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Non-Binding Employee Referenda in Transformative Transactions**

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Bodie, Matthew T., Workers, Information, and Corporate Combinations: The Case for Non-Binding Employee Referenda in Transformative Transactions. *Washington University Law Review*, Vol. 85, 2008.

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WORKERS, INFORMATION, AND CORPORATE COMBINATIONS:
THE CASE FOR NON-BINDING EMPLOYEE REFERENDA
IN TRANSFORMATIVE TRANSACTIONS

Matthew T. Bodie *

This article proposes that employees be given a vote in nonbinding referenda on mergers and other corporate combinations. The purpose of such referenda would be twofold. First, they would provide more information to managers, directors, and shareholders about the costs and benefits of the proposed transaction. Second, they would give employees a voice in the process – a voice that is valuable even if it has no material ramifications. Given the low costs in implementing the referenda, the article encourages states to consider this innovation as a small but significant addition to their corporate law schema.

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INTRODUCTION

How can I convey to you the disgust which your name awakens in me? The merger with Warner was a catastrophe. But the hitherto unimagined stupidity, the blind arrogance of your deal with Case simply beggars description. How can you face yourself knowing how much history, value and savings you have thrown away on your mad, ignorant attempt to merge with a wretched dial-up ISP? I don't know what advice you have to offer, but I have some for you. Buy some rope, go out the back, find a tree and hang yourself. If you had any honor you would.

- email from Robert Hughes, Time magazine art critic, to Gerald Levin, AOL Time Warner CEO, 2002¹

Employees present a curious puzzle for corporate law. On the one hand, employees are central to every business. The success of a corporation depends on its employees, from the chief executive officer down to the front-line production or service worker. When we think of a corporation, we think of its brand, its business, its leadership, and its employees. But for the most part, corporate law relegates employees to the sidelines. The players in corporate law dramas are management, directors, and shareholders. The tension between shareholders and management is the focal point of corporate scholarship.² Employees have no role in corporate governance.

¹ KARA SWISHER, THERE MUST BE A PONY IN HERE SOMEWHERE: THE AOL TIME WARNER DEBACLE AND THE QUEST FOR A DIGITAL FUTURE 200 (2003).

² See, e.g., ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial*

Perhaps nowhere is this contrast as dramatic as in the realm of mergers, acquisitions, and other transformative transactions. Such transactions are generally negotiated at the highest levels of management, approved by the board, and then announced to great fanfare.³ Shareholders have the power to vote on most large-scale combinations and therefore hold veto power over their ultimate consummation.⁴ Employees have no say. Even unionized employees do not have the right to bargain over these transactions; at most, they can merely bargain about their effects.⁵

However, as the email in this article's epigraph vividly demonstrates, employees do have opinions about mergers, acquisitions, and other such transformative corporate transactions. Some of these opinions may be fairly predictable: for example, employees will be fearful of a merger that promises to eliminate huge swaths of the company's workforce. But employees also have more nuanced opinions about their work environment – opinions based on much more intimate knowledge about the company than shareholders typically have. These opinions may be overlooked in the post-announcement excitement, especially since management has an interest in hearing only positive news about the forthcoming combination.

This paper proposes that employees be given the right to vote on mergers, sales of substantially all assets, and the other corporate combinations for which shareholders can vote. Unlike shareholders' ballots, the employees' choices would not be binding on the company. The referenda would be held before the required shareholders' elections, so that shareholders could know about the results before they cast their votes. Although it might be possible to

Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976) (“We focus in this paper on the behavioral implications of the property rights specified in the contracts between the owners and managers of the firm.”); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1374 (1993) (“Managerial accountability to shareholders is corporate law's central problem.”). Cf. Edward B. Rock & Michael Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PENN. L. REV. 1619, 1624 (2001) (“It was as if everyone already knew (from Berle and Means) that the master problem of corporate law was agency costs, and along came an economic model and a vocabulary to elaborate that view.”).

³ In this description I refer only to transactions in which two companies combine; I do not include hostile tender offers. Such offers may lead to shareholders' selling their shares over the objections of the target company's board.

⁴ See, e.g., DEL. CODE ANN. tit. 8, § 251 (2007); MODEL BUS. CORP. ACT § 11.03 (2004).

⁵ Employers need not bargain over issues that are within the “core of entrepreneurial control.” *First National Maintenance Corp. v. NLRB*, 452 U.S. 666, 686 (1981) (no duty to bargain over decision to shut down part of business purely for economic reasons); *International Union, United Automobile, Aerospace & Agricultural Implement Workers of Am. v. NLRB*, 470 F.2d 422, 425 (D.C. Cir. 1972) (no duty to bargain regarding “sale” of manufacturer-owned and operated retail outlets to franchisers). However, employers must bargain over the effects such actions have on terms and conditions of employment. *First National Maintenance Corp.*, 452 U.S. at 676.

implement the referenda through federal law, states could also enact the referendum as part of their systems for corporate governance.

Why require corporations to conduct non-binding employee referenda? First, the referenda will improve the information flow surrounding corporate combinations and will lead to more efficient transactions. Mergers and acquisitions are generally negotiated under a heavy shroud of secrecy by the very top levels of management.⁶ After the initial agreement is announced, management has a strong incentive to see that the merger is approved, weakening any incentive for a robust debate on the merits of the plan. An employee vote would provide concrete data about workers' opinions on the merger. Although the vote would not have any legal effect, directors, management, and shareholders may find the expression of collective employee wisdom to be useful in making their own determinations about the wisdom of the proposed combination. Moreover, the vote would offer employees and shareholders the opportunity to work together in furtherance of their mutual interest: curtailing managerial rent-seeking.

Second, the vote will make employees feel more a part of the company by giving them a voice in the process. Current corporate law doctrine treats employees as a purchased input, no different than raw materials or property expenses.⁷ The referendum will give employees a chance to express their opinion on the combination. Social psychology research has shown that employee voice leads to improved productivity and job satisfaction, as well as greater corporate compliance.⁸ Allowing employees to participate in the process creates a greater likelihood that employees will buy into the merger and thus work for its success. In addition, the process of collective deliberation has the potential to create social capital that will come into play in other societal moments of democracy.

Finally, the proposed referenda impose relatively small costs on companies. With improved technology, it is much easier and less expensive to conduct a company-wide election than it once was.⁹ Rather than mailing proxy materials to employees, employers will be able to make use of inter-office mail, email, and corporate web pages to distribute the necessary materials and

⁶ See DAVID A. BROADWIN, *NEGOTIATING AND DOCUMENTING BUSINESS ACQUISITIONS 2* (1997) (discussing the importance of confidentiality agreements to merger negotiations); J. Robert Brown, *Corporate Secrecy, the Federal Securities Laws, and the Disclosure of Ongoing Negotiations*, 36 CATH. U. L. REV. 93, 93 (1986) ("Most major arms length agreements are preceded by a period of negotiations that typically take place behind a veil of secrecy.").

⁷ Cf. KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW 60-66* (2006) (comparing the corporate law protections for shareholders with the absence of such protections for employees).

⁸ Part III *infra*.

⁹ See Part IV *infra*.

conduct the final tally. It is an ideal opportunity for state experimentation – the “genius” of American corporate law.¹⁰

The barriers between corporate and labor law have too long stymied efforts to provide employees with more involvement in their work life. Recent studies have made clear that workers want some form of meaningful participation in their place of employment.¹¹ Traditional responses, such as employee ownership, ESOPs, labor unions, and work councils, have failed thus far to provide such opportunities to a large percentage of the workforce. The implementation of these employee referenda would finally give workers a voice on issues of corporate transformation, in an area where their input would benefit managers, directors, and shareholders as well.

I. THE PROPOSAL

In the United States, corporations are creatures of state law.¹² The delegation of such a critical legal regime to a collection of fifty independent governmental regimes has drawn both praise and criticism.¹³ What is perhaps more remarkable, however, is the relative uniformity of corporate law despite its many creators. In these different regimes, the central locus of authority within the corporation is the board of directors.¹⁴ The board has the authority to hire the officers of the corporation and to terminate the officers according to contractual provisions. Although we generally think of the chief executive officer as the head of the corporation, the board has the authority to remove the CEO from office. In turn, the shareholders have the authority to elect the board. This power structure has led to the conception that shareholders are the ultimate “owners” of the corporation.¹⁵ However, directors have the right to run the corporation largely as they wish and need not follow the dictates of a

¹⁰ ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

¹¹ RICHARD B. FREEMAN & JOEL ROGERS, *WHAT WORKERS WANT* (1999).

¹² JAMES D. COX & THOMAS LEE HAZEN, *CORPORATIONS* 31 (2d ed. 2003).

¹³ See, e.g., ROMANO, *supra* note 10 (praising the system); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *YALE L.J.* 663 (1974) (criticizing it).

¹⁴ See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 *NW. U. L. REV.* 547, 550 (2003) [hereinafter Bainbridge, *Director Primacy: Means and Ends*] (discussing how boards of directors control corporations). For an example of the statutory provisions giving directors control, see *DEL. CODE ANN.* tit. 8 § 141 (2007).

¹⁵ Current corporate scholars largely consider this conception to be a misconception. See Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 *UCLA L. REV.* 601, 604 (2006) (calling this view “deeply erroneous”); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 *S. CAL. L. REV.* 1189, 1192 (2002) (“From both a legal and an economic perspective, the claim that shareholders own the public corporation simply is empirically incorrect.”).

majority of shareholders on any particular issue.¹⁶ They are thus akin to Burkean representatives: the elected representatives of their constituencies who may govern largely according to their personal conscience.¹⁷

For certain fundamental corporate acts, however, directors need the approval of a majority of shareholders. Amendments to the corporation's charter or article of incorporation must generally be approved by the Board and by the shareholders.¹⁸ Shareholders must also consent to the voluntary dissolution of the corporation.¹⁹ States have also generally required shareholder approval for transactions that transform the institutional structure of the corporation through a combination with another corporation. The standard method of combination is the statutory merger.²⁰ However, corporations also *de facto* combine when one corporation buys the assets of the other corporation or when a corporation buys the corporation's shares through a tender offer. Not all corporate combinations require shareholder approval. Mergers generally require shareholder approval from the shareholders of both companies.²¹ In Delaware, the state of incorporation for roughly fifty percent of the nation's public companies,²² mergers require approval from the shareholders of both companies unless the company's charter will remain unchanged post-merger and less than twenty percent of the company's outstanding common stock would be involved in the merger.²³ Shareholders must also approve a corporation's sale of "substantially all" of its assets.²⁴ This language, which is found in every jurisdiction, has been interpreted with some variation, but it generally means the sale of a significant portion of the corporation's assets in a transaction outside of the corporation's regular course of business.²⁵

¹⁶ For an early expounding of this principle, see *Automatic Self-Cleansing Filter Syndicate Co. v. Cunningham*, 2 Ch. 34 (Eng. C.A. 1906).

¹⁷ See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 102-03 (2004) (describing directors as "vested with wide powers to exercise their discretion by fiat").

¹⁸ See, e.g., DEL. CODE ANN. tit. 8, § 242(b) (2007); MODEL BUS. CORP. ACT § 10.03 (2004).

¹⁹ See, e.g., DEL. CODE ANN. tit. 8, § 275(b) (2007); MODEL BUS. CORP. ACT § 14.01 (2004).

²⁰ See, e.g., DEL. CODE ANN. tit. 8, § 251 (2007); MODEL BUS. CORP. ACT § 11.03 (2004).

²¹ See COX & HAZEN, *supra* note 12, at 609 ("Most states now provide for majority approval by the shares entitled to vote . . ."). Cox and Hazen note, however, that Massachusetts requires the approval of two-thirds of the shareholders, and New York requires a two-thirds vote for corporations created before 1989. See *id.* (citing MASS. ANN. LAWS ch. 156, § 46B(5) (Law. Co-op 2000); N.Y. BUS. CORP. LAW § 903 (McKinney 1986 supp. 2002)).

²² The website for Delaware's Division of Corporations states that "[m]ore than half a million business entities have their legal home in Delaware including more than 50% of all U.S. publicly-traded companies and 60% of the Fortune 500." Del. Dep't of State, Div. of Corps., *Why Choose Delaware as Your Corporate Home?*, at <http://www.state.de.us/corp/default.shtml>.

²³ DEL. CODE ANN. tit. 8 § 251(c), (f) (2007).

²⁴ *Id.* § 271(a).

²⁵ COX & HAZEN, *supra* note 12, at 594-96.

Why are shareholders given the right to veto these transforming transactions? According to one commentator, the basic idea is that “sudden, deliberate (that is, manager-initiated), major or ‘organic’ corporate changes that affect shareholder interests ought to be approved or consented to by some majority of the shareholders.”²⁶ There seem to be two primary concerns here: first, a concern about the drastic nature of the change, and second, a concern that this change is initiated and controlled by management. With respect to the nature of the change, corporate law wants to give shareholders the right to vote down a proposal that would significantly alter the nature of the holdings in the company. As residual claimants, shareholders are considered the most “vulnerable” of the corporation’s stakeholders to management agency costs.²⁷ Severe changes in the nature and scope of the enterprise will have more of a direct effect on their rights than the rights of bondholders or employees. In fact, mergers often force shareholders to exchange their stock for stock in another company or in a newly formed company.²⁸ Given the changes in their contractual rights, shareholders have a strong interest in having some control over the transformation of their company’s internal corporate structure.²⁹

There is also a concern that transformative transactions offer an opportunity for management to protect its own interests at the expense of the shareholders.³⁰ Corporate combinations offer an opportunity for executives to receive a one-time monetary, stock, or stock option bonus based on the fulfillment of the merger. When one company’s management will be replaced or subordinated as a result of the transaction, the deal will often arrange for a large payout to those managers as compensation for their loss of position.³¹ Conversely, executives of the newly-formed company may give themselves

²⁶ ROBERT C. CLARK, CORPORATE LAW § 10.2.4 at 414 (1986).

