International IDEA Handbook*. International Idea, 2009 at 62. "[S]ome countries which have no such instruments [citizens' initiatives] at the national level do provide initiative rights at the regional and the local levels – particularly large federal countries such as Brazil, Germany or the United States. In the United States, 24 of the 50 states have provisions for citizens' initiatives. Other jurisdictions offer them at the local level only, for example, Mexico, Panama and many European countries."

⁴⁸⁷ Frey, Bruno S. "Direct Democracy for Transition Countries." *Development and Transition* 7 (2003): 42-59.

⁴⁸⁸ Kriesi, Hanspeter, and Dominique Wisler. "Social movements and direct democracy in Switzerland." *European Journal of Political Research* 30, no. 1 (1996): 19-40.

matters for the legislature. Other constitutions have adopted the opposite approach where they consider constitutional amendments to be too important to be left to citizens, and only allow them to use initiatives to decide normal legislative subjects. Some other constitutions allow for initiatives on both types of decisions, i.e. constitutional amendments and normal legislative subjects.

Citizens must collect a predetermined number of signatures on a petition to demonstrate the support of a proportion of the citizenry in a specified amount of time. There might be additional requirements such as demonstrating minimum amount of support for the petition in individual geographic territories. Once the eligibility criterion is met, the petition is put to a popular vote as an initiative proposal. The required majority might be different for different types of amendments proposed. For example, it might be higher super majority requirement for constitutional amendments. Additionally, a quorum of minimum turnout as a percentage of the voting population may also be required for the popular vote to be binding.

If the proposal receives a majority, or in some cases a super-majority of the votes, two things can happen. If the initiative is binding, the proposal is adopted and it becomes law. If the initiative is non-binding, the proposal is considered by the legislature that has the final say on whether or not to adopt it.

Initiatives are, therefore, not necessarily binding on the legislature. Non-binding initiatives are known as agenda initiatives. Agenda initiatives give citizens the right to put an issue before the legislature for discussion as long as certain signature requirements are met in a specified time and the issue is open to such initiation as per the constitution. The legislature is only required to consider the proposal and is not required to vote on it, let alone required to implement it. Hence agenda initiatives are non-binding.

Like the citizens' initiative, agenda initiatives are not as wide spread as referendums. Out of 214 countries surveyed, as of 2008, agenda initiatives were only available at the national level in 46 countries and territories and only at the local or provincial level in 9 countries and territories.⁴⁸⁹

⁴⁸⁹ *Supra* note 512 at 84-89. The signature requirements for agenda initiatives vary from no less than 25% of the voting population in Uruguay to less than 1% in Georgia. The signature requirement can also vary depending on whether the agenda initiative is connected to a constitutional or legislative amendment as in the case of Costa Rica.

8.2 THE FINALITY OF DECISIONS INITIATED AND APPROVED BY SHAREHOLDERS

This section examines the power of shareholders to initiate and approve decisions to see whether they are binding or not. These decisions can be made in the form of shareholder proposals and in some cases, specifically through shareholder initiated bylaw amendments.⁴⁹⁰

Unlike the power of shareholders to approve or reject fundamental corporate decisions⁴⁹¹, their right to initiate decisions that bind the board of directors is not consistent across major economies.⁴⁹² To highlight the different schools of corporate thinking, this sub-section will separately examine the rights of shareholders to initiate policy in the US and in the UK.

8.2.1 *The US Position*

Delaware and the US states that follow the Model Business Corporation Act vest the power to manage the business and affairs of the corporation in the board of directors.⁴⁹³ This includes the power to initiate rules of the game decisions as well as specific business decisions including game-ending decisions and scaling down decisions.⁴⁹⁴

Rules of the game decisions are classified by Professor Bebchuk as those decisions that concern the ‘choice of the rules by which corporate actors play’.⁴⁹⁵ They are codified in the

Interestingly, several countries exclude important public policy issues like constitutional amendments (Austria, Brazil, Cape Verde, and Thailand), the adoption of international treaties (Austria, Mali, Peru), public expenses (Albania, Burkina Faso, Uruguay) and devolution of power (Niger) outside the purview of agenda initiatives.

⁴⁹⁰ The following discussions on US and UK law provide distinctions between shareholder proposals and shareholder initiated bylaw amendments based on the statutory provisions of the respective countries.

⁴⁹¹ See section 5.1.

⁴⁹² See section 5.2.

⁴⁹³ Delaware General Corporation Law, §141(a); Model Business Corporations Act, §8.01(b) and New York Business Corporation Law §701.

⁴⁹⁴ See section 4.1.

⁴⁹⁵ Bebchuk, Lucian Arye. “The Case for Increasing Shareholder Power.” *Harvard Law Review* (2005): 833-914.

charter of the company and in the corporate laws of the state of incorporation. The board of directors has the exclusive right to initiate changes to both these sources of rules as only the board can initiate an amendment to the charter⁴⁹⁶ or reincorporate in another state by proposing a merger with a shell company in that state. The shareholder's power to initiate rules of the game decisions is restricted to proposing bylaw amendments⁴⁹⁷ – a power they share with the board of directors. This power is hamstrung by the fact that bylaws are subordinate to the provisions of the charter and they cannot be used to opt out of default provisions of the DGCL and the MBCA.⁴⁹⁸

By and large, corporate law in the US allows for by-laws "relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees"⁴⁹⁹ By amending the bylaws, shareholders can ostensibly initiate and ratify decisions concerning these issues without the approval of the board. Interestingly, the most popular use of the bylaw amendment is to get rid of shareholder rights plans (the so called 'poison pill') or to prohibit their future adoption.⁵⁰⁰ This is

⁴⁹⁶ Delaware General Corporation Law, §242(b); Model Business Corporations Act, §10.03 and New York Business Corporation Law §803(a).

⁴⁹⁷ Delaware General Corporation Law, §109; Model Business Corporations Act, §10.20 and New York Business Corporation Law §601.

⁴⁹⁸ See *Supra* note 521 at 845. There are certain exceptions to this particularly relating to the election of directors whereby shareholders may initiate and vote upon the decision to opt out of the Delaware General Corporation Law's default of plurality voting. Modifications to the Delaware General Corporation Law in 2006 retained the plurality vote default rule but mandated that the board of directors cannot modify or rescind a shareholder adopted bylaw that requires a greater of votes for director elections. This move was reflected in amendments to the corporate laws of California, Virginia and Washington that had a similar effect. The debate regarding proxy access also relates to the ability of shareholders to initiate changes to the process whereby directors are elected by changing the default rule. The position of law on this issue is under considerable flux and there is no consensus on the optimal situation.

⁴⁹⁹ Extracted from § 109(b), Delaware General Corporation Law. Other states have similar statutes as well. See for example N.Y. Bus. CORP. LAW § 601(c); CAL. CORP. CODE § 212(b); FLA. STAT. ANN. § 607.0206(2); OHIO REV. CODE ANN. § 1701.11(A); 15 PA. CONS. STAT. ANN. § 1504(A); TEX. Bus. CORP. ACT ANN. art. 2.23(A). Examples other than the Delaware General Corporation Law and NY law cited from Hamermesh, Lawrence A. "Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street." *Tul. L. Rev.* 73 (1998): 409 at 413

⁵⁰⁰ Poison pill rights plans are anti-takeover devices that allow all shareholders except for the shareholder who has reached a threshold percentage of shareholding (the prospective acquirer) to buy additional shares at a discount. Since the board of directors has the power to decide whether or not to invoke this provision, prospective acquirers are forced to negotiate with the board. If the acquirer does not get the board's approval and the poison pill is triggered, the value of the acquirer's shares will fall as additional shares are sold at a discount. Furthermore, the acquirer's shareholding in the company will decline in terms of percentage of shares held making the takeover more difficult. See also Gordon, Jeffrey N. "Just Say Never-Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett." *Cardozo L. Rev.* 19 (1997): 511.

important for the purpose at hand because such measures are often opposed by the board of directors due to a conflict of interest since poison pills increase the ability of directors to entrench themselves.⁵⁰¹

Bylaws can be initiated and adopted by the shareholders and nothing needs to be done by the board of directors for them to take effect. Since the board of directors is bound by such bylaws, shareholders undoubtedly have the power to make binding bylaw amendments. This is because bylaws are self-executing and the board of directors has no opportunity or authority to approve or reject bylaws adopted by the shareholders.⁵⁰²

However, since shareholder bylaw amendments provide a means to shareholders to check the power of the board, such power would be ineffective if the board of directors could simply repeal or replace the amended provision in the bylaw.⁵⁰³ While this issue is discussed in detail in section 8.4, to help place it in context, the discussion is summarized here.

The corporate law of Delaware and New York do not specifically allow shareholders to adopt bylaws that forbid subsequent amendment by the board of directors as long as the charter empowers the board to amend the company's bylaws.⁵⁰⁴

As per (then) Vice Chancellor Strine of the Delaware Chancery Court, the judicial interpretation of Delaware courts on the issue is inconclusive as to "whether, in the absence of an explicitly controlling statute, a stockholder-adopted bylaw can be made immune from repeal or modification by the board of directors."⁵⁰⁵ This is because of two earlier

⁵⁰¹ See Gordon, Jeffrey N. "Just Say Never-Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett." *Cardozo L. Rev.* 19 (1997): 511. Professor Gordon agrees that shareholders have had little success in repealing poison pill rights plans through shareholder initiated bylaw amendments. However he argues that, on principle, shareholders should have the right to adopt bylaw amendments that limit the use of poison pills.

⁵⁰² Brownstein, Andrew R., and Igor Kirman. "Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions." *The Business Lawyer* (2004): 23-77 at 52-53.

⁵⁰³ See section 8.4.

⁵⁰⁴ Hamermesh, Lawrence A. "Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street." *Tul. L. Rev.* 73 (1998): 409 at 417. § 109 of the Delaware General Corporation Law and § 601 of the N.Y. Bus. CORP. LAW for example shows no evidence of such restrictions on the power of the board of directors to adopt, amend and repeal bylaws.

⁵⁰⁵ As per Vice Chancellor Strine (in dicta) in *General DataComm Industries, Inc. v. State of Wisconsin Investment Board*, 731 A.2d 818, 821 n.1 (Del. Ch. 1999).

contradictory decisions that have not yet been resolved. The first is *American Int'l Rent a Car, Inc. v. Cross*⁵⁰⁶ which held that shareholders could include provisions in a bylaw that barred the board of directors from further amending the bylaw in question. This stands in opposition to *Centaur Partners, IV v. National Intergroup, Inc.*⁵⁰⁷ In this case, the Delaware Supreme Court ruled that a bylaw limiting the number of directors was void because it specifically barred the board of directors from amending it in the future. This was because the charter of the company allowed the board of directors to determine the number of directors on the board by adopting bylaws. To add to this lack of clarity, directors can also use their exclusive right to amend the charter to undo the effect of many shareholder initiated bylaw amendments.

It should be noted that there is a special provision in the DGCL that allows shareholders to adopt bylaws related to the number or proportion of votes required for director elections that includes a clause barring the board of directors from amending the bylaw.⁵⁰⁸ This is clear evidence that the statute does indeed envisage circumstances where shareholders can initiate and adopt decisions immune from subsequent amendment by the board of directors. Section 8.3 and 8.4 analyze this issue at length and draw conclusions regarding whether or not the legislature should be allowed to amend laws passed by initiative.

Having pointed out the legal position regarding the ability of directors to amend or repeal shareholder-adopted bylaws, the power and responsibility of the board of directors to manage the business and affairs of the corporation is examined.⁵⁰⁹ This raises a question regarding which takes precedence - the discretionary power of the board or right of shareholders to adopt bylaws.

Practically speaking, proposals for binding shareholder bylaw amendments need to satisfy the conditions of Rule 14a-8 if they are to be included in the company's proxy for circulation to shareholders at the expense of the company. This is a critical requirement since privately

⁵⁰⁶ *American Int'l Rent a Car, Inc. v. Cross*, 1984 WL 8204 (Del. Ch. 1984).

⁵⁰⁷ *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A.2d 923, 929 (Del. 1990).

⁵⁰⁸ See § 216, Delaware General Corporation Law.

⁵⁰⁹ See for example Delaware General Corporation Law, § 141(a), Model Business Corporations Act, §8.01(b) and New York Business Corporation Law §701.

financing the solicitation of proxies creates a free rider problem. The solicitor of the proxies must bear the entire cost of soliciting proxies but will only be able to capture a pro rata percentage of possible benefits in proportion to his shareholding in the company. Accordingly, the requirements of Rule 14a-8 in this regard must be examined to determine the actual possibility of shareholder adopted bylaws to bar further amendments by the board of directors.

One of the requirements that any proposal circulated under Rule 14a-8 must meet is that it must be in compliance with the law of the state of the company's incorporation. This means that the legal uncertainty discussed in *American Int'l Rent a Car, Inc. v. Cross*,⁵¹⁰ *Centaur Partners, IV v. National Intergroup, Inc.*⁵¹¹ and *General DataComm Industries, Inc. v. State of Wisconsin Investment Board*⁵¹² also affects the application of Rule 14a-8. This requirement and the SEC's conservative approach to approving proposals means that many shareholder proposals are rejected due to the unsettled position of Delaware law on shareholder bylaws not amenable to amendment by the board.⁵¹³

This reluctance on the part of the SEC is based on fundamental legislative grounds caused by a conflict that is difficult to resolve. While § 109(a) of the Delaware General Corporation Law empowers shareholders to adopt bylaws, § 109(b) provides that "the bylaws may contain any provision, not inconsistent with the law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." This grant of power creates a conflict with § 141(a) of the Delaware General Corporation law which confers similarly comprehensive powers to the board of directors. Per § 141(a), "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of

⁵¹⁰ *American Int'l Rent a Car, Inc. v. Cross*, 1984 WL 8204 (Del. Ch. 1984).

⁵¹¹ *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A.2d 923, 929 (Del. 1990).

⁵¹² *General DataComm Industries, Inc. v. State of Wisconsin Investment Board*, 731 A.2d 818, 821 n.1 (Del. Ch. 1999).

⁵¹³ "When drafting a proposal, shareholders should consider whether the proposal, if approved by shareholders, would be binding on the company. In our experience, we have found that proposals that are binding on the company face a much greater likelihood of being improper under state law and, therefore excludable under Rule 14a-8(i)(1)." See Div. of Corp. Fin., Sec. & Exch. Comm'n, Staff Legal Bull. No. 14, § G, at 28 (July 13, 2001). Cited from Brownstein, Andrew R., and Igor Kirman. "Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions." *The Business Lawyer* (2004): 23-77 at 54.

a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”

It is argued that § 141(a) provides that the board of director’s authority to manage the business and affairs of the company is expressly limited by provisions of Chapter 1 of the DGCL or the certificate of incorporation. The exclusion of the bylaws as a source of limitation on the powers of the board of directors in this section can, therefore, be interpreted to be a conscious exclusion by legislature. Therefore, bylaws that interfere with the encompassing power of the board to manage the affairs of the company may fall foul of Delaware law and § 141(a) in particular. Furthermore, if § 109(a) and (b) are construed to override § 141(a), we are left with a situation where shareholders have the power to control any aspect of the functioning of the company.⁵¹⁴

Accordingly, shareholder adopted bylaws cannot be used to pass binding resolutions relating to specific business decisions that are the prerogative of the board of directors.⁵¹⁵ The power to initiate game-ending decisions involving mergers, consolidations, dissolutions and sale of all the company’s assets rests exclusively with the board of directors. The only right shareholders have regarding rules of the game decisions and game-ending decisions is the power of veto since these decisions must be approved by shareholders to come into effect.⁵¹⁶

Similarly, in the case of scaling down decisions, all authority is vested with the board of directors. These decisions involve ordering a cash or stock distribution to shareholders. This reduces the size of the company and removes excess cash or assets.⁵¹⁷ Shareholders do not have the authority to initiate such decisions nor do they even have the power to veto decisions involving the distribution of cash or stock to shareholders.

⁵¹⁴ Hamermesh, Lawrence A. “Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street.” *Tul. L. Rev.* 73 (1998): 409 at 432.

⁵¹⁵ Delaware General Corporation Law, § 141(a), Model Business Corporations Act, §8.01(b) and New York Business Corporation Law §701.

⁵¹⁶ The shareholder’s right to veto fundamental corporate decisions is discussed at length in section 2.1. This power is comparable to citizens’ rights to veto certain decisions taken by the government through a referendum.

⁵¹⁷ Bebchuk, Lucian Arye. “The Case for Increasing Shareholder Power.” *Harvard Law Review* (2005): 833-914 at 841.

Under the provisions of the DGCL, shareholders may make precatory proposals on a wider range of issues than they can adopt shareholder bylaws. In fact, when a shareholder proposal is found to violate state law by impinging on the discretion of the board under §141(a), it can be converted to a precatory proposal. Shareholders can, therefore, propose and adopt bylaws on issues that are not restricted to the discretion of the board of directors and may propose precatory proposals on other issues. However, if the shareholder proposal is to be included in the company's proxy to avoid the free rider problem, it must nevertheless meet the requirements of Rule 14a-8. It should be noted that the adoption of precatory shareholder proposals is subject to the discretion of the board.⁵¹⁸

Professor Brownstein has suggested that the purpose of Rule 14a-8 was to create a consultation mechanism to allow discussion of proposals amongst shareholders themselves and between shareholders and management. It was never to establish direct democracy in the corporate model. He argues that the SEC has itself suggested that binding resolutions under the rule would largely be impermissible. This is because binding resolutions would be considered to be beyond the scope of proper subject for action by shareholders under the relevant state corporate laws. On the other hand, if the resolutions are precatory, they are more likely to be allowed.⁵¹⁹

This view is upheld by the note to Rule 14a-8 added in 1976 which argued that binding resolutions may often fall foul of state law definitions of what is proper action for shareholders and might impinge on the discretionary powers of the board.⁵²⁰

⁵¹⁸ Levit, Doron, and Nadya Malenko. "Nonbinding Voting for Shareholder Proposals." *The Journal of Finance* 66, no. 5 (2011): 1579-1614 at 1579.

⁵¹⁹ See Brownstein, Andrew R., and Igor Kirman. "Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions." *The Business Lawyer* (2004): 23-77 at 40. "Proposals by security holders that mandate or direct the board to take certain action may constitute an unlawful intrusion on the board's discretionary authority under the typical statute. On the other hand, however, proposals that merely recommend or request that the board take certain action would not appear to be contrary to the typical state statute, since such proposals are merely advisory in nature and would not be binding on the board even if adopted by a majority of the security holders." Per Securities Exchange Act of 1934, Exchange Act Release No. 12,999, 1976 SEC LEXIS 326, at 20-21 (Nov. 22, 1976).

⁵²⁰ "Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise." Per *Adoption of Amendments Relating to Proposals by Security Holders*, Exchange Act Release No. 12999, 41 Fed. Reg. 52,994, at 7 (Dec. 3, 1976) cited from *Id.* at 41.

Therefore, this discussion shows that Delaware shareholders can initiate and adopt binding proposals in the form of bylaw amendments. There is, however, confusion regarding whether or not the shareholders can prohibit the board of directors for later modifying such bylaws. On the other hand, shareholders can typically pass only non-binding resolutions using Rule 14a-8 if the resolution is not put in the form of a bylaw amendment.

8.2.2 *The UK Position*

The American approach is not the only way of allocating rights to initiate decisions between the shareholders and the board of directors. English corporate law gives greater power to initiate decisions to shareholders. Regardless of this, the UK has still had notable success in attracting international investment in a corporate environment of large dispersed shareholding without controlling shareholders. This suggests that diluted initiation rights for shareholders are not a precondition to an efficient corporate system that can attract both investors and managers effectively.⁵²¹ This sub-section provides a positive analysis of the treatment of shareholder initiated decisions in the UK.

Under the Companies Act, 2006, shareholders have the power to initiate and adopt amendments to the articles of association⁵²² by means of a special resolution⁵²³ passed by a supermajority of 75% of the votes cast at a shareholder meeting.⁵²⁴ Because the articles of association create and limit the principal-agent relationship in UK corporations, this gives shareholders of English corporations the right to initiate rules of the game decisions. While the high supermajority requirement means the initiation and adoption of amendments by shareholders is difficult,⁵²⁵ there are other provisions that help shareholders to initiate

⁵²¹ For a detailed study of the differences in English and American corporate law and governance, see Gower, L. C. B. "Some Contrasts between British and American Corporation Law." *Harvard Law Review* 69, no. 8 (1956): 1369-1402.

⁵²² The Companies Act, 2006 merged the memorandum of association and the articles of association (similar to the charter and the byelaws of US companies respectively) to create a unified articles of association that serves the role of both charter and byelaws.

⁵²³ S. 21(1), Companies Act, 2006.

⁵²⁴ See s. 283, Companies Act, 2006. Shareholders wishing to table a special resolution at the annual general meeting of the company must give prior notice to the company and follow the provisions of Part 13 of the statute.

⁵²⁵ Davies, Paul L. *Gower & Davies: The Principles of Modern Company Law*. Sweet and Maxwell, 2008.

decisions under UK law. Ten percent or more shareholders can compel the board of directors to call a general meeting⁵²⁶ where the shareholders can vote on the special resolution containing the proposed amendment.⁵²⁷ In fact, if the board of directors fails to call such a meeting, the shareholders themselves can call a general meeting at the company's expense⁵²⁸ in order to adopt the proposal.

In the case of specific business decisions, UK law by default provides that the company should be managed by the board of directors. However, the model articles of association provided by the Companies (Model Articles) Regulations have been adopted by most public companies in that country. These model articles of association provide that "The shareholders may, by special resolution, direct the directors to take, or refrain from taking, specified action".⁵²⁹ Furthermore, the shareholders of UK companies can also initiate a proposal to replace members of the board of directors in an ordinary resolution⁵³⁰ as long as special notice is given to the concerned directors.⁵³¹

This clearly demonstrates that UK company law grants shareholders greater power to initiate decision-making and to bind the board to their decisions as compared to the company law of Delaware and of most other American states. However, it is clear that both the UK and the US have met with considerable success in attracting investors and entrepreneurs. This can only be if both investors and entrepreneurs were attracted by the principal-agent relationship created by the corporate laws of these countries. It must thus be argued that neither system's treatment of shareholders' right to initiate and ratify binding decisions creates agency costs that are high enough to make the jurisdiction non-competitive in attracting both principals and agents. Accordingly, a deeper normative discussion will be required in the following sections to ascertain an optimum degree of initiation rights for citizens in the absence of a clear answer in corporate governance.

⁵²⁶ s. 303(1) read with s. 303(3), Companies Act, 2006 and s. 304, Companies Act, 2006.

⁵²⁷ s. 303(5), Companies Act, 2006.

⁵²⁸ s. 305, Companies Act, 2006.

⁵²⁹ Regulation 4(1), Companies (Model Articles) Regulations, 2008. Note: Regulation 4(2), Companies (Model Articles) Regulations, 2008 prohibits any retrospective application of Regulation 4(1).

⁵³⁰ s. 168(1), Companies Act, 2006.

⁵³¹ s. 312, Companies Act, 2006.

8.3 COMPARING NON-BINDING SHAREHOLDER PROPOSALS WITH NON-BINDING INITIATIVES

This section begins the normative analysis into why certain types of decisions initiated by shareholders are binding while others are non-binding on the management. It examines what this implies for agency cost. Chapter 1 demonstrated that the agency relationship established by corporate and constitutional law exhibit a sufficient degree of similarity to draw useful conclusions for direct democracy. In light of this, the following arguments will use the reasoning adopted in corporate governance to determine when initiatives should be binding and when they should instead be precatory in order to minimize agency cost.

This section in particular examines why decisions initiated by shareholders should be precatory in certain circumstances in order to minimize agency cost. Intuitively, it might be said that whenever agents ignore the decisions of the principals, agency cost escalates drastically. If we assume that the principals know what is in their own interest better than their agents, agency cost will increase when agents ignore the instructions of their principals. This is because agency cost includes residual loss and residual loss is defined as the cost of the divergence of the actions of the agents from those that would be in the principal's best interests.⁵³²

This, however, makes an important assumption that the principals can effectively express their preferences through direct decision-making. This is not always true. Corporate law recognizes that directors may better understand what is in the best interests of the shareholders better than the shareholders themselves. Many provisions of corporate law give precedence to the discretion of the board of directors by treating shareholder proposals to be precatory in a large number of cases.⁵³³ The tempering of the right of shareholders to make decisions is also reflected in takeover regulations. In fact, the jurisprudence of takeovers is a careful balancing of two views. On one hand, directors, being better informed can judge the real value of the company better than their shareholders and can bargain more effectively for a good price. On the other hand, shareholders can be expected to know what is in their own

⁵³² Jensen, Michael C., and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3.4 (1976): 305-360 at 308. See section 2.2.1.

⁵³³ See section 8.1.

best interests. The considerable discretion given to directors during takeover suggests that the case in favor of shareholder discretion is not conclusive.⁵³⁴

Corporate governance literature suggests that directors, being bound by their fiduciary duties to protect the interests of shareholders must use their best judgment in evaluating the merit of a proposal passed by a majority of shareholders. They must, therefore, take factors other than the result of the shareholder resolution into account while making their decision.⁵³⁵ If the board of directors feels that a proposal adopted by the majority is not in the best interests of shareholders as a whole, they have the right and the obligation to not implement the proposal.⁵³⁶

The case of *Smith v. Van Gorkom* is a clear illustration of the duty of the board of directors to use their business judgment even when there is a clear majority vote from the shareholders in favor of a decision. In this case, the directors were held liable for breach of fiduciary duty for not following a proper process in approving the sale of the company. The court ruled so despite the fact that the sale was supported by the CEO, had been placed on the company's proxy and had received a majority vote from the shareholders.⁵³⁷

In *Am. Int'l Rent-a-Car, Inc. v. Cross*, Vice-Chancellor Berger of the Delaware Court of Chancery ruled that the board of directors cannot be said to be in breach of their fiduciary duties merely because they act contrary to the wishes of a majority of their shareholders. He argued that while the board of directors must give due consideration to the wishes of the shareholders, they must do what they consider best for the company in the exercise of their business judgment.⁵³⁸ The issue was again reviewed in the celebrated case of *Paramount*

⁵³⁴ See Grossman, Sanford J., and Oliver D. Hart. "Takeover Bids, the Free-rider Problem, and the Theory of the Corporation." *The Bell Journal of Economics* (1980): 42-64. This article explains how the free rider problem can make shareholder decision-making ineffective for protecting their best interests.