²⁷ FRANK H. EASTERBROOK & DANIEL R. FISCHER, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-39 (1991).

²⁸ For example, in its merger with Alcatel, Lucent Technologies was absorbed into an Alcatel subsidiary and ceased to exist. Former Lucent shareholders were given shares in the Alcatel subsidiary. See Lucent Technologies Form 8-K, Form No. 01-116839, Nov. 20, 2006 (Item 3.01), available at: <http://www.sec.gov/Archives/edgar/data/1006240/000089882206001443/fm8kdec6.txt>.

²⁹ More generally, former Delaware Chancellor Allen has described the shareholder franchise as “the ideological underpinning upon which the legitimacy of directorial power rests.” *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del Ch. 1988).

³⁰ The field of corporate law has largely centered around the general problem of management opportunism. See, e.g., EASTERBROOK & FISCHER, *supra* note 27; OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 171 (1996).

³¹ For example, James Kilts, the former CEO of Gillette Company, received a package worth an estimated \$165 million as part of the merger of Gillette with Procter & Gamble. Gretchen Morgenson, *What Are Mergers Good For?*, N.Y. TIMES, June 5, 2005, at 56, 58 (magazine).

bonuses for having successfully carried out the combination.³² Having the right to veto a transaction gives shareholders power to vote down a transaction that would reward management at the expense of the shareholders.³³

This paper proposes an employee referendum for transformative transactions which would piggyback on top of the existing system of shareholder voting rights. Employees at a company involved in a combination would be entitled to vote in a non-binding referendum on the combination whenever shareholders also had the right to vote on the combination. All employees would be entitled to cast a ballot. The referendum would be held prior to the shareholders' vote, with enough time for the results of the referendum to be communicated to shareholders prior to their vote.³⁴ Since the referendum would not be binding on the corporation, the directors, or the shareholders, victory or defeat would have no legal effect on the proposed transaction. The percentage of employee votes for and against would be the critical information communicated to the shareholders and (by extension) the general public.

Further specifics are, of course, in order. The statute would need to define who the corporation's "employees" were for purposes of the vote. The statute would also have to describe the timing and scope of the required disclosure that would be made to shareholders. The statute could also set forth what procedures would need to be followed for the vote, as well as whether there were any remedies for improper procedures. These details, and the effect they would have on the proposal, are discussed further in Part IV of the paper. As a reference for what such a statute might look like, I have included a proposed amendment to Delaware law in Appendix A.

The lack of any legal effect to the employee referenda may prompt an initial concern that such a vote would be "meaningless." The vote would, in fact, have no legal effect on the outcome of the proposed transaction; employees could vote overwhelmingly to reject a proposed merger only to see it enacted through director and shareholder approval. Given the lack of legal power behind the employee vote, what would be the point? The point is not to create a regime of employee participation in governance, along the lines of the German system of codetermination.³⁵ Such a system would require real power

³² See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 127-30 (2004) (discussing bonuses paid for acquisitions).

³³ Morgenson, *supra* note 31, at 58 (discussing how MONY shareholders threatened to vote against a merger with AXA because of the high executive compensation to MONY executives).

³⁴ Delaware requires notice to shareholders about the merger vote at least 20 days prior. See DEL. CODE ANN. tit. 8 § 251(c) (2007). The employee referendum would need to be held early enough so that the shareholder proxy materials could include the results of the referendum.

³⁵ For a discussion of German codetermination, see Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in EMPLOYEES AND CORPORATE GOVERNANCE 163 (Margaret M. Blair & Mark J. Roe eds., 1999).

sharing, whether through board participation, expanded union powers, or some form of binding referenda. But this proposal is not a piece of that endeavor. In fact, the objective of this proposal is to reap a portion of the benefits of employee participation without some of the drawbacks and complications codetermination engenders. With this in mind, I now turn to the reasons in support of the proposed system of non-binding employee referenda: more information, greater voice, and the low costs of experimentation.

II. REFERENDUM AS INFORMATION

As a non-binding resolution, the results of the employee referenda will have no inherent legal power of their own. What the referenda will provide, however, is information: information about whether the company's employees support or object to the corporate combination that has been proposed by management. As discussed below, this information will be useful to those groups who do have power over the transactions: shareholders and boards of directors. This information will increase the likelihood that shareholders and directors will reject inefficient transactions. As a result, management will do a better job in carrying out these transactions from the start.

In order to understand what this information will convey and how it will affect corporate decisionmaking, it is helpful to begin with a brief description of both the purposes and the processes of mergers and acquisitions.

A. The Purpose of Corporate Combinations

It may seem overkill to spend time considering the purpose of a corporate combination. Combining two companies is one of many possible business decisions and thus should share the same rationale as the decision to borrow money, hire employees, or purchase raw materials. Like any of these decisions, the decision to combine with another company should rest on the same principles behind the corporation itself. As is well known, however, the purpose of the corporation itself has been the subject of prolonged, sustained debate among corporate law scholars. Proceeding without considering this debate risks a failure to establish first principles and, thereby, a failure to establish the criteria upon which the employee referenda proposal is to be judged.³⁶

³⁶ William Klein has recently criticized the failure of corporate law academics to establish such first principles clearly. See William Klein, *Criteria for Good Laws of Business Association*, 2 BERKELEY BUS. L.J. 13, 15 (2005) ("Academics debating various aspects of the law of business associations are often like ships passing in the night. One reason for their inability to join issue may be a failure to identify goals or objectives--the failure to weigh proposals against explicitly stated criteria and to engage in effective cost-benefit analysis.").

Corporate law scholars generally employ a utilitarian approach, seeking to maximize the overall gains to society through the corporate form. In pursuing this end, the majority of corporate scholars ascribe to the notion of “shareholder primacy,” or “shareholder wealth maximization.”³⁷ The theory of shareholder wealth maximization posits that by maximizing the returns to shareholders above all other corporate goals, the corporation will also maximize its contribution to societal efficiency. This conception rests on the shareholders’ role as the sole “residual claimants” within the corporation. According to the theory, other actors within the corporation – creditors, employees, customers, suppliers – have a relationship to the corporation that is fairly well-defined through contract.³⁸ However, shareholders’ returns are residual; they are not payable until the other contractual participants had been fully satisfied.³⁹ In order to maximize social wealth, the corporation’s organizing principle should be the maximization of the residual returns payable to shareholders. In this way, all other claimants receive their contractual entitlements, and shareholders’ remainder has been maximized.

On the other side of this debate stand those who argue for a stakeholder-oriented conception of the corporation.⁴⁰ According to stakeholder theorists, the corporation’s purpose should focus on serving all of the corporation’s stakeholders. In addition to shareholders, those with a stake in the corporation include management, employees, creditors, suppliers, customers, and even the broader community in which the corporation is situated.⁴¹ Stakeholder theorists argue that a corporation and its directors should focus on maximizing returns to all of these stakeholders. Although commentators differ as to the means, most agree that directors should have a significant degree of discretion in carrying out their duties so as to serve all of these interests.⁴²

Much of recent corporate law scholarship has taken up this debate about the proper purpose of the corporation. Both sides hold strong opinions. In 2001, one set of pro-shareholder-primacy commentators stated that “[t]here

³⁷ Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 798 n.35 (2002) (“Today, most corporate law scholars embrace some variant of shareholder primacy.”).

³⁸ EASTERBROOK & FISCHER, *supra* note 27, at 67-68.

³⁹ *Id.* at 36-37. This perspective assumes that all other claimants have rigidly-set contractual entitlements, such that paying them more would be akin to a gift.

⁴⁰ See Stout, *supra* note 15, at 1190 (citing William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 264-66 (1992)).

⁴¹ Stout, *supra* note 15, at 1190.

⁴² See, e.g., LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY 118-19 (2001) (arguing that boards of directors should be self-perpetuating); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 280-81 (1999) (arguing for the notion of directors as “mediating hierarchs” for the different constituencies at the firm).

is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value,⁴³ while a stakeholder theorist argued that the notion of stock price maximization is “as destructive as it is simple.”⁴⁴ However, it is also possible to make too much of this distinction. In the long term, stock price maximization will depend on keeping the other constituencies happy as well; cheating customers, employees, or creditors will surely harm the company and by extension its stock price as well. And stakeholder theorists have acknowledged that some focus on share price can be a useful tool for constraining the discretion of management.⁴⁵ Courts, as a whole, have not spent too much time on the debate themselves, preferring to stick to the more practical concerns of fiduciary duties and conflicts of interest.⁴⁶

In this paper I sidestep this debate, arguing that non-binding employee referenda would be beneficial under both shareholder primacy theory and stakeholder theory. In other words, these referenda would improve overall societal efficiency regardless of whether the best route to such efficiency is shareholder wealth maximization or some version of stakeholder interests maximization. As discussed further below, this dual approach rests primarily on the role of the referenda in informing directors and shareholders,⁴⁷ the role of the referenda in restraining management,⁴⁸ and the role of the referenda in improving employee morale, productivity, and efficiency.⁴⁹ All of these benefits would lead to better results according to shareholder primacy as well as stakeholder theory.⁵⁰ Thus, for purposes of this paper, the purpose of corporate combinations need only be the same purpose as the corporate form: namely, increasing societal efficiency by maximizing returns to shareholders or maximizing returns to all of the stakeholders in the company. Moreover, there are reasons for concern that corporate combinations – as currently constructed – are failing along both of these measures.

⁴³ Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001).

⁴⁴ MITCHELL, *supra* note 42, at 4.

⁴⁵ Stout, *supra* note 15, at 1200.

⁴⁶ See D. Gordon Smith, *The Shareholder Primacy Norm*, 22 J. CORP. L. 277, 280, 284-88 (1998) (discussing how the concept of shareholder primacy has limited relevance to corporate law in practice).

⁴⁷ See Part II.D *infra*.

⁴⁸ See Part II.D.3 *infra*.

⁴⁹ See Part III *infra*.

⁵⁰ What they do not support is a strong notion of managerial primacy, but concern about agency costs has largely driven managerial primacy from the debate. See Bainbridge, *Director Primacy: Means and Ends*, *supra* note 14, at 549 (noting that managerial primacy “no longer has much traction in the legal academy”).

B. Problems with Corporate Combinations

The initial challenge raised to employee referenda may be that their absence under current law is a result of properly-made market decisions. If the reform really increased firm efficiency, the argument goes, the market would have already developed it.⁵¹ However, corporate combinations have been the subject of extensive study in both law and finance literature, and there are grounds for believing that such combinations decrease firm value. These substantive concerns coincide with procedural concerns about incentives on the part of executives, directors, and consultants to act inefficiently in their own interest.

1. Substantive Problem: Poor Results. Corporate combinations can often be scenes of shipwreck-level destruction for the companies involved. Although some potential for failure is inherent in any enterprise, there is evidence that corporate combinations may be generally value-reducing for the participating firms. The effects of corporate combinations on firm value and on stock price are much studied phenomena in the financial literature. The results have been different for targets (smaller companies that will be taken over) as compared with acquiring companies. There is general consensus that in the very short term, when the corporate combination is announced, there are large positive abnormal returns to companies that are the target of a proposed merger or acquisition.⁵² While there is conflicting evidence on acquirers, the evidence is sufficiently mixed that “the null hypothesis of zero abnormal performance to acquirers should not be rejected.”⁵³ These results are attributable to the general process whereby the acquirer offers to pay a premium over and above the current market price for the target’s shares. Indeed, offers that are at or are minimally above the current market price are generally rejected as non-serious.⁵⁴ Thus, in the short term, gains from a merger announcement are often

⁵¹ See, e.g., Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1736-44 (2006) (criticizing Lucian Bebchuk’s programme of shareholder empowerment because it has not already appeared in the marketplace). But see Michael D. Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 793-96 (2006) (discussing how learning and network externalities may impair efficient corporate innovations).

⁵² Anup Agrawal & Jeffery E. Jaffe, *The Post-merger Performance Puzzle*, in ADVANCES IN MERGERS AND ACQUISITIONS 7, 7 (Cary Cooper and Alan Gregory eds., 2000).

⁵³ *Id.* (citing Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986)).

⁵⁴ For example, Oracle was widely denounced for its initial bid to purchase PeopleSoft, which offered little to no premium over market price. As one analyst stated, “If [Oracle is] serious, they’re going to have to up their bid by a significant premium.” Andrew Ross Sorking & Laura Flynn, *Oracle Takes \$5 Billion Jab at PeopleSoft*, N.Y. TIMES, June 7, 2003, at C1, C2. See also Robin Sidel & David Bank, *PeopleSoft Bid By Oracle Corp. Busts Tradition*, WALL ST. J., June 10, 2003, at C1, C5 (noting that the Oracle bid “broke two longstanding traditions of deal

zero sum, as the short-term boost to the target is offset by the loss to the acquirer.

Over the long term, however, there are indications that corporate combinations do not increase overall societal efficiency. Studies on long-term returns for corporate acquisitions have generally shown “strong evidence of abnormal under-performance following mergers.”⁵⁵ There is empirical evidence on both sides, and academics continue to refine and debate the best methods for determining long-term performance.⁵⁶ However, the overall pattern has been one of value-reduction in the long term. Numerous academic, financial, and media commentators have noted the failure of corporate combinations to bring long-term gains.⁵⁷

Furthermore, corporate combinations are more likely to fail in situations where the employee referendum would take place – namely, where a vote of the shareholders is required to execute the combination. As noted earlier, shareholders must vote to approve most mergers, as well as the sale of substantially all of their company’s assets.⁵⁸ However, this leaves some large swaths of corporate combinations uncovered. Most notably, shareholders do not vote when the acquisition is through means of a tender offer. Instead, shareholders “vote” for a tender offer by tendering their shares to the acquirer, and the acquirer treats the purchase as a normal business transaction. This contrasts with mergers between two companies in which the companies trade stock to create a new corporation. Studies have demonstrated that companies

making: [m]ake an offer that carries a hefty premium to the target’s stock price and first approach the target privately with a friendly bid”).