⁵³⁵ See for example *Quickturn Design Systems, Inc. v. Shapiro*, No. 511, 1998 (Del. Sup. Ct. Dec. 31, 1998). In this case, the Supreme Court of Delaware ruled that "one of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation." See also *Smith v. Van Gorkom* 488 A.2d 858 (Del. 1985).

⁵³⁶ Brownstein, Andrew R., and Igor Kirman. "Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions." *The Business Lawyer* (2004): 23-77 at 24.

⁵³⁷ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). Note that there were additional claims regarding misinformation being given to shareholders. However, this case is widely known for its requirement that the board of directors follow a proper process in order to enjoy the protections of the Business Judgment Rule.

⁵³⁸ *Am. Int'l Rent-a-Car, Inc. v. Cross*, No. 7583, 1984 WL 8204, at 3.

Communications Inc. v. Time Inc. both by the Delaware Court of Chancery and by the Delaware Supreme Court.⁵³⁹ Both courts returned the same finding as in *Am. Int'l Rent-a-Car, Inc. v. Cross*.⁵⁴⁰

Chancellor Allen confirmed the ratio of these cases for the Delaware Chancery Court by ruling as follows in *Paramount Communications Inc. v. Time Inc.*:

*"The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm."*⁵⁴¹

When the case was heard on appeal by the Delaware Supreme Court, the Chancery Court's position was affirmed and made crystal clear by the Supreme Court ruling as follows:

*"[The plaintiff's] contention stems, we believe, from a fundamental misunderstanding of where the power of corporate governance lies. Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives... The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders."*⁵⁴²

This position has been adopted in a number of states where courts have ruled that the board is not bound to carry out the wishes of the majority of shareholder and must use their discretion in determining what is in the best interests of the company.⁵⁴³

Shareholder proposals are a strong signal of the wishes of the shareholders. Unlike stock market performance, these signals are clear indicators unaffected by external factors to the

⁵³⁹ In this case, Paramount Communications Inc. sought to enjoin Time Inc. from making a tender offer for 51% shares of Warner Communications at a time when Paramount Inc. was trying to acquire control of Time Inc.

⁵⁴⁰ *American Int'l Rent a Car, Inc. v. Cross*, 1984 WL 8204

⁵⁴¹ *Paramount Communications Inc. v. Time Inc.*, Nos. 10866, 10670, & 10935, 1989 WL 79880 (Del. Ch. July 14, 1989), aff'd, 571 A.2d 1140 (Del. 1990).

⁵⁴² *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1990).

⁵⁴³ See Brownstein, Andrew R., and Igor Kirman. "Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions." *The Business Lawyer* (2004): 23-77 at 45 for examples of judicial pronouncements by courts in a number of other states mirroring the position in Delaware.

same extent. In constitutional law, it can be said that citizens' initiatives and agenda initiatives give a clearer indication of public sentiment on a specific issue than periodic polls. This is because initiatives allow citizens to vote based on single-issue preferences while legislative elections bundle together all political, social and economic positions of a candidate into a single take it or leave it choice.

This bundling occurs because voters have to vote for legislative elections by taking into account past performance and future promises of candidates on each and every public policy issue. This means that voters cannot reward or punish a candidate based solely on his or her outlook on a particular issue. Therefore, all issues are bundled into one election and voters cannot express their preferences on particular issue. In the case of initiatives, voters can separate the issues concerning government and express their preferences on a particular issue without impacting government policy on all other, non-connected issues. This reason makes initiatives a clear indicator of the wishes of the public on a particular issue which the government can ignore at its own peril.

The benefit of a precatory resolution, whether passed by a majority or narrowly defeated, can be considered to be two-fold. Firstly, it serves as an indication of dissatisfaction of a majority of shareholders and the dissatisfaction of a significant minority if the initiative is narrowly defeated. This is a cause of concern for the board. Secondly, the tabling of the proposal forces the board to reply to the shareholder tabling the proposal. Being forced to reply to the shareholder forces the board to consider the concerns of the shareholder(s) and perhaps to reevaluate its existing position.⁵⁴⁴

This indirect benefit of a shareholder resolution should translate effectively into the political framework and a similarly conciliatory attitude can be expected from legislature to initiatives. An examination of how boards have reacted proactively to integrate shareholder feedback into their decision-making process will prove instructive to how legislatures may behave.

Boards of directors have been increasingly open to adapting their policies to address at least some issues advocated in shareholder proposals and have become more open to informal

⁵⁴⁴ Schulman, Stephen. "Shareholder Cause Proposals: A Technique to Catch the Conscience of the Corporation." *Geo. Wash. L. Rev.* 40 (1971): 1.

negotiations with the supporters of the shareholder proposal.⁵⁴⁵ Empirical research by Professors Bizjak and Marquette shows that even though shareholder proposals have considerable difficulty in securing majority votes, shareholder rights plans (i.e. poison pills) are almost three times as likely to be restructured and seven times more likely to be removed or put to a shareholder vote when there has been a precatory shareholder resolution asking for the pill to be removed. This impact is largely due to negotiations between the board of directors and the proponents of the proposal.⁵⁴⁶

The increased cooperation between the board and shareholders caused by the ability of shareholders to send clear signals is an important argument in favor of precatory ballot initiatives. This positive effect would be available in the political setting due to the similar nature of the agency problem between the dispersed principals and the centralized decision makers.

Professor Levit specifically compares the merits of binding v. non-binding shareholder proposals. He concludes that non-binding shareholder proposals are effective in aligning policy with the preferences of a majority of shareholders if managerial discipline is strong. He argues that the impact of non-binding votes is greatest when it is enhanced by the influence of the market for corporate control and especially when the proponent of the proposal threatens a proxy contest.⁵⁴⁷

This means that non-binding voting is effective when agents are not well entrenched and when there is fierce competition to replace the agents. Due to the default of plurality voting,⁵⁴⁸ shareholders do not have the power to stop the election of the Board's candidates in

⁵⁴⁵ Supra note 569 at 69, 73.

⁵⁴⁶ Bizjak, John M., and Christopher J. Marquette. "Are Shareholder Proposals All Bark and No Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills." *Journal of Financial and Quantitative Analysis* 33, no. 4 (1998) at 501.

⁵⁴⁷ Levit, Doron, and Nadya Malenko. "Nonbinding Voting for Shareholder Proposals." *The Journal of Finance* 66, no. 5 (2011): 1579-1614 at 1602-03.

⁵⁴⁸ See section 3.4.1. See also Sjoström, William, and Young Kim. "Majority Voting for the Election of Directors." *Connecticut Law Review* 40, no. 2 (2007) and Vaaler, Bryn R. "Majority Board Election: Where Do We Stand?" *Corporate Board* 168 (2008): 16. Note that there is an increasing trend for companies to adopt more onerous majority requirements for director elections. These modified plurality requirements are also known as Pfizer requirements after the first major corporation to adopt them and have now been adopted by other large companies such as Disney, Pfizer, General Electric, Safeway, Office Depot, Circuit City, Automatic Data Processing, US Bancorp and Best Buy.

the absence of a proxy contest if even one share is cast in favor of those candidates.⁵⁴⁹ Furthermore, the incumbent board of directors has the privilege of using the company's proxy statement to promote their nominees as compared to political elections which provide a level playing field for incumbents and challengers.⁵⁵⁰ These factors create entrenchment that dulls the effect of non-binding shareholder proposals.

The case of constitutional law is different. Because political elections are much more competitive, Professor Levit's argument that precatory votes are most effective when there is low entrenchment and high competition (for the position of agent) supports the case for meaningful yet non-binding initiatives. Therefore, while precatory shareholder proposals have met with some success in influencing the policy adopted by the board of directors, precatory initiatives are bound to have a greater impact on the policies adopted by the legislature. This means that, in terms of agency cost, residual loss can be minimized more effectively by allowing principals the right to initiate non-binding decisions in constitutional law than in the context of corporate governance.

This idea of using non-binding decisions initiated by the principals to increase communication and dialogue between principals and agents is the underpinning of the agenda initiative in constitutional law. An agenda initiative is a process whereby citizens can propose a petition, get the required number of signatures and vote to ask the legislature to consider discussing a particular issue. In other words, a successful agenda initiative only requests or compels the legislature to debate the issue in question rather than proposing any particular solution.

It is argued that there is little risk in requiring the legislature to discuss a measure that has the qualified support of the voting population. The purpose of an agenda initiative is to put a given issue into the spotlight and have a parliamentary debate on it. Since a successful agenda

⁵⁴⁹ See § 216, Delaware General Corporation Law; § 7.28(a), Revised Model Business Corporation Act. Plurality voting can simply be described as a system of elections where the winner is the candidate who gets the largest number of votes cast. There is no requirement to get an absolute majority of the votes cast. With the move towards introducing proxy access, arguments have been made to allow shareholders to include their own slate of nominees for election to the board of directors on the company's proxy. This has the potential to make corporate elections much more competitive if a challenger group acquires the threshold of shares required to include their representative on the company's proxy.

⁵⁵⁰ Pinto-Duschinsky, Michael. "Financing Politics: A Global View." *Journal of Democracy* 13, no. 4 (2002): 69-86.

initiative has already succeeded in putting the issue into the spotlight, it is little infringement on the discretion of the legislature if they were to also be constitutionally required to formally discuss it. Such a requirement takes away nothing from the legislature's responsibility to make the best decisions as it sees fit since the final decision rests with it. On the other hand, it allows citizens to draw attention to issues that concern a reasonably large percentage of citizens as determined by the threshold of votes required for an agenda initiative to be successful.

The insights gained from corporate governance in this section, therefore, suggest that non-binding initiatives can help information about citizen's preferences flow from citizens to legislators thereby reducing residual loss. There is also little difference in monitoring cost whether an agenda initiative is binding or whether it is non-binding. This is because the legislature is only required to consider an issue that has already been voted upon by the citizens and the collective action cost of direct democracy which is part of the monitoring cost has already been borne. Furthermore, there is little downside in requiring the legislature to consider such proposals considering that a threshold limit of signatures shows considerable popular support for the proposal.

8.4 COMPARING BINDING SHAREHOLDER BYLAW AMENDMENTS AND BINDING INITIATIVES

Having discussed the issue of precatory shareholder proposals and agenda initiatives in the previous section, this discussion focuses on the nature of shareholder bylaw amendments and binding initiatives (also known as citizen's initiatives).

Shareholder proposals under Rule 14a-8 are typically precatory since binding shareholder proposals are often found to be in violation of state law.⁵⁵¹ However, shareholders have coextensive rights to amend the bylaws of the company together with the board of directors.⁵⁵² Shareholders can, therefore, use Rule 14a-8 to pass binding resolutions as long as

⁵⁵¹ Black Jr, Lewis S., and A. Gilchrist Sparks III. "SEC as Referee-Shareholder Proposals and Rule 14a-8, The." *J. Corp. L.* 2 (1976): 1.

⁵⁵² Delaware General Corporation Law §109(a); Model Business Corporations Act; §10.20 and New York Business Corporation Law §601.

the subject of their proposal is amenable to inclusion in the bylaws and the shareholder proposal advocates the adoption of that amendment or insertion of a new bylaw.

In the majority of companies in the United States, the power to make, amend or repeal bylaws rests concurrently with both the board and the shareholders due to provision for the same in the relevant statute or the certificate of incorporation.⁵⁵³ This can lead to a situation where a board may nullify a shareholder-made bylaw by replacing it by their own new bylaw. There is a divergence in opinion amongst the laws of different American states regarding the legality of such an action. This part of the chapter examines the circumstances in which agents should be allowed to overrule their principals' decisions taken in such a manner.

About half of the US states have adopted corporate laws which follow the Revised Model Business Corporation Act. This is a draft corporate code framed by legal experts in the United States to encourage states to adopt best practices and create a degree of uniformity amongst the laws of the various states. The Revised Model Business Corporation Act has a clear statutory position allowing shareholders to pass resolutions which include a clause prohibiting the board from subsequently amending or repealing the said amendment.⁵⁵⁴

The jurisdiction of Delaware is an outlier in this regard. Unlike the states mirroring the Model Business Corporations Act, the corporate statutes of both Delaware and New York do not expressly allow for provisions in bylaw amendments that prohibit subsequent repeal by the board of directors.⁵⁵⁵ There is a key difference between the laws of New York and Delaware. The New York Business Corporations Law § 601 contains a specific provision empowering

⁵⁵³ Note that in the State of Delaware, the power to adopt, amend and repeal bylaws is given to directors by a provision in the charter rather than by statute. By default, directors can only adopt, amend and repeal bylaws until the time the company has not taken any money for its shares. This issue is discussed in depth in the following pages.