⁵⁵ Agrawal & Jaffe, *supra* note 52, at (50).

⁵⁶ See, e.g., John D. Lyon et al., *Improved Methods for Tests of Long-Run Abnormal Stock Returns*, 52 J. FIN. 165 (1999).

⁵⁷ See, e.g., ROBERT F. BRUNER, DEALS FROM HELL: M&A LESSONS THAT RISE ABOVE THE ASHES 14 (2005) (“The popular view is that M & A is a loser’s game.”); Robert G. Eccles et al., *Are You Paying Too Much for That Acquisition?*, HARV. BUS. REV. 136, 136 (July-August 1999) (noting “30 years of evidence demonstrating that most acquisitions do not create value for the acquiring company’s shareholders”); James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 BUFF. L. REV. 249, 280 (2001) (“Evidence from past merger waves shows that public companies engaging in mergers underperform their peer companies that have not followed similar acquisition strategies.”); Sara Moeller et al., *Firm Size and the Gains from Acquisition*, 73 J. FIN. ECON. 201 (2004) (finding that takeovers by large firms have destroyed \$226 billion of shareholder wealth over 20 years); Morgenson, *supra* note 31, at 56 (“Academic research suggests that few mergers add up to significantly more prosperous or successful companies”); Gregory Zuckerman, *Ahead of the Tape*, WALL ST. J., Dec. 30, 2002, at C1 (“Most mergers don’t work A mountain of academic research shows most acquisitions end up costing shareholders.”); “Why Most Big Deals Don’t Pay Off: A BusinessWeek Analysis Shows that 61% of Buyers Destroyed Shareholder Wealth,” BUS. WEEK, Oct. 14, 2002, at 60 (looking at 302 large mergers of public companies from 1995 to 2001).

⁵⁸ See Part I *supra*.

involved in stock-for-stock mergers fare more poorly than companies involved in a cash transaction in which one company purchases the other.⁵⁹

The information technology boom of the late 1990s is replete with examples of failed corporate combinations. Perhaps the most notorious of all corporate combinations is the merger between AOL and Time Warner. Known as “the worst deal in history,”⁶⁰ the combination laid waste to the market value of the new company and led to the departure of almost all of the executives responsible for the union.⁶¹ Three years after the completion of the merger, shareholders in AOL Time Warner had lost over \$200 billion in equity value.⁶² Although the company has stabilized under current leadership, its stock price remains mired in place, and it recently was the subject of an aborted proxy battle.⁶³ The AOL-Time Warner merger has become the paradigmatic example of a failed corporate combination.⁶⁴

Other high profiles deals have been less spectacularly unsuccessful, but unsuccessful nonetheless. In 2002 Hewlett-Packard CEO Carly Fiorina pushed through a merger with Compaq despite a proxy challenge from company director Walter Hewlett, son of one of HP’s founders. The media heralded the merger as a real victory for Fiorina, who succeeded despite litigation by Hewlett alleging proxy improprieties.⁶⁵ However, the merger failed to revitalize HP, instead leading to Fiorina’s ouster in 2005.⁶⁶ The merger’s difficulties came despite a complex plan, lauded in the press, that was designed to avoid the mistakes of past mergers.⁶⁷ Other flawed combinations include the merger of Mattel and The Learning Company,⁶⁸ the merger of CUC International and HFS (to form Cendant),⁶⁹ and the merger between

⁵⁹ See, e.g., Agrawal & Jaffe, *supra* note 52, at (46) (noting that “abnormal performance is worse for acquirers using stock-financing than for acquirers avoiding stock”); Carlos P. Maquieira et al., *Wealth creation versus wealth redistributions in pure stock-for-stock mergers*, 48 J. FIN. ECON. 3, 8 (1998) (noting that “research indicates that stock-for-stock mergers have systematically lower offer premiums for target firm stockholders, significantly negative abnormal returns for acquiring firm stockholders, and lower net synergistic gains created”).

⁶⁰ SWISHER, *supra* note 1, at 9.

⁶¹ BRUNER, *supra* note 57, at 275-78.

⁶² NINA MUNK, FOOLS RUSH IN: STEVE CASE, JERRY LEVIN, AND THE UNMAKING OF AOL TIME WARNER 277 (2004).

⁶³ See, e.g., Ken Auletta, *The Raid*, NEW YORKER, March 20, 2006, at 132.

⁶⁴ For a discussion of the AOL-Time Warner merger as an example of the dangers of the shareholder primacy ethos, see Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. CORP. L. 975 (2006).

⁶⁵ See *Hewlett v. Hewlett-Packard Co.*, 2002 WL 818091 (April 30, 2002).

⁶⁶ Paul R. La Monica, *Carly Fiorina Forced Out at HP*, CNNMONEY.COM, Feb. 10, 2005, available at: http://money.cnn.com/2005/02/09/technology/hp_fiorina/index.htm?cnn=yes.

⁶⁷ Pui-Wing Tam, *An Elaborate Plan Forces H-P Union To Stay on Target*, WALL. ST. J., April 28, 2003.

⁶⁸ See BRUNER, *supra* note 57, at 246-64.

⁶⁹ See Fanto, *supra* note 57, at 272-73.

BankAmerica and NationsBank (forming Bank of America).⁷⁰ Even those who question whether corporate combinations have generally poor results concede that a significant number of them have spectacularly poor results.⁷¹

Having found a strange pool of inefficiency in otherwise presumably efficient markets, scholars have sought to figure out the reasons why. They have identified the following flaws in the process as potential reasons for the poor results.

2. Process Problem: Limited Information. The process of carrying out a corporate combination generally follows a prescribed pattern. Initially, talks are carried out at the highest levels of the corporation over the feasibility and desirability of a combination. If the top officers agree to a deal, then the companies must secretly and expeditiously conduct due diligence using high-level management and outside consultants. If this hastily-conducted due diligence uncovers no problems, the boards approve the combination and the deal is announced to the public and the shareholders. The shareholders generally have a few months to digest the proxy materials and media reports before they vote to approve or quash the merger. If the combination receives shareholder and regulatory approval, the combination ultimately goes into effect.

There are strategic reasons for the structure of this process. Executives begin in secrecy because news of negotiations can send stock prices up.⁷² Competitors may also jump into the process if word gets out, making the negotiations more complicated and costly.⁷³ Failed merger negotiations can damage both companies' reputations, or make one company seem weak and ripe for the taking. The ramifications of such negotiations are so far-reaching that executives do their best to keep the discussions under tight wraps. They may be so secret that only a handful of the company's top executives even know about them.⁷⁴

While this secrecy serves a purpose, it also narrowly restricts both the information and the perspectives that can be brought to bear. The decision to actually carry out the merger is generally made at the very highest levels before any due diligence. For example, in the AOL – Time Warner merger, Case and Levin made the decision to merge the two companies at a dinner in a private

⁷⁰ See *id.* at 274.

⁷¹ See BRUNER, *supra* note 57, at 95-340 (discussing particularly poor performers).

⁷² See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224, 234-35 (1988) (discussing the importance of keeping merger negotiations secret).

⁷³ See Brown, *supra* note 6, at 93 (“Corporate officials fear that premature disclosure may result in a competitive disadvantage or may jeopardize continuation of the negotiations.”).

⁷⁴ See MUNK, *supra* note 62, at 141-43 (discussing how AOL CEO Steve Case and Time Warner CEO Gerald Levin met in secrecy at hotels and homes to carry out their talks).

room at the Rihga Royal Hotel.⁷⁵ For the next two months, small groups of executives and advisors on both sides haggled over the final details, such as the number of board seats each side would have in the new company, and the values of shares given to each set of shareholders.⁷⁶ The negotiations were intense, and the transaction was called off at various points. Ultimately, Levin and Case made the final agreement over dinner with only two other executives present.⁷⁷ Only four executives at Time Warner knew about the possibility of a merger before the agreement had been reached.⁷⁸

While Levin may have been unusually secretive with his upper-level cohorts, the general rule for merger negotiations is a shroud of secrecy maintained by a small number of executives and advisors.⁷⁹ As a result, corporate combinations are extremely top-down affairs. The critical decision to combine is made at the very top, often by the CEO alone. Only after the decision to combine has been made are larger circles of executives and advisors included in the planning.

As a result, the board and the shareholders are often handed something of a *fait accompli*. Presumably the board has the benefit of due diligence conducted by investment banks which is designed to draw out any potential flaws in the merger.⁸⁰ But those conducting the due diligence know the end result they are supposed to come to – allowing the combination to proceed. Due diligence is generally conducted by the same investment banks who have

⁷⁵ See MUNK, *supra* note 62, at 143 (“By the end of the evening, Levin and Case were of one mind. Together they could create the world’s most powerful and respected Internet-driven media and entertainment company.”).

⁷⁶ *Id.* at 145-56.

⁷⁷ Also present were Kenneth Novack, AOL’s vice chairman, and Richard Bressler, the head of Time Warner Digital Media. *Id.* at 156.

⁷⁸ *Id.* at 158 (noting that only Bressler, Rob Marcus (who worked under Bressler), then-president Richard Parsons, and deputy general counsel Chris Bogart had heard of the negotiations). The chief financial officer and the general counsel had no knowledge of the negotiations. *Id.* at 159-60.

⁷⁹ See, e.g., BILL VLASIC AND BRADLEY A. STERTZ, TAKEN FOR A RIDE: HOW DAIMLER-BENZ DROVE OFF WITH CHRYSLER 227 (2000) (“Only ten executives in Chrysler knew of the pending deal, and only a few more than that at Daimler.”); Press Release, Walter Hewlett Responds to Statement from Hewlett-Packard, Feb. 19, 2002, available at: <http://www.sec.gov/Archives/edgar/data/47217/000089161802000839/f77503i1dfan14a.htm> (“According to [Hewlett-Packard] management’s own earlier claims, the Compaq merger [with Hewlett-Packard] is the culmination of a surprise telephone conversation between [Hewlett-Packard CEO] Carly Fiorina and [Compaq CEO] Michael Capellas which occurred only a few short months before the merger was announced.”).

⁸⁰ See, e.g., Goldman Sachs, Investment Banking, available at: http://www2.goldmansachs.com/client_services/investment_banking/index.html; Robert J. Giuffra, Jr., Note, *Investment Bankers’ Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 121-25 (1986). For a narrative example of the role of financial advisors in a merger, see *Emerald Partners v. Berlin*, 2001 WL 21003437, at *8-*12 (Del.Ch.,2003).

been working with the firms' principals; these banks stand to earn fees if the combination proceeds.⁸¹ Moreover, they are often given incredibly short periods of time in which to conduct the diligence. For the AOL Time Warner merger, the largest combination in history, the banks were given three days over a weekend to prepare their fairness reports for the companies' boards.⁸²

The board has the final approval of the deal before it is announced as a deal to the media. As the situs of corporate power,⁸³ the board might be considered the driver behind any corporate combination. However, in reality the board is at best a check against top executives; at worst, the board is simply a rubber stamp to management's decisions. Much has been written about the role of the board in the modern corporation, and recent corporate governance reforms have focused on strengthening the board's ability to monitor management.⁸⁴ But boards are made up of top management or part-timers. The part-timers may or may not be independent; so-called independent directors often have a powerful tie or obligation to management.⁸⁵ In any event, they are part-timers, generally with significant responsibilities of their own to another firm.⁸⁶ As a result, it is difficult for directors to obtain and digest the information necessary to monitor management with any degree of intensity.

These monitoring weaknesses are exacerbated by the limited timeframe for the board's decision. Management generally informs board members about

⁸¹ MUNK, *supra* note 62, at 166 (noting that the two investment banking firms involved in the AOL Time Warner merger each received a fee of \$60 million); Giuffra, *supra* note 80, at 127-28 (noting that "investment banks face strong incentives to provide opinions that serve management's interests").

⁸² MUNK, *supra* note 62, at 161-62. As one of the bankers involved in the opinions noted, "If you do a deal over a weekend, you take shortcuts. In hindsight, it was sloppy." *Id.* at 163.

⁸³ See Bainbridge, *Director Primacy*, *supra* note 14.

⁸⁴ Commentary on the board's role in monitoring management has been voluminous. The discussion stems from the focus placed on managerial agency costs. See Jensen & Meckling, *supra* note 2. Many commentators have seen the board's primary role as reducing these costs through monitoring. See MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 205-09 (1976) (discussing board structure to maximize monitoring). The failures of the boards at Enron, WorldCom, and other failed companies has led to a reexamination of the board as monitor. See, e.g., Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356 (2004).

⁸⁵ See, e.g., *In re Oracle Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003) (holding that directors, who were professors at Stanford University, lacked independence as to defendant executives, who had promised substantial charitable gifts to the university). For recent work on the function of independent directors, see Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007), and Usha Rodrigues, *The Fetishization of Independence*, available at: <http://ssrn.com/abstract=968513>.

⁸⁶ See BEBCHUK & FRIED, *supra* note 32, at 31-37.

the potential deal at the last minute in order to maintain secrecy.⁸⁷ Directors get their information about the deal from the bank's fairness opinion, which has been drafted with the purpose of convincing the board to do the deal. The board then has an extremely limited amount of time to decide on whether to do the deal. The process is not designed to provide board members with a true informational picture of the combination. It is instead designed to get the board's approval at the last minute, as a prelude to the formal announcement.⁸⁸

The announcement itself shows the front-loaded nature of the process. When the principals call a press conference to announce the combination, the deal appears to the public to be complete.⁸⁹ The announcement is not framed as one step in a process of approval, but rather as the announcement of the actual deal, pending a few technicalities. The announcement has the air of a celebration, and the media often joins in on the fun.⁹⁰

In contrast to the board, shareholders are given significantly more time to make their decision concerning the merger and can look to the required proxy disclosure about the merger. Depending on the size of the merger, the media may also be a source of information. But again, the process is designed not to give shareholders an active role in the combination, but rather to secure their "yes" vote with as little controversy as possible. State law as well as federal securities regulations require substantial disclosure when public companies solicit proxies.⁹¹ The materials tend to be quite lengthy.⁹² While the

⁸⁷ The need to keep merger negotiations secret was at the heart of *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). The court ruled that executives were not free to lie about their negotiations, despite the need for secrecy. *Id.* at 236. The court reasoned that a consistent "no-comment" policy would protect the secrecy of the negotiations without misleading investors. *Id.* at 239 n.17. *But see* Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1069-71 (1990) (arguing that secrecy is critical to the M & A market and arguing that lying should be permitted in that context).

⁸⁸ *See, e.g.,* MUNK, *supra* note 62, at 170-74 (discussing the Time Warner board's approval of the merger with AOL).

⁸⁹ For a recent example of premature closure, see *Whole Foods is Buying Wild Oats*, ASSOC. PRESS, Feb. 21, 2007 ("Whole Foods Market Inc. said Wednesday it will pay \$565 million for Wild Oats Markets Inc., a chain of natural and organic food markets in the United States and Canada."); Andrew Martin, *Whole Foods Buys Smaller Rival*, N.Y. TIMES, Feb. 22, 2007 (web version). The Times changed the title in time for the print version. Andrew Martin, *Whole Foods Makes Offer for a Smaller Rival*, N.Y. TIMES, Feb. 22, 2007, at C1.

⁹⁰ *See* Fanto, *supra* note 57, at 298 ("[T]he media has celebrated [mega-merger] transactions and lionized the CEOs proposing them . . .").

⁹¹ State law generally requires that corporations have a duty to disclose the facts material to their stockholders' decisions to vote on a merger. *See, e.g.,* *Arnold v. Society for Savings Bancorp., Inc.*, 650 A.2d 1270, 1277 (Del.1994). The test is generally stated as follows: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.... Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having

required disclosure is designed to provide shareholders with critical information, firms and their counsel generally design such disclosure in order to minimize risk of after-the-fact liability for improper disclosure.⁹³ As a result, the disclosure tends to be a static, lump-sum document which is written primarily to advance the proposal while meeting legal requirements.

In some circumstances, particularly for larger combinations, the media does serve a role in investigating the proposal and serving as a check against management. However, business journalists generally need some sort of hook in order to generate interesting coverage. Most shareholder votes are dull affairs for the media, with the proposal receiving the overwhelming majority of votes.⁹⁴ The only recent shareholder vote on a corporate combination that drew any press was the vote for the Hewlett-Packard and Compaq merger. That vote drew attention because of Walter Hewlett's battle against the merger and subsequent litigation over the proxy contest.⁹⁵ Even those combinations that draw a significant amount of attention may not receive the appropriate

significantly altered the 'total mix' of information made available." *Zirn v. VLI Corp.*, 621 A.2d 773, 778-79 (Del.1993) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976)). In Delaware, two recent cases by Vice Chancellor Leo Strine, Jr. have highlighted the company's disclosure obligation to shareholders. The vice chancellor enjoined a shareholder's vote in *In re Lear Corp Shareholders Litigation*, 926 A.2d 94 (Del. Ch. 2007) because the company had failed to disclose the CEO's financial situation that made a buyout personally favorable to him. *See id.* at 98 (concluding that shareholders were "entitled to know that the CEO harbored material economic motivations that differed from their own that could have influenced his negotiating posture"). In *In re Topps Co. Inc. Shareholders Litigation*, 926 A.2d 58 (Del. Ch. 2007), Vice Chancellor Strine held that the company had failed to disclose several critical factors to shareholders about its proposed merger, such as the willingness of the acquirer to retain current management and the seriousness of a competing bid. In both cases, the shareholders vote was enjoined until shareholders received the appropriate disclosures.

Federal securities regulations provide for more uniform disclosure through § 14 of the 1934 Securities Exchange Act. 15 U.S.C. § 78n (2006). Specific disclosures are provided for in the regulations. *See* 17 C.F.R. §§ 240-14a-3, §240-14a-101 (Schedule 14A) (2007).

⁹² For example, the proxy solicitation materials regarding the proposed Lucent-Alcatel merger are 175 pages plus 75 pages of appendices. *See* Lucent-Alcatel Merger Proxy Statement, August 4, 2006.

⁹³ Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 146 (2006) (noting that companies base disclosure decisions on liability concerns).

⁹⁴ Shawn Tully, *Taking the Guesswork Out of Proxy Voting*, CNNMoney.com, December 21, 2006, available at: http://money.cnn.com/magazines/fortune/fortune_archive/-2006/12/25/8396763/index.htm (noting that "most of the deals win shareholder approval by an overwhelming margin").

⁹⁵ *See, e.g.*, Dawn Kawamoto, *Walter Hewlett Speaks Out*, CNET News, at: <http://news.com.com/2100-1001-858499.html>. Hewlett hired consulting firms, made numerous presentations, and took out several ads all with the purpose of persuading shareholders to vote no. It is estimated that both sides combined spent over \$100 million in their efforts to persuade shareholders. Michael Brick & Steve Lohr, *Fiorina Claims Victory in Hewlett-Compaq Proxy Battle*, N.Y. TIMES, March 19, 2002.

journalistic scrutiny; the press has been largely adulatory of the CEOs who can bring off a high-stakes merger.⁹⁶

Thus, from start to finish the typical corporate combination is hampered by the absence of critical information. At the beginning, the CEO and her trusted coterie must labor in secret in developing the basic decision on whether or not to combine. Once the CEO has decided to go forward, the board generally approves the combination under hurried conditions with information provided by those who are already invested in the deal – the CEO, her advisors, and an investment bank that stands to earn hefty fees if the deal goes through. Then, shareholders vote after receiving a thoroughly vetted, lengthy disclosure document and perhaps hearing some media scrutiny. By that point, however, the company itself has committed to the combination. Given this process, there is real reason to question whether the information used in making the decision is optimal.

3. *Process Problem: Managerial Overconfidence.* Limited information is not the only obstacle to efficiently negotiated corporate combinations. Within the negotiations themselves, commentators have long been concerned that top executives may not be negotiating with economic rationality. Instead, there is a concern that CEOs may be acting with hubris – an inflated sense of their own abilities and the transactions they seek to effectuate.⁹⁷ This hubris may be a product of two types of systematic irrationalities known as heuristics – the optimism bias and the commitment bias. These two heuristics form what one commentator has labeled the optimism-commitment “whipsaw.”⁹⁸

⁹⁶ See Fanto, *supra* note 57, at 298-304. Even proxy advisors such as Institutional Shareholder Services (ISS) have been strangely acquiescent towards many of the ill-founded mergers of recent past. See Tully, *supra* note 94 (“M&A is ISS’s weak point. It has a long record of recommending deals that were doomed from conception, and it has consistently endorsed mergers in which the buyer agreed to vastly overpay.”).

⁹⁷ Richard Roll has argued that corporate takeovers were generally a value-neutral proposition, and that therefore rational executives would not seek them out. Roll, *supra* note RR1, at 198 (“It will be argued here that takeover gains may have been overestimated if they exist at all.”). In order to explain the frequency of combinations, Roll relied not on rational market theory, but rather managerial hubris. *Id.* at 200. Relying on the empirical evidence that individual decisionmaking is not always rational, Roll noted that takeovers were an apt subject for such research, since takeovers reflect individual decisions. *Id.* at 199. Given that the data, in his view, did not show added value from takeovers to the acquiring firm, Roll hypothesized that managerial hubris – namely, the notion that their (higher) valuation of the target was better than the market’s (lower) valuation – was responsible for takeover activity. *Id.*

⁹⁸ Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) [hereinafter Langevoort, *Organized Illusions*].

Scholars have keyed in on the effects of the optimism or overconfidence bias on high-level corporate decisionmakers.⁹⁹ The optimism bias is one of the most well-chronicled and intuitively-resonant biases.¹⁰⁰ The bias refers to people's irrational beliefs that they are smarter, more successful, and more talented than they actually are. The quintessential optimism bias study concerns questions about whether one's ability in a certain area is "above average." Subjects on average believe that their talents are above average.¹⁰¹ Relatedly, evidence also suggests that individuals underestimate others' abilities, especially those of their competitors.¹⁰² Optimism bias also leads individuals to believe that good things are more likely to happen to them, and bad things are less likely to happen to them, than they are to other people.¹⁰³ Another component of the optimism bias is the so-called "illusion of control." This irrationality means that "people not only think that they are better than

⁹⁹ See, e.g., MAX H. BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 37-39 (3d ed. 1994) (discussing overconfidence among managers).

¹⁰⁰ See, e.g., Werner F.M. De Bondt & Richard H. Thaler, *Financial Decision-Making in Markets and Firms: A Behavioral Perspective*, in 9 HANDBOOKS IN OPERATIONS RESEARCH AND MANAGEMENT SCIENCE: FINANCE 385-410 (R.A. Jarrow et al. eds., 1995) ("Perhaps the most robust finding in the psychology of judgment is that people are overconfident.").

¹⁰¹ See David Dunning et al., *Ambiguity and Self-Evaluation: The Role of Idiosyncratic Trait Definitions in Self-Serving Assessments of Ability*, in HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 324, 324 (Thomas Gilovich et al. eds., 2002) (finding that seventy percent of high school students in one study rated themselves above average in leadership skills, while only two percent ranked themselves below average on that dimension); Ola Svenson, *Are We All Less Risky and More Skillful Than Our Fellow Drivers*, 47 ACTA PSYCHOLOGICA 143, 146 (1981) (finding that most drivers believe they are above average drivers); D. Walton, *Examining the Self-Enhancement Bias: Professional Truck Drivers' Perceptions of Speed, Safety, Skill and Consideration*, 2 TRANSP. RES. Part F 91, 99 (1999) (finding that nearly eighty percent of truck drivers believe they are safer drivers than the average truck driver); E. W. Zuckerman & John T. Jost, *What Makes You Think You're So Popular? Self Evaluation Maintenance and the Subjective Side of the "Friendship Paradox"*, 64 SOC. PSYCH. Q. 207 (2001). This tendency is sometimes called the "Lake Wobegon Effect." See The Lake Wobegon Effect, Wikipedia, available at: http://en.wikipedia.org/wiki/Lake_Wobegon_effect.

¹⁰² A recent example of such behavior is the case of "Rahodeb," the online user name for Whole Foods CEO John Mackey. Mackey used his anonymous online account to praise Whole Foods and pillory competitor Wild Oats. David Kesmodel & John R. Wilke, *Whole Foods is Hot, Wild Oats a Dud – So Said "Rahodeb"*, WALL ST. J., July 12, 2007, at A1.

¹⁰³ Jolls et al., *supra* note CJ1, at 1524 ("A common feature of human behavior is overoptimism: People tend to think that bad events are far less likely to happen to them than to others."); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationalist Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1058 (2000) (describing the overconfidence bias as "the belief that good things are more likely than average to happen to us and bad things are less likely than average to happen to us").

average when skill or ability is relevant to outcomes, they sometimes believe that they have more control over outcomes than they do.”¹⁰⁴

Although the optimism bias creates an irrational perspective, social psychologists believe the bias may be rationally adaptive.¹⁰⁵ A bias towards optimism gives the individual a reason to strive to overcome difficulties. It may inspire others to similarly persist. The illusion of control may lead individuals to try harder to succeed, since they have the “illusion” that success is within their grasp. In fact, many believe that corporate executives are well-served by these very traits.¹⁰⁶ The tournaments which drive the market for managerial talent reinforce optimism and the illusion of control by giving those with such biases a greater likelihood of success.¹⁰⁷

However, those same irrationalities that allow CEOs to climb the corporate ladder successfully also may work against the company’s fortunes when applied to business decisions. And in fact, research has shown that executive overconfidence has demonstrated effects on corporate decisionmaking. According to the research, executive overconfidence leads to excessive entry into unfamiliar markets,¹⁰⁸ overpaying in the context of auctions,¹⁰⁹ an overreliance on the executive’s personal information and

¹⁰⁴ Russell Korobkin, *Psychological Impediments to Mediation Success: Theory and Practice*, 21 OHIO ST. J. ON DISP. RESOL. 281, 288 (2001). See generally Ellen J. Langer, *The Illusion of Control*, 32 J. PERSONALITY & SOC. PSYCHOL. 311 (1975).

¹⁰⁵ See, e.g., Pamela C. Regan et al., *Unrealistic Optimism: Self-Enhancement or Person Positivity?*, 21 PERSONALITY & SOC. PSYCHOL. BULL. 1073, 1079-80 (1995) (finding that unrealistic optimism resulted in a greater chance of experiencing positive, future life outcomes); Shelley E. Taylor & Peter M. Gollwitzer, *Effects of Mindset on Positive Illusions*, 69 J. PERSONALITY & SOC. PSYCHOL. 213, 224- 25 (1995) (demonstrating that people tend to use positive thinking when implementing goals).

¹⁰⁶ Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 288 (2004) (noting that “over-optimism, an inflated sense of self-efficacy and a deep capacity for ethical self-deception are favored in corporate promotion tournaments, so that people who possess them are disproportionately represented in executive suites”).

¹⁰⁷ E.g., Donald C. Langevoort, *The Organizational Psychology of Hyper-competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968 (2002); Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673 (2005); Anand Mohan Goel & Anjan V. Thakor, *Rationality, Overconfidence & Leadership* (working paper), available at: <http://ssrn.com/abstract=244999>. For a brief overview of the tournament for managerial talent, see Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557, 1586-87 (2005).

¹⁰⁸ Colin Camerer & Dan Lovallo, *Overconfidence and Excess Entry: An Experimental Approach*, 89 AM. ECON. REV. 306 (1999).

¹⁰⁹ See, e.g., RICHARD H. THALER, *THE WINNER’S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE* (1992).

perspective,¹¹⁰ and a belief that the market is undervaluing the executive's own company.¹¹¹ As a result, executive overconfidence may lead to a consistent pattern of market irrationality, resulting in inefficiencies.