⁵⁵⁴ See MODEL Bus. CORP. ACT § 10.20(a)(2). This provision has been given force in CAL. CORP. CODE § 211; FLA. STAT. ANN. § 607. 1020(1)(b); NEV. REV. STAT. § 78.120(2); PA. CONS. STAT. ANN. tit. 15, § 1504. The Revised Model Business Corporation Act is a revision of the Model Business Corporation Act of 1946. Like the earlier version, the Revised Model Business Corporation Act is an attempt by US legal experts to formulate a model corporate code that states may adopt, in full or in part in order to promote a degree of harmonization in the corporate laws of the different American states. For a detailed study of the Revised Model Business Corporation Act, see Goldstein, Elliott, and Robert W. Hamilton. "The Revised Model Business Corporation Act." *The Business Lawyer* (1983): 1019-1029.

⁵⁵⁵ See Delaware General Corporation Law § 109; N.Y Bus. CORP. LAW § 601

the shareholders to amend any bylaw adopted by the board of directors.⁵⁵⁶ However, there is no corresponding provision that expressly gives the board of directors the power to amend bylaws adopted by the shareholders. The express inclusion of the right of shareholders to amend bylaws passed by the board but the absence of a converse provision leads to the conclusion that the legislature deliberately chose to deprive the board of such a power.⁵⁵⁷ This is especially the case if the shareholder-adopted bylaw prohibits further amendment by the board. This is not the case in Delaware law. While there is no clear provision in the DGCL to this effect, case law discussed subsequently is a strong indicator that a clause in a shareholder bylaw barring future repeal or amendment by the board would be in violation of Delaware law.

It should be noted that under the DGCL, the board is not granted the power to make or repeal bylaws by the statute but rather through the certificate of incorporation of an overwhelming majority of its corporations. DGCL § 109(a) provides that the original bylaws of a company can be adopted, amended or repealed by the incorporators or by its initial directors. DGCL § 109(a) further provides that the board of directors may continue to adopt, amend or repeal the company's bylaws but only up to the time that the company does not receive any payment for its shares. Once a company does receive payment for its shares, DGCL § 109(a) shifts the responsibility and authority to amend the bylaws to the shareholders.⁵⁵⁸

This is, however, not the practice in any large Delaware public company because DGCL § 109(a) provides that the certificate of incorporation can give the power to adopt, amend or

⁵⁵⁶ See N.Y. Bus. CORP. LAW § 601(a): "When so provided in the certificate of incorporation or a by-law adopted by the shareholders, by-laws may also be adopted, amended or repealed by the board by such vote as may be therein specified, which may be greater than the vote otherwise prescribed by this chapter, but any by-law adopted by the board may be amended or repealed by the shareholders entitled to vote thereon as herein provided."

⁵⁵⁷ "The doctrine of *expressio unius est exclusio alterius*, however fallible as a guide to statutory construction, would quite plausibly lead a court construing section 601 of the New York Business Corporation Law to conclude that having expressly conferred upon the shareholders the power to amend or repeal by-laws adopted by the directors, the legislature could not and would not have remained silent on the obvious converse power of the directors to amend or repeal by-laws adopted by the shareholders." Cited from Hamermesh, Lawrence A. "Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street." *Tul. L. Rev.* 73 (1998): 409 at 468.

⁵⁵⁸ Delaware General Corporation Law § 109(a): "After a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote..."

repeal bylaws to the board of directors.⁵⁵⁹ In fact, the certificate of incorporation of all significant Delaware public companies contains a provision to this effect without any reservations. It should be noted that DGCL § 109(a) further provides that the shareholders continue to have the authority to adopt, amend and repeal bylaws even if the certificate of incorporation gives such power to the board of directors.⁵⁶⁰

Regarding the issue of the board of directors amending or repealing shareholder-adopted bylaws, there is no express legislative instruction to guide the courts. However, there are hints as to legislative intent in DGCL § 203 and § 216. Section 203(b)(3) places an express restriction on the right of the board of directors to further amend or annul a shareholder bylaw under section 203 concerning dealings between the company and any shareholder holding greater than 15% of the company's shares. DGCL § 216 has a similar clause in respect to the choice of majority v. plurality voting for director elections. It reads. "A bylaw amendment adopted by shareholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors".

The presence of specific instances in the DGCL that prevent the board of directors from amending shareholder-adopted bylaws suggests that the board does have such power in normal circumstances. This argument is based on the principle *Expressio unius est exclusio alterius* ("the express mention of one thing excludes all others")⁵⁶¹ which is a canon of the interpretation of statutes.

This argument is supported by judicial pronouncement to a certain degree. The best argument that Delaware law prohibits shareholder bylaws from limiting the power of the board to subsequently amend or repeal them was given in the *Centaur Partners* case.⁵⁶² The court argued that the power to amend bylaws is given to the board by the certificate of

⁵⁵⁹ Delaware General Corporation Law § 109(a): "any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors."

⁵⁶⁰ Delaware General Corporation Law § 109(a): "The fact that such power has been so conferred upon the directors... shall not divest the stockholders... of the power, nor limit their power to adopt, amend or repeal bylaws."

⁵⁶¹ Garner, Bryan A., *Black's Law Dictionary*, (7th ed.). St. Paul, MN: West Publishing, 1999 at 602.

⁵⁶² *Centaur Partners IV v. Nat'l Intergroup Inc.*, 582 A.2d 923 (Del. 1990). Has been previously discussed in section 8.2.1. In this case, the Delaware Supreme Court ruled that a bylaw limiting the number of directors was void because it barred the board of directors from amending it. This was because the charter of the company allowed the board of directors to determine the number of directors on the board by adopting bylaws.

incorporation and this arrangement is allowed by a specific statutory position, i.e. DGCL §109. Since the power of the board to amend and repeal bylaws is granted by the certificate of incorporation which takes precedence over the provisions of the bylaws, it is unlikely that a bylaw provision can limit the power of the board to amend and repeal bylaws, a power granted by the certificate of incorporation and specifically allowed by statute.⁵⁶³

In *Centaur Partners IV v. Nat'l Intergroup Inc.*, shareholders of the company adopted a bylaw prohibiting further amendment by the board of directors that read “the foregoing sentence [expanding the board to 15] is not subject to amendment, alteration or repeal by the Board of Directors.”⁵⁶⁴ However, like most Delaware companies, the charter of the company required that the number of directors shall be specified in the bylaws of the company and also gave the directors the right to amend the bylaws. Due to this, the court found that the provision that prohibited the directors from further amending or repealing that particular bylaw was contrary to the provisions of the charter. Since the provisions of the charter supersede those of the bylaws, the provision limiting the power of the board to change the number of directors was held to be invalid. The operative part of the judgment in this respect is reproduced below:

“Where a bylaw provision is in conflict with a provision of the charter, the bylaw provision is a nullity”⁵⁶⁵

The legal position on the issue in question is, however, not settled. In *American Int'l Rent a Car, Inc. v. Cross*, the Delaware Chancery court, in dicta, specifically stated that shareholders who wish to prohibit the board of directors from repealing a shareholder bylaw amendment can do so.⁵⁶⁶ The court wrote that shareholders can do this by including a provision in the

⁵⁶³ *Ibid.*

⁵⁶⁴ *Ibid.* cited from Hamermesh, Lawrence A. “Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street.” *Tul. L. Rev.* 73 (1998): 409 at 471.

⁵⁶⁵ See *Centaur Partners IV v. Nat'l Intergroup Inc.*, 582 A.2d 923 (Del. 1990) at 929. Reaffirmed in *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991).

⁵⁶⁶ The term ‘in dicta’ refers to the part of a legal judgment that does not directly address the issues being litigated. The part of the judgment delivered in dicta does not have to be followed by lower courts (as is normally the case in common law jurisdictions due to the principle of precedence) and is considered only to have persuasive value.

bylaws that prohibits the board from amending the said bylaw.⁵⁶⁷ However, this observation was in dicta and, therefore, has only persuasive value and cannot be used as precedent.

Vice Chancellor Strine (now Chancellor) of the Delaware Chancery Court had the opportunity to review this matter several years after both *Centaur Partners* and the *American Int'l Rent a Car, Inc.* decisions. Having considered the previous judicial precedents, he ruled that the matter remained undecided.⁵⁶⁸

This issue was re-examined in 2008 by the Delaware Supreme Court in *CA, Inc. v. AFSCME*.⁵⁶⁹ The Delaware Supreme Court ruled the power of shareholders to adopt bylaws cannot be inconsistent with the law of the State of Delaware which includes DGCL § 141(a). Accordingly, the court ruled that DGCL § 109 cannot be construed to be an exception to DGCL § 141(a).

These are the main legal arguments for and against allowing shareholders to amend bylaws adopted directly by the shareholders. These arguments have significant implications for constitutional law. Whether or not shareholders can adopt bylaws that cannot be amended or repealed by the board of directors can help answer whether agency cost is most effectively minimized if citizens are empowered to use initiatives to pass laws that cannot later be amended or repealed by the legislature.

Direct democracy relies on the ability of the principals to influence the decisions of their agents through the ability to supersede or veto the decisions of their agents or to directly influence policy. If either the board of directors or the legislature has the power to amend or repeal decisions taken by principals *ex-ante*, the ability of principals in both systems to supersede or veto the decisions and to directly influence policy is reduced in a similar way.

Allowing agents to amend or repeal decisions directly taken by their principals can lead to an increase in residual loss since it enable agents to move policy away from the preferences of

⁵⁶⁷ *American Int'l Rent a Car, Inc. v. Cross*, 1984 WL 8204. "If a majority of American International's stockholders in fact disapproved of a Board's amendment of the bylaw, several recourses were, and continue to be, available to them. They could vote the incumbent directors out of office. Alternatively, they could cause a special meeting of the stockholders to be held for the purpose of amending the bylaws and, as part of the amendment, they could remove from the Board the power to further amend the provision in question."

⁵⁶⁸ *General DataComm Indus. v. State of Wis. Inv. Board*, 731 A.2d 818 (Del. Ch. 1999) at 822.

⁵⁶⁹ *CA Inc. v. AFSCME Employees Pension Plan* 953 A.2d 227 (Del. 2008).

their principals as expressed through direct democracy. On the other hand, if a bar on agents prohibiting them from deviating from policy set by direct democracy prevents them from reacting suitable to changed circumstances in the future, monitoring cost can be said to have increased. This is because the costs brought about by the lack of the agent's ability to respond can be attributed to the binding decisions taken by the principals trying to control their agent's behavior *ex ante*. This trade-off is explained in the following arguments.

If a citizens' initiative amends a piece of regular legislation and includes a provision that prohibits the subsequent repeal of the amendment by the legislature, the reasoning of *Centaur Partners* would be applicable. This would be the case unless the constitution specifically provides that law created through initiatives cannot be amended by the legislature and such cases do exist in practice.⁵⁷⁰ In some cases, a supermajority of the legislature may be required to amend a law adopted through initiative.⁵⁷¹ Since the government gets its authority to pass legislation and govern the country from the constitution, regular legislation ordinarily cannot negate that right. This is similar to the court's thinking in *Centaur Partners* which maintained that a provision in the bylaws cannot abrogate the right of the board of directors to manage the business and affairs of the company.⁵⁷²

Because the legislature gets its power to make laws from the constitution, it would appear that a citizens' initiative that amends or creates a regular law (as opposed to a constitutional amendment) would run into the same problem. Most countries having rigid constitutions do not permit ordinary legislation to nullify or be contrary to the provisions of the constitution.

⁵⁷⁰ See for example Art 3, § 52(f) of the Constitution of the State of Wyoming that provides that laws adopted via initiative cannot be repealed by the legislature within two years of their effective date. Cited from Hamermesh, Lawrence A. "Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street." *Tul. L. Rev.* 73 (1998): 409 at 474.

⁵⁷¹ See Art 2, § 41 of the Constitution of the State of Washington that requires a two thirds majority in both houses of the legislature to amend a law adopted through the initiative process. Cited from Hamermesh, Lawrence A. "Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street." *Tul. L. Rev.* 73 (1998): 409 at 474.

⁵⁷² That is because the power of the board of directors comes from a nearly universally adopted provision in the charter which takes precedence over the provisions of the bylaws. It should be noted that under the Delaware General Corporation Law, the board of directors has the power to amend the bylaws till they have received payment for the company's shares. Once that happens, the power to amend the bylaws shifts to the shareholders. (See § 109(a), Delaware General Corporation Law). The reason why the board shares this power with shareholders in almost all Delaware companies is because nearly all of them provide for such a sharing of power in their charters.