Furthermore, overconfidence can combine with another behavioral heuristic to do even more damage to corporate decisionmaking.¹¹² Social psychologists have identified a human tendency to stay with a project or endeavor past when it remains profitable or beneficial to do so. This reluctance to abandon prior sunk costs is known as the commitment bias.¹¹³ Studies have demonstrated this bias within the corporate world.¹¹⁴ When commitment bias teams up with the optimism bias, executives will not only make overly optimistic choices, but they will also stay with those choices long after the evidence should show them the error of their ways – the aforementioned “optimism-commitment whipsaw.”¹¹⁵ The exacerbated effects of these irrationalities may lead to unethical behavior, as executives realize too late how bad the situation is and desperately try to get themselves out of it.¹¹⁶

It is easy to see how these biases may lead to poor decisionmaking in the context of corporate combinations. At the beginning of negotiations, the CEO and just a few trusted advisors are put in the position of determining whether the combination makes sense, and on what terms.¹¹⁷ The success of the combination, in the eyes of the CEO, may largely depend on his or her own finesse and ability in making the transaction work. The overconfidence bias is thus likely to make the CEO more likely to believe that he or she can make the combination a success. Once the two sides agree to the transaction, the commitment bias takes over. Even though only the CEO and a small group of executives have decided on the combination, in their minds the commitment has been made. Thus, they are prone to push hard for the deal and genuinely (if even irrationally) believe that the deal will make the corporation better off. The commitment bias will then affect the board's judgment once it has decided in

¹¹⁰ Antonio Bernardo & Ivo Welch, *On the Evolution of Overconfidence and Entrepreneurs*, 10 J. ECON. & MGMT. STRATEGY 301 (2001)

¹¹¹ J.B. Heaton, *Managerial Optimism and Corporate Finance*, 31 FIN. MGMT. 33 (2002); Ulrike Malmendier & Geoffrey Tate, *CEO Overconfidence and Corporate Investment*, 60 J. FIN. 2661 (2005).

¹¹² See Langevoort, *Organized Illusions*, *supra* note 98.

¹¹³ See, e.g., Lawrence E. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767 (2002).

¹¹⁴ See, e.g., Barry M. Staw, *Rationality and Justification in Organizational Life*, in 2 RESEARCH IN ORGANIZATIONAL BEHAVIOR 45 (Barry M. Staw & L.L. Cummings eds., 1980); Charles R. Schwenk, *Information, Cognitive Biases, and Commitment to a Course of Action*, 11 ACAD. MGMT. REV. 298 (1986).

¹¹⁵ Langevoort, *Organized Illusions*, *supra* note 98, at 147.

¹¹⁶ *Id.*

¹¹⁷ See BRUNER, *supra* note 57, at 347 (“Overoptimism (also called ‘hubris’) is pervasive at the start of most of these failed deals.”).

favor of the transaction. These players are thus more likely to stick with their decision even if further evidence changes the cost-benefit analysis that a bias-free actor would make.

As noted earlier, scholars have particularly noted the presence of management overconfidence and hubris in the market for corporate control.¹¹⁸ Unlike other areas of corporate conduct, the finance literature has made a place for behavioral irrationalities such as overconfidence in large-scale mergers and acquisitions. These irrationalities place a further burden on the combination process.

4. Process Problem: Managerial Financial Incentives. In addition to irrational biases in favor of the combination, managers and directors will often have quite rational biases in favor of executing the deal. Because combinations are a time of upheaval and reorganization, they are also a time to revisit the positions and compensations of the executives and directors who run each company. It should not be surprising that companies often make large payouts at these times – payouts that may not be justified under an arms-length system of compensation negotiation.

The payments come on all sides and for all different reasons. When a small company is being merged into a bigger company, the so-called “target” company will often pay its departing executives a sizeable sum.¹¹⁹ This payment is justified as compensation for a loss or downgrade of position, and it may be necessary to move a profitable combination forward. But it also means that these managers and directors can exact a price for their acquiescence to the plan – a premium unavailable to most employees. And that premium may be excessive, and against shareholder interests. Sometimes this payment is made by the target company itself, while in other cases the acquiring company pays the sum. In both cases, there is concern that the executive will become too attached to the payout and will fail to follow shareholder interests.¹²⁰

¹¹⁸ In his article on CEO overconfidence, Troy Paredes turns repeatedly to corporate combinations for examples of overconfidence at work. See Paredes, *supra* note 107, at 674-75 (discussing Comcast’s bid to acquire Disney); *id.* at 692 (discussing VeriSign’s acquisition of Network Solutions); *id.* at 745 (discussing a remedy against overconfidence in the context of “big-ticket items, such as significant mergers [and] acquisitions”). Another recent study found evidence of behavioral heuristics and biases in the context of required disclosure documents for the thirty biggest stock-for-stock mergers over a three-year period. See James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333, 1354-74 (2001).

¹¹⁹ These may be referred to as “golden parachutes,” since they insure the executives a soft landing after they have been jettisoned by the company.

¹²⁰ BEBCHUK & FRIED, *supra* note 32, at 91 (relating the story of a \$170 million “retention pool” for MCI executives promised by British Telecommunication in a proposed merger; the executives then continued to support the merger even after BT reduced its offer by 20 percent).

Companies also give executive bonuses when they are on the acquiring end of the deal. According to one study, the acquiring company's CEO received a gratuitous multimillion-dollar bonus in about 40 percent of acquisitions.¹²¹ The bonuses are often given as cash for work that falls within the overall job expectations of a chief executive officer. Acquisition bonuses are a critical example of the "managerial power" thesis: these bonuses are not the result of compensation negotiations but rather the CEO's power over the board.¹²² In addition, they provide a powerful incentive for executives to pursue acquisitions. Another recent study has found that executives' decisions to expand company size are associated with increases in subsequent pay.¹²³ There is a real concern that "the promise – or even the expectation – of an acquisition bonus could exacerbate managers' excessive acquisition tendencies."¹²⁴

In addition, shareholders may not know ahead of time whether the board will view the merger and its implementation as a justification for a substantial bonus after the merger has been approved. In his campaign against the Hewlett-Packard merger with Compaq, renegade director Walter Hewlett raised this issue explicitly. In a report distributed as part of his campaign, Hewlett accused the company of "hiding the ball" with respect to post-merger compensation.¹²⁵ Because he believed that management was not forthcoming, he leaked board discussions that had contemplated compensation packages totaling more than \$115 million.¹²⁶ It is, of course, highly unusual to have a dissident board member leak such information; shareholders are generally not privy to such understandings or discussions.

Given the propensity for managers to use combinations as a reason for higher pay, it is no wonder corporate combinations themselves have come under greater scrutiny.¹²⁷ Even if such bonuses are based on desert, they still can provide a powerful incentive to initiate or continue with deals that should not be done.

¹²¹ Yaniv Grinstein & Paul Hribar, *CEO Compensation and Incentives – Evidence from M&A Bonuses*, 73 J. FIN ECON. 119 (2004).

¹²² BEBCHUK & FRIED, *supra* note 32, at 127-29.

¹²³ Lucien A. Bebchuk & Yaniv Grinstein, *Firm Expansion and CEO Pay*, November 2005, available at: <http://ssrn.com/abstract=838245>.

¹²⁴ BEBCHUK & FRIED, *supra* note 32, at 128.

¹²⁵ Walter B. Hewlett et al., Proxy Materials, Report on Executive Compensation, Feb. 26, 2002, available at: <http://www.sec.gov/Archives/edgar/data/47217/000089161802000923/-f77503j7dfan14a.htm>

¹²⁶ *Id.*

¹²⁷ Gretchen Morgenson answered the title of her article "What Are Mergers Good For?" with the answer, "Not much, unless you're one of the bankers or executives whose compensation goes up with every deal you do." Morgenson, *supra* note 31, at 56.

5. *Process Problem: Deal Protection Provisions.* In addition to the information and behavioral problems that can lead to bad corporate combinations, many firms find themselves locked into a decision not only by the commitment bias, but also by contractual provisions. Deal protection provisions include agreements to sell certain assets to the bidding company at a reduced price if the transaction does not go through; agreements to submit the transaction to the shareholders, even if the board changes its mind; termination fees if the transaction does not occur; and side agreements with key shareholders as to their votes. Such provisions have been the subject of considerable judicial consideration and academic discussion for their role in discouraging hostile takeovers.¹²⁸

There is substantial literature in support of deal-protection provisions: such provisions protect the initial bidder and may increase the likelihood that bidders will enter into combination agreements in the first place.¹²⁹ However, such provisions also extract a price: they make it much more difficult for boards and shareholders to get out of a deal after the fact. In fact, deal protection provisions are often written to provide protection to the disappointed firm even if the shareholders reject the proposed combination.¹³⁰ Certainly deal protection provisions offer an opportunity for managers and directors to make it more painful for shareholders to reject a proposed merger. The costs of such proposals have led some commentators to recommend more judicial skepticism of such provisions.¹³¹

C. *The Employee Referendum as Information Generator*

¹²⁸ See, e.g., *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 939 (2003) (holding certain deal protection provisions to be invalid); Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Acquisitions*, 75 MINN. L. REV. 239 (1990); John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of Lockups: Theory and Evidence*, 53 STAN. L. REV. 307 (2000); Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539 (1996).

¹²⁹ See, e.g., Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare*, 29 J. CORP. L. 569, 595-615 (2003) (arguing that restriction on deal protection devices may reduce shareholder welfare by decreasing a target board's options in the midst of competing deals); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1461 (2005) ("I think most objective observers believe that the majority decision [in *Omnicare*] was simply wrong.").

¹³⁰ See, e.g., Lucent-Alcatel Merger Proxy Statement, *supra* note LAMPS, at 8 ("A fee of \$250 million, which is referred to as the initial termination fee, will be payable by one party to the other party if: (a) either party terminates the merger agreement because the paying party's shareholders failed to approve the merger . . . and prior to the paying party's shareholders meeting, a competing acquisition proposal was made known to the paying party").

¹³¹ Coates & Subramanian, *supra* note 128, at 389 (arguing that "lockups can in fact protect deals from third-party higher-value bidders, thereby reducing allocational efficiency in the market for corporate control").

An overview of the corporate combination process reveals problematic tendencies toward inefficient behavior. The combination begins with discussions between a small group of executives at the highest level, who are by necessity acting on limited information. They soon become locked into the deal, however, and the other participants in the process – namely, the directors and the shareholders – often play a purely reactionary role. The process would become more efficient with more information, particularly information from players who are not tied into the success of the combination.

Employees are a natural fit for this role. In the 1980s and 1990s both academic and popular business literature discussed the ways in which firms could take better advantage of the information held by employees.¹³² The success of Japanese businesses led many to investigate ways in which Japanese firms sought to work with employees to better design the business.¹³³ Groups such as “quality circles” and “quality improvement teams” were heralded as a way of getting workers to contribute their knowledge to the corporation.¹³⁴ Such methods stood in opposition to hierarchical management structures and the Taylorist method of production, which held that managers generated the information and disseminated down the ladder.¹³⁵

The employee referendum would be one way of tapping into this employee knowledge base. The referendum would ask employees whether they thought the proposed merger should go through. The results of the referendum itself – the percentage voting for, the percentage voting against – would be useful information. Beyond that, however, those results would in turn lead to efforts to explain the results. These explanatory efforts would generate more information about the merger and its wisdom.

¹³² For a sampling of the legal academic literature, much of it involving employee ownership, see MARGARET M. BLAIR, *OWNERSHIP AND CONTROL* (1995); *THE NEW RELATIONSHIP: HUMAN CAPITAL IN THE AMERICAN CORPORATION* (Margaret M. Blair & Thomas A. Kochan eds. 2000); JOSEPH R. BLASI, *EMPLOYEE OWNERSHIP: REVOLUTION OR RIPOFF?* (1988); HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 66-119 (1996); SAUL A. RUBENSTEIN & THOMAS A. KOCHAN, *LEARNING FROM SATURN: POSSIBILITIES FOR CORPORATE GOVERNANCE AND EMPLOYEE RELATIONS* (2001); PAUL WEILER, *GOVERNING THE WORKPLACE* (1990); Alan Hyde, *In Defense of Employee Ownership*, 67 *CHI.-KENT L. REV.* 159, 160 (1991).

¹³³ See, e.g., ROBERT E. COLE, *WORK, MOBILITY, AND PARTICIPATION: A COMPARATIVE STUDY OF AMERICAN AND JAPANESE INDUSTRY* (1980). Enthusiasm for Japanese production methods continues today. See Jon Gertner, *From 0 to 60 to World Domination*, *N.Y. TIMES (Magazine)*, Feb. 18, 2007, at 34.

¹³⁴ See, e.g., JOSEPH M. JURAN, *QUALITY BY DESIGN* (1992); DAVID I. LEVINE, *REINVENTING THE WORKPLACE: HOW BUSINESS AND EMPLOYEES CAN BOTH WIN* (1995); PAUL LILLRANK & NORIAKI KANO, *CONTINUOUS IMPROVEMENT: QUALITY CONTROL CIRCLES IN JAPANESE INDUSTRY* (1989).

¹³⁵ See Katherine V.W. Stone, *Labor and the Corporate Structure: Changing Conceptions and Emerging Possibilities*, 55 *U. CHI. L. REV.* 73, 143-46 (1988) (discussing Taylorism in the workplace).

At first glance, the results of the referendum itself may not seem all that important. After all, it is a non-binding referendum that simply says whether the employees believe the merger is a worthwhile endeavor. Much of this information, it could be argued, is accessible simply by asking the employees. However, although managers may be able to get a general sense of employee sentiment through internal channels, that anecdotal information is not the same as a referendum. Anecdotal information may be insightful, but it may also vary wildly from the actual reality. Managers cannot be expected to contact every employee about their thoughts on the combination.¹³⁶ Given the lack of unionization among private sector employees, most companies will not have union representatives that they can turn to as barometers of employee sentiment.¹³⁷ In addition, managers will be primed to read employee sentiment as supporting the merger, since they have already bought into it. Psychological biases will lead managers to overvalue employee support and undervalue employee criticism.¹³⁸ In addition, employees will be more likely to publicly support the combination, whatever their own views, if they think managers are looking for positive feedback.¹³⁹ Employees might be fearful that failure to support the combination will be punished. Finally, even if managers could get a realistic read on employee sentiment, they will in all likelihood keep that information to themselves. They are unlikely to share the information with directors, the shareholders, or the public, particularly if employees are generally unfavorable about the transaction.

The difficulties in determining employee sentiment without a referendum were highlighted in the recent proxy battle over the Hewlett-Packard (H-P) merger with Compaq. Both sides in that battle claimed that employees agreed with their position. In fact, H-P shareholder and merger opponent David W. Packard commissioned independent polls of employees on the merger.¹⁴⁰ The polls were conducted by surveying residents in three towns that were known to have high concentrations of H-P employees.¹⁴¹ The results showed that employees surveyed (which included retirees) were against the

¹³⁶ Cf. JAMES SUROWIECKI, *THE WISDOM OF CROWDS* 205 (2004) (noting that “with so many layers separating the men in the executive suit from workers in the field, it was hard for top executives to know if the picture they had of their own corporation resembled reality” (citing THOMAS J. PETERS & ROBERT H. WATERMAN, *IN SEARCH OF EXCELLENCE* (1982))).

¹³⁷ U.S. Dep’t of Labor, Bureau of Labor Statistics, News Release, Union Membership in 2006, Table 3, January 25, 2007, *available at*: <http://www.bls.gov/news.release/union2.t03.htm> (union members account for only 7.4% of the private workforce).

¹³⁸ See Part II.B.3. *supra* (discussing the optimism bias).

¹³⁹ Cf. FREEMAN & ROGERS, *supra* note 11, at 141 (citing research that shows that employees want joint participation with management on worker organizations).

¹⁴⁰ David W. Packard, The Case for the H-P Way, Advertisement, *available at*: <http://www.crn.com/it-channel/18837628>.

¹⁴¹ *Id.*

merger by a 2-to-1 ratio.¹⁴² However, Hewlett-Packard claimed that it had internal survey data demonstrating that more than sixty percent of employees were in favor of the merger.¹⁴³ Both sides attacked the other's data.¹⁴⁴ In both cases, however, the results reflected surveys of small portions of employees – not comprehensive efforts to determine what employees thought as a collective whole.

In addition to providing a definitive, quantitative account of employee sentiment, the referendum will then generate a second level of information: reporting on the referendum's results and the reasons behind those results. Once the votes are counted, the results will trigger a discussion about the meaning behind the numbers. They will provide for a more grounded dialogue amongst employees, managers, directors, and shareholders. Moreover, instead of merely relying on anecdotal accounts from individual employees, members of the press will have a concrete figure to discuss and dissect. They can then look to the company, employees, and analysts for explanations of the result. Much of this information will still be anecdotal, but it will be in response to a firm-wide survey of employees. It will be grounded in a more scientific slice of reality.¹⁴⁵ This second level of information generation will add an important layer of context to the raw numbers.

Having identified the type of information that the referendum will generate, we are still left with determining the usefulness of this information. What does a vote for or against the combination say about that combination? What are the reasons behind it? An employee's vote can likely be explained by three different general areas of concerns: business judgment concerns, employee-related concerns, and managerial opportunism concerns. Some employees may vote based solely on one of these reasons, while others may cast their vote based on all three. Each category will have different benefits and uses for management, directors, and shareholders. But this is the type of information that is likely to bubble up in the referendum's wake.

¹⁴² *Id.*

¹⁴³ Peter Burrows, *What Price Victory at Hewlett-Packard?*, BUSINESSWEEK, April 1, 2002.

¹⁴⁴ H-P CEO Carly Fiorina referred to the Packard-commissioned polls as "employee surveys in a small town in Oregon with 500 employees and half of them are retirees." *Fiorina Says Pay No Heed to Hewlett*, ZDNET, Feb. 28, 2002, available at: <http://www.zdnet.co.uk/misc/print/0,1000000169,2105201-39001084c,00.htm>. David Packard attacked the company's surveys for being biased, directed at certain employees, and non-confidential. Packard, *supra* note DWP1.

¹⁴⁵ For example, stories about employee discontent will be more meaningful than simply the traditional "handful of disgruntled employees" accounts. See, e.g., Alorie Gilbert, *PeopleSoft Customers, Employees Weigh Deal*, CNET NEWS.COM, Dec. 14, 2004, available at: http://news.com.com/2100-1014_3-5490219.html ("Several employees interviewed at the firm's Pleasanton campus on Monday, each of whom requested anonymity, expressed concerns about the deal.").

1. Business-Judgment Concerns. Business judgment concerns reflect a judgment on the part of employees about the business sense of the combination. This judgment may be reflected in majority support for the combination, which would signal agreement with the managers' business judgment, or it may be reflected in majority disapproval of the combination, which would signal disagreement with the managers' judgment. Employees may agree or disagree with managers on a variety of business-related judgments: the culture of the other firm, the value of the other firm's business or technology, the need for a combination to expand the business or enter new markets. A vote that centered on these concerns would generate further information about these business-related issues.

Information generated in this category is obviously useful to all three groups of decision-makers: managers, directors, and shareholders. Managers will benefit by getting feedback on their planned combination. They may choose to abandon the plan if employees raise significant enough concerns, or employee support may bolster their confidence in the plan. Even if they disagree with the employees' judgment, knowing those concerns will make it easier for management to adapt the plan so that, down the road, employees buy into the new arrangement. Employee participation in and adaptation to the combination are perhaps the most important factor in achieving a successful new company.¹⁴⁶

Directors would benefit from the information in their role as stewards of the transaction and the firm. Although directors will have approved of the merger before the referendum, they maintain the ability to withdraw the combination from consideration by the shareholders or to recommend a "no" vote to the shareholders. Some merger agreements contain a "fiduciary out" clause, in which the board is given the right to withdraw from the agreement if their fiduciary duties as directors require the deal to be nixed.¹⁴⁷ If employee

¹⁴⁶ BRUNER, *supra* note 57.

¹⁴⁷ See, e.g., William T. Allen, *Understanding Fiduciary Outs: The What and Why of an Anomalous Concept*, 55 BUS. LAW. 653, 654 (2000) ("A fiduciary out typically provides that if some triggering event occurs (often the receipt of a defined 'Superior Offer' and sometimes the receipt from the corporation's outside lawyers of an opinion to the effect that the board must as a matter of fiduciary duty do an act that the contract forbids or must not do an act the contract requires), then the doing of that act (or the refraining from doing a required act) will not constitute a breach."); Michael A. Stanchfield, *Fiduciary Duties in Negotiated Acquisitions: Questioning the Legal Requirement for "Outs,"* 27 WM. MITCHELL L. REV. 2261, 2263-66 (2001) (discussing the prevalence and varieties of such "outs"). There is some suggestion that a "fiduciary out" is necessary under Delaware law. See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 939 (Del. 2003) ("The fiduciary duties of a director are unremitting and must be effectively discharged in the specific context of the actions that are required with regard to the corporation or its stockholders as circumstances change."); Edward D. Herlihy, *Takeover Law and Practice* 2005, 1528 PLI/CORP. 341, Jan. 25, 2006 ("*Omnicare's* emphasis on the 'unremitting' nature of the board's duties to obtain the best price, and its flat per se rule that

referenda are implemented, perhaps directors will stipulate that employee disapproval gives a board the discretion to terminate the agreement.¹⁴⁸ An employee vote disapproving the deal, together with the information supporting that vote, may be sufficient to change a board's mind about the wisdom of the transaction.

Finally, shareholders might also look to the employees' business judgment in casting their vote about the proposed combination. For reasons discussed above, management and directors might not give the proper weight to negative information generated by the employee referendum about the deal's business impact.¹⁴⁹ Executives and the board will have already formulated and executed the deal and are then looking for shareholders to go along with the plan. Their buy-in, combined with behavioral heuristics, may lead them to irrationally ignore or discount business judgment concerns generated from employees. Shareholders, however, will not be subject to these irrationalities and thus could vote against the plan based on the employees' business judgment concerns.

Indeed, in the most hotly contested merger proxy contest in recent memory, both sides looked to employees to bolster their claims about the wisdom of the proposed transaction. In the battle over the Hewlett-Packard merger with Compaq, both management and the dissident group argued that employees agreed with their position. In presentations and advertising, Walter Hewlett emphasized that H-P employees were against the merger; one advertisement stated, "If employees are opposed to the Compaq merger at a rate of almost 2 to 1, what hope is there for the Compaq merger?"¹⁵⁰ In addition, both the dissident group and David Packard quoted employee responses discussing the merits of the merger proposal.¹⁵¹

Even if these scenarios are possible, one might question whether employees would actually have the business judgment necessary to detect and then vote against a proposed deal based simply on the merits. Firms generally do not call upon the combined judgment of employees in making business decisions; instead, executives are hired to make these big-picture decisions using their access to both public and confidential sources of information along with their intelligence and experience. The likelihood is slim to none, it might be argued, that employees as a whole would actually exercise better business

replaces previous factual, case-by-case analysis, may suggest that contracts will require some form of fiduciary out to pass muster in the future.").

¹⁴⁸ Of course, canceling the deal would likely result in a termination fee, but agreements generally require such fees even if shareholders vote down the proposed combination.

¹⁴⁹ See Part II.B *supra*.

¹⁵⁰ Walter B. Hewlett et al., Advertisement, Feb. 28, 2002, available at: <http://www.sec.gov/Archives/edgar/data/47217/000089161802000966/a77503k4dfan14a.htm>.

¹⁵¹ *Id.*; Packard, *supra* note DWP1.

judgment on a deal than management and the cadre of professionals who advise them.

However, this conventional wisdom about employees' judgment may be overstated and, in fact, misplaced. As discussed earlier, firms are now using methods to draw more and more information from their employees.¹⁵² Much of this activity is focused on the lower level, such as the shop floor.¹⁵³ However, employees may also have collective wisdom on big-picture items as well. In *The Wisdom of Crowds*, James Surowiecki argues that firms should tap employees not only for bottom-level productivity concerns, but also for top-level problems of cognition.¹⁵⁴

These are the problems that define corporate strategy and tactics. They include everything from deciding among potential new products to building new factories to forecasting demand to setting prices to contemplating mergers. Today, in most corporations, the answers to these problems are ultimately decided by one man: the CEO. Yet they are the problems that . . . are probably most amenable to collective decision making, even if the collective is a relatively small group.¹⁵⁵

Surowiecki goes on to promote the use of “methods of aggregating collective wisdom” in making strategic decisions.¹⁵⁶ In an age which saw the sharp rise and swifter fall of Enron, the allegedly “smartest guys in the room,”¹⁵⁷ the luster of professional expertise in strategic decisionmaking has lost some of its shine.¹⁵⁸ In its place, the use of collective intelligence, through such mechanisms as organizational structure, referenda, and information markets, has enjoyed a recent surge in interest and popularity.¹⁵⁹ Similarly, the wisdom

¹⁵² See Part II.C *supra*.

¹⁵³ See, e.g., MICHAEL J. PIORE & CHARLES F. SABEL, *THE SECOND INDUSTRIAL DIVIDE: POSSIBILITIES FOR PROSPERITY* 231-36 (1984) (discussing the practice of “flexible specialization” on the shop floor).

¹⁵⁴ SUROWIECKI, *supra* note 136.

¹⁵⁵ *Id.* at 216.

¹⁵⁶ *Id.* at 220-21. Surowiecki specifically discusses the uses of trading markets drawing a diverse mix of employees as methods of assessing projected sales and regulatory decisions. *Id.* at 221-22.

¹⁵⁷ BETHANY MCLEAN AND PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2003).

¹⁵⁸ See, e.g., Malcolm Gladwell, *The Talent Myth*, *NEW YORKER*, July 22, 2002 (arguing for organizational structure, not individual intelligence, as the way to institutional success, and criticizing the “McKinsey” approach to employee hiring).

¹⁵⁹ See, e.g., Michael Abramowicz, *Predictive Decisionmaking*, 92 VA. L. REV. 69 (2006); Michael Abramowicz, *Information Markets, Administrative Decisionmaking, and Predictive Cost-Benefit Analysis*, 71 U. CHI. L. REV. 933 (2004); Michael Abramowicz & M. Todd

of the average employees has been (again) heralded in recent popular business literature.¹⁶⁰

Of course, employees may be wrong. But if a majority of employees vote “no” based on business-judgment concerns, then at least management has an awareness of the problem and the opportunity to respond to those concerns. A more vigorous debate of the wisdom of the merger increases the likelihood that the eventual decision will be the most efficient one.

2. *Employee-Related Concerns.* The vote might also reflect employee-specific concerns about the proposed transaction. For example, employees might vote for a merger because the merger will offer greater opportunities for employees to move up in the organization. Conversely, employees might vote against a combination because of proposed layoffs or closings that the combination would engender. Unlike business judgment concerns, employee-specific concerns specifically relate to the employee’s interests and may be counter to the interests of managers, shareholders, and other stakeholders in the firm.

A “no” vote from a majority of employees may signal specific employee-related concerns about the proposed transaction. Most obviously, employees may be concerned about lay-offs or terminations that would result from post-combination redundancies. In fact, the very reason for the deal may be the cost savings from a reduced payroll. Employee rejection of such a deal would be unsurprising and perhaps not all that illuminating to decisionmakers within the firm.

However, for those who believe in a stakeholder or “mediating hierarchy” theory of board governance, an employee referendum offers a way to quantify the breadth of employee sentiment for and against a proposed transaction. As discussed earlier,¹⁶¹ stakeholder theorists believe that the role of the board is to balance between the concerns of the various stakeholders in the firm. Unlike shareholder primacists, who believe that directors must maximize residual returns to shareholders, stakeholder theorists argue that boards must generally maximize returns across all of the stakeholders to the firm.