In such countries, it would appear that citizens' cannot place limitations on the legislature's power to amend a regular law by means of a provision in another or the same law.⁵⁷³

How constitutional law differs drastically from the DGCL is that certain countries allow citizens to initiate amendments to the constitution as well as changes to legislation. Out of the 37 countries in the world that provide for initiatives at the national level, 20 countries allow citizens' initiatives to amend the constitution. On the other hand, 26 of the 37 countries allow initiatives to only be used to adopt and amend ordinary legislation. This is in variance to the DGCL, which restricts the right to initiate charter amendments to the board of directors.⁵⁷⁴ However, it is in line with UK law that allows shareholders to pass amendments to the unified articles of association.⁵⁷⁵

It can be said that allowing legislators the right to reverse any amendments made through the initiative process would undo the advantage of providing for initiatives to prevent ex ante diversion from the policy favored by the principals. This would increase residual loss. While it may be argued, and rightly so, that legislators would think twice about reversing a measure adopted by popular vote, the Swedish example of the government undoing a no vote in a referendum without holding another one shows that this is not inconceivable. On October 16, 1955, Sweden held a non-binding referendum to decide whether to switch to driving on the right hand side of the road rather than the UK and Commonwealth trend of driving on the left hand side. The proposal was comprehensively defeated by a vote of 82.9% against the switch and 15.5% for it. Despite the fact that the voter turnout for the referendum was greater than

⁵⁷³ See 'Chapter: III: Flexible and Rigid Constitutions' in Bryce, James Bryce. *Studies in History and Jurisprudence*. Vol. 1. Oxford University Press, American Branch, 1901. Constitutions that allow apex or constitutional courts to strike down legislation (or parts of legislation) that conflict with provisions of the constitution are examples of rigid constitutions. On the other hand, Viscount Bryce writes that ancient constitutions like those of the Greek states like Athens, of Rome, Carthage etc. were flexible and that such constitutions are increasingly rare nowadays. He states,

"Excluding despotically governed countries, such as Russia, Turkey, and Montenegro, there are now only three in Europe, those of the United Kingdom, of Hungary—an ancient and very interesting Constitution, presenting remarkable analogies to that of England—and of Italy, whose constitution, though originally set forth in one document, has been so changed by legislation as to seem now properly referable to the Flexible type. Elsewhere than in Europe, all Constitutions would appear to be Rigid."

While Viscount Bryce wrote this in 1901, the situation today remains similar.

⁵⁷⁴ § 242(1), Delaware General Corporation Law

⁵⁷⁵ s. 21(1) r/w s. 283 of the Companies Act, 2006.

50% and the public consensus was clearly against switching to driving on the right hand side (82.9% against), on September 3, 1967, the government did so anyway without again consulting the people.

Admittedly, the Swedish example concerns a referendum rather than an initiative but the lesson is the same – legislatures may ignore direct democracy when it is expedient for them to do so.

This shows that the government may reject the principal's preferences expressed through a popular vote thereby threatening an escalation of residual loss.⁵⁷⁶ If agents amend or repeal decisions directly adopted by a majority vote of their principals, this deviation would tend to increase since the agents are moving away from their principals' expressed preferences. Allowing the legislature to reverse amendments adopted through initiatives can, therefore, lead to increased agency cost.

On the other hand, not giving the legislature the power to amend laws adopted via initiatives may interfere with the ability of the government to cater to certain unforeseen circumstances. Since direct democracy is considered a monitoring mechanism for the purposes of this dissertation, the costs brought about by its use by constraining the ability of agents to react to changed circumstances would be an increase in monitoring cost. This problem was recognized by the Supreme Court of Idaho in the legislative context. The court recognized the problem of constraining agents from reacting from changed circumstances after the direct democracy mechanisms had been used. It also considered the risks associated with of drafting and lack of deliberation and compromise between competing interests in initiatives and found that legislatures should have the power to reverse such decisions if they find them to be problematic.⁵⁷⁷

Since the legislature is far better suited to quick decision-making in times of crisis than the initiative process, such un-amendable provisions may create considerable problems when unforeseen situations arise in the future. Furthermore, if the negative consequences of citizens initiatives are widely dispersed and invisible but the benefits are clearly visible, it might be

⁵⁷⁶ As pointed out in section 2.2, residual loss is the cost imposed by the deviation of the actions of the agents from the preferences of their principals.

⁵⁷⁷ See *Luker v. Curtis*, 136 P.2d 978, 979-80 (Idaho 1943); See also Hamermesh, Lawrence A. "Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street." *Tul. L. Rev.* 73 (1998): 409 at 475.

difficult to motivate the citizens to use direct democracy to reverse such a decision. For example, citizens of a country with poor education about climate change may adopt initiatives that defang environmental regulations in order to get a short term boost in economic growth. Here, it might be difficult to convince the citizens to repeal such laws because environmental damage is slow and difficult to quantify while economic benefits can be felt more substantially. This sort of situation can lead to inefficient laws. Accordingly, in *Luker v. Curtis*, the Supreme Court of Idaho ruled that “[T]he initiative provision . . . places no limitation whatever on the power of *amendment or repeal* of an initiative act.”⁵⁷⁸ However, the court ruled that citizens can expressly include a provision in the amendment introduced through the initiative which prohibits the legislature from repealing or further amending it.

Many states, therefore, take the position that unless the initiative specifically provides that the law so adopted may not be amended by the legislature, the legislature may validly amend or repeal it. This position is reflected in ruling by courts in the states of Colorado, Nebraska, Ohio, Oklahoma, Oregon and Tennessee as well as Idaho.⁵⁷⁹ This situation is analogous to the discussion in section 8.2.1 about the ability of shareholders to adopt bylaws that contain a clause prohibiting the board of directors from subsequently amending or repealing it.

A greater issue for minimizing agency cost than inefficient laws is situations whether the initiative creates rules to improve monitoring of the legislators or the interest groups that influence them.⁵⁸⁰ In countries with a tenuous democratic history, giving potentially autocratic or corrupt legislators the right to reverse popular measures such as these can lead to dangerous escalations in residual loss and therefore increases in agency cost. In some

⁵⁷⁸ *Luker v. Curtis*, 136 P.2d 978, 979-80 (Idaho 1943).

⁵⁷⁹ See *In re Senate Res. No.4*, 130 P. 333,336 (Colo. 1913); *Luker*, 136 P.2d at 979; *Klosterman v. Marsh*, 143 N.W.2d 744, 748 (Neb. 1966) (“In the absence of specific constitutional restraint, either [the people or the Legislature] may amend or repeal the enactments of the other.”); *State ex rei. Singer v. Cartledge*, 195 N.E. 237,239 (Ohio 1935); *Granger v. City of Tulsa*, 51 P.2d 567, 569 (Okla. 1935); *State ex rei. Pierce v. Slusher*, 248 P. 358 (Ore. 1926); *State ex rei. Richards v. Whisman*, 154 N.W 707, 710 (S.D. 1915), *appeal dismissed*, 241 U.S. 643 (1916); *Chattanooga-Hamilton Co. Hosp. Auth. v. City of Chattanooga*, 580 S.W.2d 322, 327-28 (Tenn. 1979). Cases cited from Hamermesh, Lawrence A. “Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street.” *Tul. L. Rev.* 73 (1998): 409 at 474.

⁵⁸⁰ Rent seeking in this context can be simply characterized as the expenditure of resources by group to increase the share of existing wealth allocated by the group rather than through the creation of more wealth. For a detailed discussion, see Tullock, Gordon. *Rent Seeking*. Brookfield: Edward Elgar, 1993.

states, popular pressure on legislators that would result from repealing a law passed by a popular initiative may not be enough.

For example, citizens might use the initiative process to adopt key measures like term limits, restrictions on the power of the President, financial declaration requirements for legislators etc. that can reduce agency cost but are restrictive on the agents. In such cases, the pressure of public opinion to avoid amending or repealing such popularly adopted legislation may not be enough to stop autocratic or dishonest representatives from doing so. It may, therefore, be prudent to protect legislation which restricts the power of agents to improperly enrich or entrench themselves. This can be done by putting a clause in such legislation that prohibits the legislature from subsequently amending or repealing it.

Constitutions contain ‘rules of the game’ decisions that determine the extent and scope of the power of the legislature and the executive. When citizens have the right to amend the constitution, they can ensure that their agents cannot again give themselves excessive powers and restrict citizen’s rights. Citizens can do this by introducing term limits, disclosure requirements for legislators’ personal finances, election campaign finance etc. Since such provisions are introduced to regulate the conduct of legislators in order to reduce agency cost, allowing the legislators to amend or repeal the provisions that regulate their own behavior can be counter-productive. In fact, citizens may use initiatives to introduce constitutional amendments that check the rise of authoritarian leaders. The question, therefore, arises: Will the authoritarian representatives such provisions are introduced to deter care sufficiently about a public backlash for amending the provisions? Or should citizens be allowed to bar their agents from amending the very provisions that serve as a check and balance on their power?

Examining these questions in terms of how to minimize agency cost provides the following insights. Allowing amendments adopted through initiatives to be exempt from repeal by legislature can help to reduce agency cost. This is particularly the case when the citizen-initiated amendment is specifically designed to reduce residual loss. These can be through amendments introducing disclosure requirements which enhance the ability of principals to monitor the agents, for example, or term limits that restrict entrenchment. If the legislature is allowed to repeal such laws, the protections of the constitution designed to reduce agency cost will fail when they are needed most – to constrain legislatures who do not care enough about the public backlash that would come from repealing such policies.

It is, therefore, opined that the UK model which allows shareholders to adopt amendments to the articles of incorporation including clauses prohibiting subsequent amendment by the board of directors is the appropriate stance to minimize agency cost. The detailed examination of the case law on shareholders' right to adopt bylaws that the board of directors cannot amend later shows that there is qualified support for this argument in the US as well. US Courts, in *American Int'l Rent a Car, Inc. v. Cross*⁵⁸¹ held that shareholders could include provisions in a bylaw that barred the board of directors from further amending the bylaw in question while *Centaur Partners, IV v. National Intergroup, Inc.*⁵⁸² states the opposite. This lack of consensus, unlike the clear UK position, cannot be advanced as advocacy for not allowing subsequent amendments by agents. Nevertheless, the analysis of various decisions and principles of interpretation of statutes carried out in this chapter shows that the UK position is not incompatible with US practice.

On the other hand, the existence of citizen initiated and adopted decisions that bar subsequent amendment by legislature relating to ordinary business decisions may lead to inefficiencies like a compromised ability to react to certain crises. After all, given sufficient time, an unforeseen event might occur which the initiative made law does not adequately account for. In the case of many ordinary business decisions (except game-ending decisions), the potential for increased residual loss is not great enough to take the risk of high monitoring cost that can be the consequence of making laws rigid and not adaptive to crisis. Even more importantly, the potential for selfish gain for the agents through such decisions is also lower than 'rules of the game' decisions which means that the public backlash from amending directly adopted laws should deter most legislators from doing so. In other words, the gains to the agents are unlikely to be worth antagonizing the electorate by overtly acting against their wishes.

The best balance may, therefore, be to allow un-amendable initiative-based laws only in cases that deal with monitoring the government and are adopted to protect democratic institutions and processes. It must be noted that this analysis the tradeoff between residual loss and monitoring cost discussed above is dependent on the unique institutional characteristics of the constitutional system as well as the political climate of the country. If the legislators are either extraordinarily responsive to citizen's demands or extraordinarily well entrenched and

⁵⁸¹ *American Int'l Rent a Car, Inc. v. Cross*, 1984 WL 8204 (Del. Ch. 1984).

⁵⁸² *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A.2d 923, 929 (Del. 1990).

self-serving, the suggestions given here may not be applicable. In the case of uniquely responsive representatives, even rules of the game decisions taken by initiative can be subjected to amendment by the legislature since the chances of residual loss are lowered by the high integrity of the representatives. On the other hand, countries with extraordinarily well entrenched and potentially corrupt legislators might incur high residual loss by allowing legislative amendment of ordinary business decisions taken by initiative and may prefer to incur the relatively lower monitoring cost of having laws that may not be suitably responsive to future needs.

8.5 KEY CONCERNS REGARDING BINDING INITIATIVES AND BYLAW AMENDMENTS

8.5.1 *Drafting*

This chapter has shown that Rule 14a-8 governs the solicitation of proxies for nearly all proposed shareholder bylaw amendments. This rule requires the shareholder who initiates the amendment to draft the proposed bylaw and submit it to the company so it may be placed on the company's proxy and circulated to all the shareholders. If the draft bylaw and the request for its circulation amongst shareholders satisfy all the legal requirements, the proposal to amend the bylaws along with the draft amendment is circulated to all shareholders and then voted upon in the shareholder meeting.⁵⁸³

This means that the actual draft being voted upon by shareholders has not had the advantage of being discussed and debated. Additionally, the proposal's drafters have not had the opportunity for compromise or improvement. The free rider problem and the fact that shareholders do not have access to the company's expert human capital and financial resources also means that the proposal will lack the specialist treatment from lawyers and other experts that a board sponsored amendment would receive. These factors mean that the draft bylaw might not achieve the best compromise between all the interests involved and might not identify the best possible solution to a particular problem. Since direct democracy

⁵⁸³ Black Jr, Lewis S., and A. Gilchrist Sparks III. "SEC as Referee-Shareholder Proposals and Rule 14a-8, The." *J. Corp. L.* 2 (1976): 1.

is envisaged as a monitoring tool, such imperfect law making through initiatives will increase monitoring cost and, therefore, increase agency cost.

In a post on the Harvard Law School Forum on Corporate Governance and Financial Regulation, James Morphy of Sullivan & Cromwell LLP has suggested that it is the precisely the difficulty in drafting bylaws that has led to most institutional investors putting forward precatory proposals even when they have the option of putting forward a binding proposal. This is because binding proposals carry with them far greater drafting responsibilities which institutional investors would rather avoid.⁵⁸⁴ By making the proposal precatory, the institutional shareholders can specify the substance of the bylaw amendment they want and leave the responsibility of drafting the final language of the bylaw to the board of directors.

The argument that dispersed principals lacking specialized drafting skills and negotiating mechanisms might lead to sub-optimal rules can also be extended to laws made via initiatives. This is in contrast to laws made by the legislature which are characterized by vigorous discussion and debate on the floor of the house and intense scrutiny by committees and experts. Additionally, legislative rule making is also characterized by compromise and improvement that happens when deals are struck amongst legislators to gain support for the changes proposed. National and even state legislatures rely on staffs of hundreds, if not thousands of experts and legislative draftsmen. Legislators also have the advantage of receiving advice from leading external experts who private individuals are unlikely to have similar access to. Furthermore, laws and constitutional amendments have a far wider ranging impact than corporate bylaws. This makes it harder to foresee all possible consequences of legislative or constitutional amendment.

It is, therefore, clear that legislative drafting is a highly specialized skill that proponents of citizens' initiatives would have limited expertise in.⁵⁸⁵ This means that the all-important language of the initiative proposal will not be as precise and effective as it might have been if

⁵⁸⁴ See Morphy, J., "Proxy Access Proposals: Review of 2012 Results and Outlook for 2013", June 28, 2012, *The Harvard Law School Forum on Corporate Governance and Financial Regulation* available at <http://blogs.law.harvard.edu/corpgov/2012/06/28/proxy-access-proposals-review-of-2012-results-and-outlook-for-2013/#2b> (Visited on May 1, 2013).

⁵⁸⁵ For a discussion into the "careful deliberation and reasoned decision-making" that legislative processes provide that are not available to the initiative process, see Staszewski, Glen. "Rejecting the Myth of Popular Sovereignty and Applying an Agency Model to Direct Democracy." *Vanderbilt Law Review* 56 (2003): 395 at 398.

the legislature had drafted it. Improper wording in the initiative proposal might also have harmful unintended consequences because the unskilled and non-expert drafters of initiatives might not foresee contingencies that experts might otherwise have catered to. Even though drafting legislation is not an exact science, experience plays a critical role in foreseeing eventualities and examining the potential interpretations of the legislation's language in light of past judicial practice. Therefore, implementing a citizens' initiative as law without giving the legislature a chance to review it carries some risk regarding concerns over the drafting of the provision.

The problem of unforeseen consequences and imperfect wording of the proposal can be avoided by allowing the legislature the power to fine tune the language of the resultant legislation. One way of doing this would be to allow the legislature to put forward its own expertly drafted proposal that gives effect to the demands of the citizen initiative. The legislature may then appeal to the citizens to pick its version over the original draft. In fact, the legislature can also preempt improperly framed initiatives by passing legislation that addresses the concerns espoused by that initiative before it is voted on by the citizens. Once effectively drafted legislation has addressed the concerns, the legislature can negotiate with the initiative's proponents to ask them to withdraw the now redundant proposal or appeal to the citizens to vote against it. It is, therefore, argued that as long as the legislature is willing to pass legislation that complies with the spirit of popular initiatives, they can preempt the adoption of improperly drafted initiatives that threaten unforeseen consequences or interpretations.

8.5.2 Diluting the Accountability of Agents

Chapter five explained that the excessive use of referendums can lead to a dilution of the accountability of agents and an attendant increase in monitoring cost.⁵⁸⁶ This happens because principals cannot hold their agents accountable for decisions that they (the principals) have themselves approved. Professor Kessler has also argued that representatives only have the incentive to inform themselves of issues necessary to make reasoned decisions

⁵⁸⁶ See section 5.4.1.

if they have the discretionary power to make those decisions.⁵⁸⁷ This means that directors and legislators would expend lesser effort on gathering and assimilating relevant information if their decisions is subject to the approval of shareholders and citizens respectively, than if their decision was final.

This discussion extends the line of argument to address binding initiatives. If principals have the power to make decisions that are binding on the agents, the agents cannot be said to have discretionary authority on that subject. The agents would, therefore, have reduced incentives to inform themselves regarding the relevant issues. Furthermore, principals who take decisions that are binding on their agents cannot hold their agents accountable for those decisions since the agents have no authority to interfere with or to correct such decisions. Therefore, for the purposes of initiatives, the accountability of agents is predicated on whether or not the agents have discretionary power, which depends on whether or not initiatives are binding. This discussion focuses on examining this issue.

As discussed earlier, the ramifications of legislative and constitutional amendments are far-reaching and are often not entirely predictable. In a system where the discretion of the agents is frequently replaced by the principals, it may be difficult to determine whether it was the actions of the agents or the principals that caused poor performance in the future. For example, if citizens pass even a few binding initiatives that have a significant impact on economic or fiscal policy, they will not be able to hold the legislature solely responsible for future economic outcomes. This is because legislation, especially economic and fiscal legislation, has far reaching and unexpected consequences that cannot be separated from the results of other legislation. In other words, when citizens actively make decisions on certain issues, they will have a hard time determining whether unwanted outcomes in the future are the result of their initiatives or were caused by the policies of the legislature. More specifically, citizens will not know in what proportion the blame can be allocated when things go wrong or whom to give credit to when things go well.

The inability to apportion blame and give credit where it is due means the ability of the principals to monitor their agents will be compromised. Since difficulty in monitoring would lead to elevated monitoring costs, agency cost would also rise in a corresponding manner.

⁵⁸⁷ Kessler, Anke S. "Representative versus Direct Democracy: The Role of Informational Asymmetries." *Public Choice* 122, no. 1-2 (2005): 9-38 at 10.

Regarding the merits of binding or non-binding initiatives, it seems that a binding initiative leaves no room for any accountability of the legislature for that decision. This is because the legislature is outside the decision-making process and the initiative proposal bypasses it entirely to make laws.

It is, therefore, clear that binding initiatives will lead to a certain dilution in the accountability of government as it shifts authority from the legislature to the citizens. Having determined that binding initiatives decrease the accountability of the legislature, the question that remains to be answered is whether non-binding initiatives also dilute the accountability of agents and contribute to an increase in monitoring cost and agency cost? This question is answered below.

Talking about the value of authority, Professor Arrow wrote, "if every decision of A is to be reviewed by B, then all we really have is a shift in the locus of authority from A to B and hence no solution to the original problem."⁵⁸⁸ At first glance, this would suggest that if the legislature reviews all non-binding initiatives, there would be no loss of accountability since the decision-making authority would have shifted back to the legislature. The legislature would, therefore, be responsible for the consequences of all policy, even if some of it is proposed through the initiative process and the non-binding initiative would cause no increase in monitoring cost due to reduced accountability of agents. This is because for the purposes of Professor Arrow's argument, it is the legislature and not the citizens who exercise decision-making authority in the case of non-binding initiatives because the decision of the citizens is subject to review by legislature.

Unfortunately, the situation is not that simple. Professor Hamermesh, in the context of corporate governance, suggests that it may be overstating the case to claim that accountability transfers entirely from principals to the agents just because the agents have the power to review decisions adopted via non-binding initiatives.⁵⁸⁹ In fact, responsibility for such decisions may not pass to the agents even if they have the final say because the principals will nevertheless take partial credit or blame for the consequences. This would mean that the responsibility for the consequences of decisions taken by the citizens and then affirmed by

⁵⁸⁸ Arrow, K. E. *The Limits of Organization*. Norton, 1974 at 78.

⁵⁸⁹ Hamermesh, Lawrence A. "Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street." *Tul. L. Rev.* 73 (1998): 409 at 463.

the government would fall on both citizens and legislators. Therefore, neither would be entirely accountable.

To summarize, it is clear that binding initiatives can lead to a serious dilution in the accountability of the legislature if misused. This would cause an increase in monitoring cost and, therefore, an increase in agency cost. However, binding initiatives minimize residual loss because the policy adopted directly by the citizens tends to reflect the majority view of the principals. The problem of not being able to hold the agents accountable for the outcomes of initiatives can be alleviated somewhat by making the initiatives precatory and subject to the approval of the legislature. However, the requirement to get the legislature's approval for non-binding initiatives does not entirely eliminate the dilution of accountability.

It is, therefore, proposed that initiatives should be binding only when there is a high likelihood of a conflict of interest between citizens and legislators. In such cases, the interest of ensuring that agents do not overrule the wishes of the principals to benefit themselves is greater than the cost of lowered accountability. In other words, the chance of extraordinary residual loss is greater than the threat of high monitoring cost caused by reduced accountability. Section 6.4 discussed a similar matter in the context of consistency in planning and maintaining a long term approach. It explained that concerns of consistency in policy may be less important than preventing legislators from making self-serving decisions when decisions involving a strong conflict of interest for legislators have to be made. On the other hand, when there is no such conflict of interest, greater discretion can be given to legislators.

Similarly, in this case, binding initiatives should be allowed for decisions that create a conflict of interest for legislators such as decisions to introduce term-limits, mandate financial disclosures for legislators, regulate campaign finance etc. Here, the risk that the legislature may reject a non-binding initiative introducing such provisions due to self-interest is likely to be greater than the risk that such a decision might reduce legislators' accountability and increase monitoring cost.

Decisions on issues that do not pose a serious conflict of interest for legislators can be restricted to non-binding initiatives. For example, giving the legislature the final say on non-binding initiatives involving education reform, energy policy etc. is unlikely to suffer from a conflict of interest. On the other hand, such decisions have high potential to reduce

accountability. After all, education and energy policies are highly complicated and it would be difficult to determine whether future improvements or problems in education and energy supply were caused by legislative actions or were the triggered by laws adopted via a binding initiative. This would make it difficult to hold legislators accountable for future performance thereby increasing monitoring cost and leading to increased agency cost. When the chances of conflict of interest are low, the enhanced flexibility and partial transfer of accountability to the legislature brought about by non-binding initiatives, therefore, seems to be the better option because extraordinary residual loss is not the primary problem in such cases.

8.5.3 *The Role of Special Interest Groups*

Chapter six discussed the role of special interest groups in direct democracy.⁵⁹⁰ This discussion extends that line of argument examining how special interest groups differently influence binding and non-binding initiatives. While the adoption or rejection of initiatives (and shareholder bylaw amendments) is a decision made by a majority of the principals, it has been pointed out that “the direct lawmaking process gives powerful leverage to initiative drafters, who are situated to construct a phantom popular intent through strategic drafting.”⁵⁹¹

As discussed in connection with referendums, framing can play a powerful role in determining the outcome of majority votes.⁵⁹² Special interest groups can, therefore, use a cleverly worded proposal to create a gap between the real preferences of the people and their perceived preferences as are expressed through the majority vote.⁵⁹³

⁵⁹⁰ See Section 6.5

⁵⁹¹ Schacter, Jane S. “The Pursuit of “Popular Intent:” Interpretive Dilemmas in Direct Democracy.” 105 *Yale Law Journal* 107 (1995).

⁵⁹² See section 7.5.

⁵⁹³ See for example the text of the referendum question put by General Pinochet before the Chilean people discussed in section 6.5.

“In the face of international aggression against the government of our fatherland, I support President Pinochet in his defense of Chile’s dignity, and I once again confirm the legitimacy of the government of the republic in its leadership of the institutional proceedings in this country.”

While this is the text of a referendum, the same framing concerns arise regardless of whether the proposal is framed by unscrupulous legislators or unscrupulous special interest groups.

This problem has been recognized in corporate governance with respect to initiation of decisions by the principals. Professor Gordon postulates that the ability of factions amongst shareholders to use direct decision-making to secure private gains rather than common gains is a key reason why the board of directors has extraordinary discretionary power. In particular, he says that this is a critical argument against shareholder initiation of decisions.⁵⁹⁴

Citizens have a greater diversity of interests than shareholders because issues of distribution create competing interests within the voting population in a country. This means that there is a greater risk that special interest groups may advance the interests of some principals at the expense of the others. Special interest groups, therefore, pose a greater problem constitutional law than in corporate governance.⁵⁹⁵ Accordingly, binding citizens' initiatives are fraught with risk of special interest groups capturing private gains. This problem is magnified by the role of super agents which might selectively serve the interests of special interest groups. This creates a high chance of incurring significant monitoring costs to oversee the actions of the super agents.⁵⁹⁶

Making such initiatives non-binding may alleviate this risk. This solution would allow the legislature to block the most objectionable initiatives while explaining their reasons to the voting population in fulfilment of their fiduciary responsibility to all citizens. This trades the possibility of a small risk of increased residual loss for a minimization in the chance of incurring considerable monitoring costs

Accordingly, the recommendation of allowing binding initiatives only in cases where the legislature has a strong conflict of interest and precatory initiatives in all other circumstances alleviates the threat posed by special interest groups. The suggestion of only permitting initiatives that deal with a single issue suggested earlier in the dissertation will also reduce the scope for special interest groups to coordinate their activities and advance their interests at the expense of other citizens.