Henderson, *Prediction Markets for Corporate Governance*, Working Paper, available at: <http://ssrn.com/abstract=928896>; Miriam A. Cherry & Robert L. Rogers, *Tiresias and the Justices: Using Information Markets to Predict Supreme Court Decisions*, 100 NW. U. L. REV. 1141 (2006).

¹⁶⁰ See, e.g., ORI BRAFMAN & ROD A. BECKSTROM, *THE STARFISH AND THE SPIDER: THE UNSTOPPABLE POWER OF LEADERLESS ORGANIZATIONS* 181-91 (2006); ADRIAN GOSTICK & CHESTER ELTON, *THE INVISIBLE EMPLOYEE: REALIZING THE HIDDEN POTENTIAL IN EVERYONE* (2006).

¹⁶¹ See Part II.A *supra*.

Scholars disagree whether existing corporate law is more oriented toward shareholder primacy or stakeholder theory.¹⁶² One clear example of stakeholder theory in action, however, is the state corporate constituency statute. Over half of the states¹⁶³ have a provision allowing directors to make certain decisions based on the needs of all corporate constituencies. New York, for example, provides that when considering a change or potential change in the control of the corporation, a director “shall be entitled to consider” the effects that the corporation's actions may have upon the corporation's various stakeholders, including current employees, retired employees, customers, creditors, and the communities in which it does business.¹⁶⁴ The purpose of the statute is to give directors the freedom to consider the impact of a control transaction¹⁶⁵ on stakeholders other than shareholders. Constituency statutes have generated a voluminous literature both in favor and against such statutes.¹⁶⁶

The most generally recognized weakness of the constituency statute is the lack of accountability for its use. Directors are only given authorization to consider the needs of other constituencies; they are not obligated to do so.¹⁶⁷ Directors are not legally accountable to any of the stakeholders for failure to consider their needs.¹⁶⁸ Thus, critics fear that constituency statutes will be used

¹⁶² Compare Hansmann & Kraakman, *supra* note 43, at 441 (“[A]s a consequence of both logic and experience, there is convergence on a consensus that the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests.”), with Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 650 (2006) (“Although corporate law mandates managerial fidelity to shareholder interests both through shareholder election rights and through fiduciary principles, existing law does not actually require officers and directors to make operational decisions with the sole objective of shareholder wealth maximization.”).

¹⁶³ See Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 215 tbl.1 (2006) (finding that thirty-one states have constituency statutes).

¹⁶⁴ N.Y. BUS. CORP. LAW § 717(b) (McKinney 2006).

¹⁶⁵ The statute states that “[f]or purposes of this paragraph, ‘control’ shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the corporation, whether through the ownership of voting stock, by contract, or otherwise.” *Id.*

¹⁶⁶ For a recent summary of the arguments for and against constituency statutes, Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227, 1232-36 (2004).

¹⁶⁷ See, e.g., Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 579 (1992) [hereinafter Mitchell, *Framework*].

¹⁶⁸ For example, New York's statute states: “Nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions.” N.Y. BUS. CORP. LAW § 717(b) (McKinney 2006).

as a “fig leaf” by boards to act in their own interests, rather than in stakeholders’ interests.¹⁶⁹ Despite numerous proposals to beef up constituency statutes,¹⁷⁰ they remain in their largely hortatory form.

Employee referenda are a way of putting more substance into constituency statutes. In their current form, directors could cite to vague or anecdotal employee concerns in order to approve, nix or counter a proposed corporate combination. With an employee referendum in place, directors would have a concrete representation of employee sentiment upon which to base their actions, at least for that constituency. The information generated in response to the referendum would also be useful to directors in formulating their constituency-balancing. By providing quantitative evidence about employee views, the referendum would provide a better foundation for director decisions based on the stakeholder framework.

It is true that constituency statutes were created to allow boards to fight hostile takeovers, and such takeovers do not generally involve shareholder votes. Instead, the hostile bidder makes a tender offer for the company which the target board may then try to defeat. However, such statutes apply to any change of control situation, which may include a company being taken over by another pursuant to a merger or sale of substantially all assets. A board could use the employee referendum to shut down or back out of a deal that employees disliked. And it could do so based simply on employee-related concerns.¹⁷¹

More generally, the employee referendum supports the stakeholder model by looking for input from stakeholders other than shareholders on critical decisions of corporate strategy. Employees would have the opportunity

¹⁶⁹ Letter from Joseph Grundfest, Commissioner, Securities Exchange Commission, to Mario Cuomo, Governor for New York (June 6, 1989), cited in Mitchell, *Framework*, *supra* note LM2, at 580 & n.4. See also Mitchell, *Framework*, *supra* note 167, at 581 (“The principal criticism of rejecting this traditional relationship is that authorizing the board to consider constituencies that have no monitoring or enforcement powers would leave the board accountable to nobody.”); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001) (“A stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, but only their own.”). Even constituency statute proponents have deep concerns about this problem. See David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, in PROGRESSIVE CORPORATE LAW at 1, 30 (Lawrence E. Mitchell ed., 1995) (“However attractive [the constituency] model might be in theory, communitarian scholars have yet to show persuasively that it could function effectively in practice.”); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Non-Shareholder Constituency Statutes*, 21 STETSON L. REV. 45, 70 (1991) (noting that constituency statutes provide “very little” actual protection to employees and other constituents).

¹⁷⁰ See, e.g., Mitchell, *Framework*, *supra* note 167.

¹⁷¹ A board could also commission their own referendum in the midst of a hostile tender offer to canvass employee feelings on the proposed takeover.

to voice their own, potentially self-interested concerns, and directors could take those concerns into account. The referendum invigorates the stakeholder model by offering a concrete way for employees to reach the board with their input. Under stakeholder theory, directors are obliged to take this input seriously; directors could even incorporate the referendum into the process of the transaction itself.¹⁷² Thus, even where employees simply vote based on their own interests, the employee referendum would be useful to corporate decisionmakers.¹⁷³

3. *Managerial Opportunism Concerns.* Thirdly, a vote might reflect employee concerns related to management and managerial opportunism. Even if the combination makes sense from a business judgment perspective, employees might still vote against the merger if they believe management has used the transaction as an opportunity to extract unnecessary rents from the firm.

As discussed earlier,¹⁷⁴ corporate combinations offer management the opportunity to extract particularized rents. Because the combination requires some degree of reshuffling, both of the corporate structure and the managerial hierarchy, the combination will generally require changes in managerial positions as well as compensation. The combination is often an opportunity for management to give itself bonuses for pulling off the merger. If the new corporation must offer new stock, performance-related pay packages will be restructured to accommodate the new system. These new packages often provide benefits to managers, such as accelerated vesting of stock options, new options packages, or new grants of stock or restricted stock.¹⁷⁵ Even base pay may be changed to reflect the new corporate culture of the combined entity.

¹⁷² For example, as noted earlier, the transaction agreement could allow the board to terminate the merger based on stakeholder concerns, such as those expressed in the referendum. But since the board would not be compelled to do anything based on the referendum, it would still satisfy those scholars who believe that directors must have unfettered discretion to implement policy. See, e.g., Blair & Stout, *supra* note 42, at 254 (“Where progressives have argued that corporate law ought to be reformed to make directors more accountable to stakeholders, the mediating approach suggests that directors should not be under direct control of either shareholders *or* other stakeholders.”).

¹⁷³ The information would also be useful for outside unions and other employee activists who would advocate against the change based on employee preferences. Katherine Stone’s “citizen union” covering employee concerns in a certain region might find the information particularly useful. See KATHERINE V.W. STONE, FROM WIDGETS TO DIGITS: EMPLOYMENT REGULATION FOR THE CHANGING WORKPLACE 229-30 (2004) (“Citizen unions could act at the local and regional level to pressure corporations to become good corporate citizens.”).

¹⁷⁴ See Part II.B.4. *supra*.

¹⁷⁵ For an extreme example, see Scott Thurm, *The “I Must Do A Merger” Bonus*, WALL ST. J., April 6, 2004, at C1 (discussing a CEO bonus that was dependent on the company’s “entry into new businesses by means of acquisitions”).

While directors may be expected to police instances of excessive compensation, there are a variety of reasons to doubt their effectiveness. First, the directors themselves may be in on the deal. Just as managerial reshuffling can lead to payouts, so too directorial reshuffling. The firm may decide to award bonuses to directors as well as managers.¹⁷⁶ Second, directors may already feel beholden to managers. Top-level executives have significant power over the board nomination and reelection process¹⁷⁷ as well as the directorial compensation process.¹⁷⁸ Personal ties help cement the feelings of loyalty and friendship.¹⁷⁹ Third, the merger process is so complicated and hurried that directors may focus on the big picture and neglect to work through the complicated compensation details. As discussed, managers generally turn to the board for approval of these transactions at the last minute. As they generally do, boards may trust that investment bankers, compensation consultants, and other advisors have dealt with the compensation issue sufficiently.¹⁸⁰

In the context of a merger or acquisition, shareholders are empowered to protect against such compensation themselves by vetoing the proposed combination. However, shareholders have to know about the problem in order to police it. Increasingly, shareholder service providers are taking steps to police management and inform large institutional shareholders about problems or corruption.¹⁸¹ But such services are not complete. We are still far from a world in which shareholders are completely informed about their firms and have the power and incentives to act on that information.¹⁸²

¹⁷⁶ See also *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997) (discussing the issues surrounding a stock option grant to directors).

¹⁷⁷ BEBCHUK & FRIED, *supra* note 32, at 25-27.

¹⁷⁸ *Id.* at 27-31 (discussing how top-level managers can financially reward directors).

¹⁷⁹ Brian G.M. Main, Charles A. O'Reilly III & James Wade, *The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives*, 11 *INDUS. & CORP CHANGE* 292 (1995).

¹⁸⁰ See BEBCHUK & FRIED, *supra* note 32, at 37-39. See also *In re Walt Disney Shareholders' Litigation*, 2005 WL 2056651, *7-*10 (Del.Ch.) (discussing the process through which Michael Ovitz was hired by Walt Disney in 1995). Despite denying a duties of care and good faith challenge against the Ovitz hiring, Chancellor Chandler acknowledged that "the compensation committee met for one hour" to discuss the terms of Michael Ovitz's compensation along with the compensation packages for various Disney employees, 121 stock option grants, top-level executive Robert Iger's employment agreement, and board member and compensation committee chair Irwin Russell's \$250,000 compensation for negotiating the Ovitz deal. *Id.* at *9 (emphasis in the original).

¹⁸¹ See, e.g., *Institutional Shareholder Services*, at: <http://www.issproxy.com/index.jsp>.

¹⁸² Lucien A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 *HARV. L. REV.* 833, 880 (2005) ("Unlike management, shareholders do not have access to inside, private information."); Larry Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 *NOTRE DAME L. REV.* 1431, 1467 (2006) ("[E]ven institutional shareholders face obstacles in managing details of each firm in their portfolios.").

Employees are ideally situated to ally with shareholders in an effort to police management. Indeed, this appears to be already taking place. Labor unions, for example, have become much more involved in traditional corporate governance activism.¹⁸³ In the 1980s, unions were generally antagonistic to shareholder concerns and supported anti-takeover tactics such as constituency statutes.¹⁸⁴ However, unions have increasingly joined the side of shareholders in pushing through shareholder-friendly corporate governance measures.¹⁸⁵ Unions and union-affiliated pension funds have promoted anti-takeover measures through shareholder proposals under SEC Rule 14a-8.¹⁸⁶ “The amazing thing about these union-sponsored shareholder proposals,” notes one set of commentators, “is how ordinary they are, from the perspective of any institutional investor.”¹⁸⁷

There is thus a new role for union activism: an alliance with shareholders in an effort to maximize long-term growth for shareholders and other stakeholders.¹⁸⁸ In particular, unions can use their “monitoring advantages to take actions to increase firm value by policing management shirking and reducing the agency costs of equity.”¹⁸⁹ In addition, unions have a greater incentive to monitor management, because “[w]orkers are locked into the firm with firm-specific capital investments.”¹⁹⁰ If unions can monitor and credibly relay their information to other shareholders, their role in current corporate governance processes will only expand.¹⁹¹

However, the overwhelming majority of employees do not have union representation.¹⁹² For them there is no institution to play the role that unions play in receiving and channeling employee information. The referendum would provide employees with the opportunity to express themselves collectively on an issue of corporate governance. The referendum results, along with the information generated by those results, would play a similar role in informing shareholders and board members about collective employees concerns. And

¹⁸³ Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998).

¹⁸⁴ *Id.* at 1036.

¹⁸⁵ *Id.*

¹⁸⁶ Examples include efforts to remove poison pills and repeal classified boards. *See id.* at 1045-46.

¹⁸⁷ *Id.* at 1045.

¹⁸⁸ Schwab & Thomas, *supra* note 183, at 1090.

¹⁸⁹ *Id.* As Schwab and Thomas note, unions have “special monitoring abilities” given their closeness to the firm and their access to employee information. *Id.* at 1036.

¹⁹⁰ *Id.* at 1037.

¹⁹¹ *Id.*

¹⁹² U.S. Dep’t of Labor, Bureau of Labor Statistics, News Release, Union Membership in 2006, Table 3, January 25, 2007, *available at*: <http://www.bls.gov/news.release/union2.t03.htm> (union members account for only 7.4% of the private workforce).

employees would have the incentive and the ability to express concerns about managerial overreaching.

The referenda thus offer the opportunity for employees to join with shareholders in policing management opportunism. Unlike directors, employees do not have the complications that can often muffle complaints about executive overreaching.¹⁹³ And unlike shareholders, employees are immersed in the firm and are more likely to know about managerial misconduct. Employees could vote against a transaction on the grounds that the compensation packages for managers were too rich and undeserved. Although this signal would have no binding ramifications, it would highlight a problem that shareholders could address in their binding vote on the matter.