⁵⁹⁴ Gordon, Jeffrey. "Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law" *University of Cincinnati Law Review* 60: 347-354 at 361.

⁵⁹⁵ Unlike shareholders who share a common goal of enhanced shareholder value with differences as to long term or short term outlook, citizens have more fundamental differences in interest. Perhaps the best example of a divergence of interest amongst groups of citizens is the distribution of wealth which places the interests of rich citizens directly in opposition to the interests of poor citizens.

⁵⁹⁶ See the role of super agents in direct decision making discussed in section 3.3.2.

8.6 FINDINGS

Delaware courts have recognized that there are no easy solutions to reconcile the discretion of the board of directors' to manage the business and affairs of the company and the rights of shareholders to adopt, amend and repeal bylaws. This stems from the absence of judicial consensus on the conflict between DGCL §141(a) and DGCL §109(b). This confusion is heightened when the case of the UK is considered since the principal-agent relationship created by the corporate laws of the UK allows shareholders to direct the actions of the directors to a greater degree than in Delaware.⁵⁹⁷

Since corporate governance has been unable to settle the issue of shareholders' right to initiate binding decisions in a decisive fashion, various solutions offered in corporate governance literature to help resolve this impasse are examined. This examination is used to identify which options would be most effective in minimizing agency cost if applied to constitutional law.⁵⁹⁸ The focus on theory is necessary since the different systems in the US and the UK have both seen success in reducing agency cost to a level low enough to become internationally competitive in attracting investment and management talent.

Professor Coffee suggests that a suitable litmus test for restricting the power of the board through direct decision-making is a distinction between ordinary and fundamental matters. He suggests that shareholders might be allowed to pass bylaws regulating or restricting the power of the board to make fundamental decisions but not their power to make ordinary business decisions.⁵⁹⁹ This classification mirrors a constitutional scheme that permits citizens' initiatives on constitutional amendments but not on regular legislation. This would allow citizens to share agenda control and discretionary power with the legislature on fundamental 'rules of the game' decisions but excludes them from ordinary matters corresponding to 'specific business decisions'.

⁵⁹⁷ See section 8.2.2.

⁵⁹⁸ Agency cost is defined as the cost of using an agent. Since direct decision-making is used here as a monitoring mechanism, it forms part of the total agency cost. This concept is discussed in detail in Chapter 1.

⁵⁹⁹ Coffee Jr, John C. "Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests, The." *U. Miami L. Rev.* 51 (1996): 605 at 613-14.

Rules of the game decisions such as fundamental corporate decisions govern the relationship between principals and their agents and between the principals themselves.⁶⁰⁰ Such decisions often have an impact on the continued employment, career advancement or empire building ambitions of agents. Rules of the game decisions, therefore, have the potential to create a conflict of interest when agents are solely responsible for making them.

By following the same approach and by providing citizens' with the right to propose and adopt binding initiatives on matters where the legislature has a conflict of interest or the decision affects the "rules of the game", constitutional law can address the most serious concerns for agency cost. At the same time, restricting binding initiatives to certain defined classes of decisions and not permitting binding initiatives on "specific business decisions" will limit the chance of them being abused.

Admittedly, the cost of collective action incurred due to initiatives may be high due to a combination of factors such as control of the process for drafting initiatives, the dilution of agent's accountability, agent's incentives to inform themselves and special interest groups amongst principals. Since direct democracy is used to intervene in delegated decision-making in a limited manner to keep policy in line with the wishes of the principals, its cost is characterized as monitoring cost. As long as the cost of collective action (here a component of monitoring cost) remains lower than the high residual loss expected from decisions where the agents have a conflict of interest, agency cost can be minimized using binding initiatives.

A larger cost of collective action is worth incurring in situations where the risk of a conflict of interest for the agents is high. This is because agents with vast discretionary power such as directors and legislators can impose huge residual losses if they breach their fiduciary duties. This means that the expected residual loss stemming from not allowing binding initiatives on rules of the game decisions and conflict of interest decisions is higher than the increased monitoring cost brought about by binding initiatives. Accordingly, the proposed solution of allowing citizens to use binding initiatives to make decisions when the legislators have a conflict of interest and to amend the "rules of the game" will minimize agency cost.

⁶⁰⁰ See Bebchuk, Lucian Arye. "The Case for Increasing Shareholder Power." *Harvard Law Review* (2005): 833-914 at 844. An explanation of rules of the game decisions is also given in section 4.1.1.

The Influence of Direct Democracy on Agency Costs:
Lessons from Corporate Governance

9 CONCLUSION

This dissertation aims at providing insights from the field of corporate governance to minimize agency cost in constitutional law by improving the use of direct democracy. Chapter two establishes the basis for a comparative analysis by assuming that companies and countries are both governed through delegated decision-making. The use of direct decision-making by principals is an exceptional intervention which serves as a monitoring mechanism. Accordingly, the cost of collective action imposed by direct democracy is considered to be a part of the monitoring cost. On the other hand, the convergence of policy with the preferences of the principals reduces residual loss. Agency cost is thus lowered by the use of direct democracy only when the reduction of residual loss exceeds the accompanying increase in monitoring cost.

The dissertation argues that findings from corporate governance have much to offer constitutional law in this regard. To identify such insights, the corporate law of the State of Delaware, read together with relevant federal laws and regulations was selected as the subject of the comparative analysis. This is because the principal-agent relationship addressed by corporate law in Delaware has emerged as a fore-runner in attracting numerous and dispersed investors (principals) and top management talent (agents), out-performing not only other jurisdictions but also other vehicles for business such as limited liability partnerships.

However, the UK is also known worldwide for having a large number of big public companies with dispersed shareholders. It has also been very successful in attracting agents to manage these companies. Accordingly, when there are differences in the use of direct decision-making between US (Delaware) and UK law, both systems are analyzed.

The third chapter examines how certain key differences between corporate and constitutional law impact this comparative analysis and looks at how these differences can be compensated for.

Using this methodology, two questions were answered.

- Are initiatives useful even when referendums are provided for?
- Should the results of direct democracy be binding?

The first question is selected because it directly relates to the status quo in corporate governance around the world. Chapter five explains that constitutional law varies between countries regarding the availability of referendums and initiatives and the presence or absence of these provisions are not by themselves indicative of agency cost in those countries. On the other hand, the corporate laws of nearly every country provide that shareholders' approval is mandatory for fundamental corporate decisions. Interestingly, however, like constitutional law, corporate law varies across jurisdictions on the rights of shareholders to initiate decisions.

Seeing that corporate law almost universally gives shareholders rights equivalent to a referendum regarding fundamental corporate decisions, whether or not this requirement reduces agency cost is examined. This is followed by an analysis of whether these findings from corporate law are applicable to constitutional law. It appears that the near universal ability of shareholders to veto a fundamental corporate decision reduces agency cost by separating decision management from decision control.⁶⁰¹ Furthermore, by providing a veto for rules of the game decisions and normally not providing a veto for ordinary business decisions, corporate law provides extra monitoring for major decisions that have are likely to pose a greater conflict of interest for the agents.⁶⁰²

This is followed by an exploration of corporate governance literature to identify theoretical insights that help to determine when principals should have the right to initiate decisions. Chapter five demonstrates that referendums do not reduce agency cost when agents prefer the status quo, agents prefer the worse of two beneficial options or when agents bundle a value increasing proposal with a value decreasing one.⁶⁰³ In such cases, only initiatives can help principals to adopt the policy they wish to pursue.

It is argued that initiatives can reduce agency cost by separating specific issues from elections, bypassing a biased executive to provide information to legislators and by preventing distortions in constitutional evolution. Additionally, initiatives can separate

⁶⁰¹ See section 2.4 and Fama, Eugene F., and Michael C. Jensen. "Agency Problems and Residual Claims." *Journal of Law and Economics* 26, no. 2 (1983): 327-349.

⁶⁰² Rules of the game decisions often involve a conflict of interest when decided by agents because they involve the relationship between principals and agents and between the principals themselves.

⁶⁰³ See section 5.3.

specific issues from elections by allowing citizens to adopt policies that the incumbent legislature has not initiated. Citizens can, therefore, avoid the need to replace the legislature just to change a single policy. It also means that citizens only need the information required to make a single decision rather than information on all government policies which is required to replace the legislature.

Initiatives also provide a direct view of citizens' preferences to the legislators. In the alternative, legislators are restricted to information supplied by bureaucrats who have a personal interest in protecting and advancing their careers and may adjust the information they pass on accordingly.

The initiative process can also ensure that legislators do not get exclusive control over the agenda when it comes to amending the constitution thereby preventing a distortion in constitutional evolution in favor of the legislators. If initiatives are not provided for, a series of amendments over the extremely long lifespan of the constitution can lead to a situation where legislators accumulate more power than their citizens want them to have and what any single amendment taken alone could have given them.

This is followed by chapter six which contrasts the advantages of initiatives discussed above to certain problems that the use of initiatives can give rise to. Furthermore, this chapter also examines corporate governance literature to see how these problems are addressed in corporate law. It examines how difficulty in determining whether decisions made by the agents or decisions made by citizens are responsible for future outcomes can dilute the accountability of legislators. Next, it looks at how corporate law avoids the submission of nuisance proposals and how those principles can be applied to screen initiatives in constitutional law. Then the issue of imperfect information available with citizens is addressed. It is shown here that citizens use cues from trusted parties and this, combined with the influence of the Condorcet Jury Theorem suggests that they can vote to advance their interests even if they are not perfectly informed at the individual level.

This chapter also looks at how corporate law recognizes the need to have consistent, long-term policy to manage the company and how this long-term policy can be protected from being derailed by shareholder proposals that take a short-term view. It also looks at how the laws regulating shareholder proposals protect the directors from blackmail by special interest groups who threaten extreme shareholder proposals if their demands are not met.

The findings of this chapter suggest that constitutional law would benefit from adopting a rule that has seen nearly universal adoption in corporate law. That is, the requirement for principals to approve decisions that impact the principal-agent relationship by altering the relationship between the principals and their agents. Such rules are called ‘rules of the game’ decisions. The dissertation also argues that the approval requirement for adopting and amending such rules should also be extended to decisions that involve a substantial conflict of interest for the agents even if they are not ‘rules of the game’ decisions.

With respect to initiatives, the conclusions are more limited and tempered with certain reservations. It is found that allowing for initiatives has considerable advantages as well as the possibility for abuse. Accordingly, it is opined that the best solution in this case is to create a default rule that provides for initiatives rather than making mandatory provisions for or against the use of initiatives. For example, if non-binding initiatives are provided for by default and are later found to be more trouble than they are worth, citizens would propose a decision to do away with initiatives and the legislature would support such a decision. On the other hand, if initiatives are not provided for by default, the legislature might not introduce later even if they are then found to be desirable. This is because legislators may not want to share agenda control and in such cases, citizens will have no means to introduce initiatives at a later date. This solution suggests that agency cost can be minimized by adopting a default rule that is more restrictive on the legislators and counting on them to opt out of the default rule if it is later found to be ineffective.

Corporate law also has insights to offer regarding issues of information and incentives related to citizens’ participation in direct democracy. Chapter six points out that shareholders who have a large and undiversified interest in the company such as individual activist investors, hedge funds etc. most often engage in shareholder activism. Because such shareholders have a large stake in the company and receive a substantial proportion of the company’s profits, they have the incentive to gather sufficient information required for direct decisions making. The free rider problem can, therefore, be overcome by principals who have a large enough interest in the success of the company even though they do not own a hundred percent of the shares.

Since most citizens live their whole lives in the same country, they can be considered to be undiversified. Because the social and economic wellbeing of citizens is deeply affected by the policies of their country, they are found to have a large and substantial interest in the country.

In light of this, it is believed that citizens would have adequate incentives to get informed about issues relevant to referendums and initiatives. This information may be gathered through cues and with the assistance of super agents. In fact, the dissertation argues that even if citizens are not informed, the results of the vote may be representative due to the Condorcet Jury Theorem. This theory suggests that a large enough sample of voters will accurately represent their preferences as long as each of them individually has a greater than fifty percent chance of identifying the best option based on the available information.

Lastly, Chapter six proposes that the proper purpose test of Rule 14-8(i)(1) may be used to determine the proper subject for initiatives. According to this, if a shareholder proposal does not bind the board of directors, it is presumed to fall within the 'proper purpose' of shareholder action and may be circulated and voted upon under Rule 14a-8. In such cases, the onus shifts to the board of directors to prove that the subject matter of the proposal is not suitable if they wish to exclude the proposal from the company's proxy statement and stop it from being voted upon by shareholders. Applying this rule to constitutional law, it is proposed that initiatives framed as recommendations, which do not bind the government, should also be presumed to be suitable for inclusion on the ballot as long as other requirements are satisfied.

When initiatives do require action on the part of the government, the application of Rule 14-8(i)(1) read together with Delaware law must be considered. Applying §141(a), DGCL to constitutional law suggests that initiatives must relate to subjects that are 'substantially related to the functions of government' but do not pertain to the 'ordinary business and affairs of the country'. This implies that citizen initiatives must address strategic rather than managerial decisions and must confine themselves to issues that the government is empowered and expected to address.

Chapter seven looks at whether referendums should be binding in order to best minimize agency cost. As mentioned earlier, the corporate laws of nearly all countries require the approval of shareholders for fundamental corporate decisions. Of particular importance here is the fact that such approval is mandatory. In other words, the decision of the shareholders is binding on the directors and the directors cannot pursue a policy rejected by the shareholders. When constitutional law around the world is examined, it becomes clear that there is no uniformity amongst countries regarding whether or not the approval of citizens in a referendum is mandatory. Some countries provide for binding referendums while others

provide for non-binding referendums. To shed light on which option might provide the least agency cost, corporate governance scholarship on shareholder approval of board proposals is examined in depth.

Briefly summarized, it is found that there is a potential for extraordinary residual loss and a high potential for self-dealing and corruption when agents make ‘rules of the game’ decisions under constitutional law. Legislators have a large degree of immunity from prosecution and in some countries they may also be highly entrenched. This can lead to situations where legislators may ignore non-binding referendums and risk upsetting the citizens if the conflict of interest is large enough. Therefore, it is often better to accept the increased monitoring cost caused by binding referendums rather than risk extraordinary residual loss that may be imposed by corrupt legislators who may choose to ignore a non-binding referendum. This argument is supported by an analysis of how the choice of binding v. non-binding referendums affects the incentives of citizens and legislators to get informed, how it influences framing concerns and how it impacts the separation of decision management from decision control.

Chapter eight examines whether initiatives should be binding or non-binding in order to most effectively reduce agency cost. To conduct a comparative analysis, a positive examination of corporate law is carried out. This study shows that shareholders are allowed to initiate binding as well as non-binding decisions. Shareholder proposals per se are typically non-binding otherwise they are not approved by the SEC under Rule 14a-8 due to the state law exception. However, shareholders share the right to amend the bylaws with the board of directors. Since bylaws are self-executing, shareholders can initiate and adopt bylaws which would be binding on the board of directors. The result of this is that shareholders can initiate binding decisions on matters that are subject to inclusion in the company’s bylaws.

The position in the UK is clear. Shareholders can initiate amendments to the articles of association and give binding instructions to the board of directors. The US position is highly complicated. To decide the issue one way or another to decide which option provides more useful lessons for constitutional law, corporate governance literature is examined in depth.

First, this chapter examines whether shareholder-initiated decisions have sufficient influence on the agents to bring the agents’ behavior in line with the wishes of the shareholders. Then it compares the relative merits of non-binding shareholder proposals v. binding bylaw

amendments. The lessons learnt from this are applied to understand the relative merits of binding v. non-binding initiatives. Then the discussion is taken one step further and the chapter looks at whether decisions taken by principals should be subject to repeal or amendment by the agents at a later date. In the absence of clear statutory indications, the evolution of case law on the matter is examined. To see how DGCL §141(a) and DGCL §109 can be reconciled, *General DataComm Industries, Inc. v. State of Wisconsin Investment Board*, *American Int'l Rent a Car, Inc. v. Cross*, *Centaur Partners, IV v. National Intergroup, Inc.* and finally *CA, Inc. v. AFSCME* are examined. This chain of decisions suggests that even though there is a lack of clarity on the issue, shareholders may not be able to adopt bylaws with provisions that prevent the board of directors from subsequently amending or repealing the bylaw.

The case on point in constitutional law is *Luker v. Curtis* in which the Supreme Court of Idaho held that nothing prevented the legislature from amending or repealing provisions enacted through initiatives *unless the initiative prohibited it*. It is argued that allowing citizens to adopt laws through initiatives that cannot later be amended by the legislature can be dangerous because it does not take into account unforeseen circumstances. This is doubly dangerous since initiatives are drafted without the deliberation and expert treatment the legislature can provide. On the other hand, allowing legislators to amend or repeal laws adopted via initiatives can lead to high agency cost if the government chooses to reverse a measure that restricts their power. It is, therefore, proposed that the legislature should only be prohibited from amending laws adopted through the initiative process if such laws deal with issues where the legislators have a conflict of interest and in the case of rules of the game decisions. In all other cases, it is recommended that the legislature should be allowed to repeal or amend such laws to ensure that the legislature is empowered to respond to unforeseen eventualities. This will ensure that when conflict of interest is at its highest, agents can be prohibited from subsequently amending or repealing the provisions designed to stop agents from breaching their fiduciary duties.

The application of insights from corporate governance can, therefore, be used to gain insights into how direct democracy can be used to minimize agency cost in corporate governance. This dissertation has explored some of the important issues relating to the use of direct democracy and provided possible solutions should help to make the principal-agent relationship in constitutional law more efficient. The rapid pace of evolution in corporate

governance means that several opportunities to gain further insights continue to emerge. On October 1, 2013, the UK adopted the Enterprise and Regulatory Reform Act 2013 which requires the binding approval of shareholders for the executive compensation policies of public companies. This is a drastic departure from the previous 'say on pay' regime in the US and the UK which was strictly non-binding. As more data becomes available, it would be useful to see what impact making shareholder approval of executive compensation binding has on executive compensation vis-à-vis the period when 'say on pay' was precatory. The results of the new UK provisions can also be contrasted with the results of precatory 'say on pay' requirements that continue to exist unchanged in the US.

This study can allow a comparison to see whether requiring binding shareholder approval where the directors have a conflict of interest is more effective at reducing agency cost than requiring only non-binding approval. The findings of this dissertation suggest that binding decisions taken via direct democracy create more monitoring cost than non-binding direct democracy measures. However, the dissertation still recommends binding decision-making via direct democracy in cases where the agents have a conflict of interest and in major rules of the game decisions. This is because the consequences if agents ignore the principals' wishes can be extremely serious in constitutional law. The resultant increase in residual loss can, therefore, negate the savings in monitoring cost that non-binding decision-making would produce. An examination of the change in monitoring cost and residual loss caused by the introduction of binding say on pay rules in the UK is, therefore, a promising direction for further research.

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Summary

This doctoral dissertation seeks to improve the usage of direct democracy in order to minimize agency cost. It first explains why insights from corporate governance can help to improve constitutional law and then identifies the relevant insights from corporate governance that can make direct democracy more efficient.

To accomplish this, the dissertation examines a number of questions. What are the key similarities in corporate and constitutional law? Do these similarities create agency problems that are similar enough for a comparative analysis to yield valuable insights? Once the utility of corporate governance insights is established, the dissertation answers two questions. Are initiatives necessary to minimize agency cost if referendums are already provided for? And, should the results of direct democracy be binding in order for agency cost to be minimized?

This comparative analysis is valuable because no existing research can be found which uses corporate governance to draw insights that can minimize agency cost in constitutional law, particularly by improving the use of direct democracy.

After having explained the theoretical framework, this dissertation looks at circumstances where the right to veto (e.g. referendums) cannot help principals to reduce agency cost. Building on the corporate governance debate, this dissertation argues that introducing initiatives in constitutional law can reduce agency cost by separating individual issues from general elections. It also argues that giving legislators exclusive control of the agenda can, over the course of decades, lead to a situation where legislators accumulate more authority than citizens wish to delegate.

Because initiatives also carry the risk of diluting the accountability and responsibility of the legislators, the dissertation proposes a system of 'penalty defaults' in favor of initiatives. By creating a default restrictive on legislators (namely a default rule allowing for initiatives), the constitution can ensure that initiatives are possible in the normal situation in which they actually reduce agency cost. At the same time, legislators are well situated to push for an end to the use of initiatives if they are being abused too frequently.

The dissertation then argues that referendums should be binding on the legislature in two cases: one, when they relate to 'rules of the game' decisions; and two, when the legislators

have a conflict of interest. This is based on insights from the almost universally accepted right of shareholders to approve or reject fundamental corporate decisions initiated by the board of directors or whenever they have a conflict of interest.

The last issue covered by the present work is whether or not initiatives should be binding in order to minimize agency cost. The U.S. and the UK have both been successful in attracting investors and managerial talent despite considerable differences in the ability of shareholders to initiate decisions. In light of this, these two legal systems and the pertinent academic literature on corporate governance are examined in order to identify when initiatives should be binding in order to minimize agency cost. Based on this analysis, it is argued that binding initiatives should only be allowed for making 'rules of the game' decisions especially when the legislators have a conflict of interest. Interestingly, this dissertation recommends that initiatives should also be allowed on 'ordinary business decisions', but such initiatives should be non-binding in order to minimize agency cost.

Samenvatting

Dit proefschrift tracht het gebruik van directe democratie te verbeteren teneinde agency kosten te minimaliseren. Als eerste wordt verklaard waarom inzichten van corporate governance kunnen helpen om constitutioneel recht te verbeteren. Vervolgens worden relevante inzichten van corporate governance geïdentificeerd waardoor directe democratie efficiënter kan worden gemaakt.

Om dit te bereiken wordt in dit proefschrift een aantal vragen onderzocht. Wat zijn de belangrijkste overeenkomsten tussen ondernemingsrecht en constitutioneel recht? Veroorzaken deze overeenkomsten agency problemen die zodanig overeenkomen dat een vergelijkende analyse waardevolle inzichten op zou kunnen leveren? Nadat de waarde van corporate governance inzichten is vastgesteld, worden er in dit proefschrift twee vragen beantwoord. Zijn er initiatieven nodig om agency kosten te minimaliseren als hier al referendums voor bestaan? En zouden de uitkomsten van directe democratie bindend moeten zijn voor de minimalisering van agency kosten?

Deze vergelijkende analyse is waardevol omdat er geen bestaand onderzoek te vinden is dat corporate governance gebruikt om inzichten te verschaffen die agency kosten in constitutioneel recht kunnen minimaliseren, met name door de toepassing van directe democratie te verbeteren.

Na een uitleg van het theoretische raamwerk te hebben gegeven, kijkt dit proefschrift vervolgens naar de omstandigheden waar het vetorecht (bijv. referendums) de principals niet kan helpen om agency kosten te beperken. Voortbouwend op het corporate governance debat, beargumenteert dit proefschrift dat het introduceren van initiatieven in constitutioneel recht de agency kosten kan verlagen door individuele zaken te scheiden van algemene verkiezingen. Het stelt tevens dat het overdragen van exclusieve controle over de agenda aan wetgevers in de loop der tijd kan leiden tot een situatie waar wetgevers meer macht verkrijgen dan burgers wensen te delegeren.

Omdat initiatieven tevens het risico met zich meebrengen dat de aansprakelijkheid en verantwoordelijkheid van wetgevers wordt verminderd, wordt in dit proefschrift een systeem van 'standaard boetes' voorgesteld ten gunste van initiatieven. Door een standaard beperking voor wetgevers te creëren (namelijk een standaardregel die initiatieven toestaat), kan de constitutie zich ervan verzekeren dat initiatieven mogelijk zijn in de normale situatie waar zij

inderdaad agency kosten verlagen. Tegelijkertijd zijn wetgevers juist in de positie om een einde te maken aan het gebruik van initiatieven als deze te vaak worden misbruikt.

Het proefschrift beargumenteert vervolgens dat referendums bindend zouden moeten zijn voor de wetgevende macht in twee zaken: (1) wanneer ze gerelateerd zijn aan 'regels van het spel' beslissingen; en (2) wanneer er sprake is van een belangenverstremgeling bij de wetgevers. Dit is gebaseerd op inzichten van het vrijwel algemeen geaccepteerde recht van aandeelhouders om door de Raad van Bestuur geïnitieerde fundamentele beleidsbeslissingen goed of af te keuren, of wanneer er sprake is van een belangenverstremgeling.

Het laatste punt dat in dit proefschrift wordt behandeld, is of initiatieven al dan niet bindend zouden moeten zijn teneinde agency kosten te minimaliseren. De V.S. en de UK zijn beide succesvol in het aantrekken van investeerders en leiderschapstalent ondanks aanzienlijke verschillen in de bevoegdheid van aandeelhouders om beslissingen te initiëren. In het licht hiervan worden deze twee juridische systemen en relevante wetenschappelijke literatuur onderzocht teneinde initiatieven te identificeren die bindend zouden moeten zijn om agency kosten te minimaliseren. Gebaseerd op deze analyse wordt beargumenteerd dat bindende initiatieven alleen toegestaan zouden moeten worden om 'regels van het spel' beslissingen te nemen, in het bijzonder wanneer er sprake is van belangenverstremgeling bij de wetgevers.

Interessant is dat dit proefschrift aanbeveelt dat initiatieven ook toegestaan zouden moeten worden voor 'gewone zakelijke beslissingen'. Deze initiatieven zouden echter niet-bindend moeten zijn om agency kosten te minimaliseren.