In addition, employees themselves may have ownership interests in the company. An employee may be invested in her company in a variety of forms. The employee might buy stock independently. A more common scenario involves employee purchases of company stock through a 401(k) plan. Recent reports suggest that thirty to forty percent of the assets of 401(k) plans that offer an employer stock fund are invested in that fund.¹⁹⁴ In fact, lower-wage workers are more likely to be heavily invested in their company's stock.¹⁹⁵ But employees may also have ownership interests that do not provide the traditional shareholders' rights. Stock options provide another way for employees to have ownership in the company but do not provide a right to vote. The purpose of the stock option is to encourage employees to think like owners.¹⁹⁶ Millions of employees receive stock options and thus have similar incentives to shareholders without a vote on corporate combinations.¹⁹⁷

The employee referendum thus gives more power to the shareholders by increasing the odds that they can use their vote as an effective curb against managerial opportunism. Shareholder proponents have lamented the weakness

¹⁹³ Schwab & Thomas, *supra* note 183, at 1038 (“[O]utside directors who are CEOs of another company may be unwilling to raise serious questions about executive compensation for fear of having the spotlight turned on their own pay one day.”).

¹⁹⁴ Susan J. Stabile, *I Believed My Employer and Didn't Sell My Company Stock: Is there an ERISA (or '34 Act) Remedy for Me?*, 36 CONN. L. REV. 385, 385 (2004). Stabile has criticized this underdiversification and has suggested efforts to remedy it. *See id.*; Susan J. Stabile, *Freedom to Choose Unwisely: Congress's Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices*, 11 CORNELL J.L. & PUB. POL'Y 361 (2002).

¹⁹⁵ Susan J. Stabile, *Another Look at 401(k) Plan Investments in Employer Securities*, 35 J. MARSHALL L. REV. 539, 543 (2002). Employers may also match employee contributions with their own contributions of company stock. Howell E. Jackson, *To What Extent Should Individual Investors Rely on the Mechanisms for Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns*, 28 J. CORP. L. 671, 682 n.16 (2003).

¹⁹⁶ Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539, 548 (2003).

¹⁹⁷ *Id.* at 541.

of shareholder protections.¹⁹⁸ A non-binding employee referendum gives shareholders the benefits of employee information with essentially no strings attached. Shareholders may accept or reject employees' judgments depending on their own independent analysis. But shareholders will benefit from the additional set of monitors that the referendum puts in place when it comes to corporate combinations. These monitors will have an incentive to work with shareholders, since they have no power acting on their own. And they have common ground: the desire to prevent managerial overreaching. Indeed, this concern may explain why firms have not voluntarily conducted referenda in the past: managers may have been afraid of precisely this result.

If employees vote against a merger because of a particular concern about management, managers have the opportunity to correct this problem before shareholders vote on the transaction. This happens from time to time without the referenda; for example, in the merger between the MONY Group and AXA Financial, MONY postponed a shareholder vote and cut \$7.4 million out of executive pay packages in response to shareholder concerns about excessive compensation.¹⁹⁹ But with employees on the scene and able to express themselves, there is a greater chance that managerial opportunism will be caught and brought to the attention of shareholders. Knowing this, management will be more likely to curb opportunism, both *ex ante* before the referendum and *ex post* between the referendum and the shareholders' vote.

The employee referendum could be just one part of the new coalition between shareholders and employees to discipline top-level management. Regardless, the referendum provides shareholders with a way to tap into inside knowledge for their own benefit. This change will strengthen the use of the shareholder franchise.²⁰⁰ For this reason, assuming the referenda costs are low,²⁰¹ shareholder primacists should welcome the addition of the non-binding employee referendum to the corporate law framework.

III. REFERENDUM AS VOICE

The employee referendum is a way for employees to communicate their opinions about the wisdom of a proposed corporate combination. This communication is beneficial not merely for its instrumentality in increasing in

¹⁹⁸ See, e.g., Lucien A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

¹⁹⁹ Jonathan Stempel, *MONY delays AXA merger vote, cuts management payout*, REUTERS, Feb. 23, 2004, available at: <http://www.forbes.com/newswire/2004/02/23/rtr1271644.html>.

²⁰⁰ Cf. Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 263-64 (2001) (discussing the importance of shareholder self-governance in the overall structure of the corporation).

²⁰¹ See Part IV *infra*.

the flow of information about the transaction. These referenda would also give employees a chance to voice their concerns in a systematic and public manner. The vote itself – the chance to be heard – has important benefits beyond the derivative information gains.

This section discusses the benefits of giving employees a voice in the corporate transaction. It starts with the basic sense of satisfaction and utility that employees will derive from the vote itself. It then discusses the improvements in employee performance and compliance with institutional norms that come from the chance to participate. Finally, the section discusses how improving the civic life of the firm may lead to improved civic life in society more generally.

A. Employee Satisfaction

In their landmark study of the state of employee perceptions, Richard Freeman and Joel Rogers undertook “the most extensive analysis of American worker attitudes toward workplace relationships and power in more than twenty years.”²⁰² Using focus groups and telephone surveys of over 2400 employees, the Worker Representation and Participation Survey (WRPS) sought to get an unbiased look into the concerns of American workers.²⁰³ The stakes were sufficiently high that management and labor groups fought over the framing of the study and its results.²⁰⁴

According to the WRPS, workers had one primary concern at the workplace: a desire for more voice. As Freeman and Rogers summarized, “American workers want more of a say/influence/representation/participation/voice (call it what you will) at the workplace than they now have.”²⁰⁵ The study found that employees wanted greater participation because of the improvement to their own working lives as well as the improvement to the productivity and success of their company.²⁰⁶ They wanted not only voice as individuals, but collectively as well – particularly on issues that affected the workers as a group.²⁰⁷ Workers wanted their participation to be cooperative with management, and believed that management resistance was the primary reason they did not have more voice within the firm at present.²⁰⁸

Although the WRPS focused on workers’ involvement in employee-related issues, it found evidence that workers wanted a voice in higher-level company concerns, as well. The study found that over half of the workers surveyed worked at a company that had a program for employee involvement,

²⁰² FREEMAN & ROGERS, *supra* note 11, at 3.

²⁰³ *Id.* at 3, 17-38.

²⁰⁴ *Id.* at 26.

²⁰⁵ *Id.* at 4.

²⁰⁶ *Id.*

²⁰⁷ *Id.* at 4-5.

²⁰⁸ *Id.* at 5.

and thirty-one percent of employees participated in these programs.²⁰⁹ A substantial number of these employees reported that their employee-involvement committees discussed issues of corporate direction.²¹⁰ Overall, however, eighty-two percent of employees who participated in employee-involvement programs believed that giving employees a greater say in these programs would make them work better.²¹¹ This is consistent with the WRPS's findings that workers want more of a voice.

The notion that employees want more of a voice is consistent with a growing number of findings relating to overall satisfaction in a variety of circumstances. These findings show that humans want more than simply a satisfactory outcome; they also place great importance on a satisfactory process. The "procedural justice" school of social psychology has emphasized the importance of process to individual satisfaction and utility.²¹² According to research, individuals look to a number of factors in determining whether a decisionmaking process is procedurally just. The decisionmaker's impartiality, honesty, and ethicality are critical components, as are the opportunity to appeal and the quality of the decision. But another critical component is voice: more specifically, some role for being represented within the decisionmaking process. Indeed, the importance of voice is evidenced by "one of the most reliable findings in research on procedural justice: that people react more favorably to procedures that give them considerable freedom in communicating their views and arguments."²¹³

The employee referendum is an opportunity for employees to participate in the process of corporate combinations. As currently constructed, this process affords no room for employee voice. The ball passes from top-

²⁰⁹ *Id.* at 92.

²¹⁰ *Id.* at 102 (noting that twenty-four percent of employees who participated in long-term committees discussed issues of corporate direction).

²¹¹ *Id.* at 113.

²¹² Economics and its "rational actor" model of human behavior have tended to focus on the utility of actual outcomes in determining overall human satisfaction. Procedural justice theorists, on the other hand, believe that the process whereby that outcome was reached is also critical in determining satisfaction with that outcome. One example of this phenomenon is dissatisfaction with dispute resolution procedures even when the dispute is resolved in one's favor. In one study, those who challenged parking tickets were found to be upset with the court's procedures, even though their cases were dismissed. E. ALLAN LIND & TOM R. TYLER, *THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE* 2 (1988) (discussing an earlier study). Procedural justice research has focused generally on the influence of such concerns on processes of dispute resolution. See Rebecca Hollander-Blumoff & Matthew T. Bodie, *The Effects of Jury Ignorance about Damage Caps: The Case of the 1991 Civil Rights Act*, 90 IOWA L. REV. 1361, 1389-90 (2005) ("Procedural justice effects have been found in a variety of legal contexts, including with juries, police, mediators, and other government authorities."). However, procedural justice is an issue whenever groups or organizations must make decisions.

²¹³ LIND & TYLER, *supra* note 212, at 9.

level management to the board to the shareholders without any formal method for employees to express their opinions. At best, employees may voice their opinions to each other, to their supervisors, or to the media. But such opportunities are interstitial, sporadic, and uncertain. Moreover, they offer no collective opportunity for employees to exercise judgment on the proposed transaction. By denying employees a voice in the process, corporations and corporate law reduce employee satisfaction with the outcome, regardless of its distributive favorability.

Early procedural justice theorists argued that voice and representation were important for the effect these had on the ultimate outcome of the procedures.²¹⁴ Participation in the process was not important in and of itself, but rather for its instrumental effects. This theory, known as the “control model,” had significant effects on the development of procedural justice scholarship.²¹⁵ However, a growing body of literature suggests that voice is not solely important for its effect on the process. Rather, voice is a non-instrumental value. This alternative approach, known as the “group-value” model, argues that expression of one’s view is important without reference to the impact on the outcome.²¹⁶ Instead, “[t]he opportunity to present one’s views enhances procedural justice judgments in and of itself.”²¹⁷ These findings confirm what is probably intuitive: we appreciate the opportunity to make ourselves heard during decisionmaking processes simply for that opportunity.

These findings have important ramifications for the notion of a non-binding employee referendum. One criticism of the proposal would be that employees will not care about the opportunity simply to express themselves. Because management and shareholders are free to ignore the employees’ vote, the vote may seem meaningless and trivial. But procedural justice findings indicate that the vote will have value just as an opportunity for employees to express their views. “Communicating their views and arguments” is itself a benefit.²¹⁸

In researching the reasons why voice is a non-instrumental value, social psychologists have found that the opportunity to participate has important ramifications for a group’s self-valuation. This model, known as the relational model of authority, finds that “people are concerned with those aspects of

²¹⁴ See, e.g. JOHN THIBAUT & LAURENS WALKER, *PROCEDURAL JUSTICE: A PSYCHOLOGICAL ANALYSIS* (1975); TOM R TYLER & STEVEN L. BLADER, *COOPERATION IN GROUPS: PROCEDURAL JUSTICE, SOCIAL IDENTITY, AND BEHAVIORAL ENGAGEMENT* 90-91 (2000) (discussing the control model).

²¹⁵ *Id.*

²¹⁶ *Id.* at 91.

²¹⁷ See LIND & TYLER, *supra* note 212, at 215.

²¹⁸ *Id.*

procedures that convey information to them about their status in their group.”²¹⁹ A just process communicates to those involved that they have importance and worth to the decisionmakers. In a study of 404 employees from a variety of employment settings,²²⁰ Tom Tyler and Steven Blader found strong support for the relational model of authority. Overall the study found that employees concerns about procedural justice exceeded their concerns about distributive justice and outcome favorability.²²¹ Looking at what employees found most important in assessing the fairness of their workplaces, Tyler and Blader found that concerns relating to status recognition and neutrality were significantly more important than their ability to exercise control over their workplace or the likelihood of favorable outcomes.²²² To the employees in the study, conceptions of fairness were based more on the relational norms evidenced by certain procedures, and less on their power to take part in the actual decisionmaking.

These findings suggest that the employee referendum will provide employees greater satisfaction by providing employees with a higher level of recognition and status. Having a formalized role in the process demonstrates that employees are valued members of the community entitled to participate. Even if they have no control over the process, and even if the end result is a combination that is disadvantageous to workers, having a role in the process will provide employees with a greater sense of fairness and greater satisfaction with their workplace. Combined with the informational benefits that the referenda provide to shareholders and directors, the referenda proposal is a win-win-win for all three of the primary groups involved.

Of course, it may seem unsettling that employees could be satisfied with a largely symbolic role, rather than actual decisionmaking power. In fact, the larger notion that people care more about looking important rather than being important suggests the possibility for manipulation or fraud. Procedural justice theorists have described this phenomenon as the “false consciousness problem.”²²³ In one study, for example, an opportunity to voice one’s opinion about a decisionmaker’s verdict led to an increase in the perception of fairness

²¹⁹ TYLER & BLADER, *supra* note 214, at 91-92 (citing Tom R. Tyler & E. Allan Lind, *A Relational Model of Authority in Groups*, 25 *ADV. IN EXPERIMENTAL SOCIAL PSYCH.* 115, 175-76 (1992)).

²²⁰ *Id.* at 18.

²²¹ *Id.* at 83 (“Thus, we have strong empirical evidence that people’s concern with the fairness of group processes exceeds their concerns about what they garner via their group membership . . .”).

²²² *Id.* at 92-96 & tbls. 8-1, 8-2 & 8-3.

²²³ LIND & TYLER, *supra* note 212, at 4; *see also* Robert J. MacCoun, *Voice, Control and Belonging: The Double-Edged Sword of Procedural Fairness*, draft available at: <http://repositorioscdlib.org/cs/ls/fwp/30> (May 5, 2005) (discussing how procedural justice theorists need to spend more time on the “dark side” of procedural justice).

even when there was no chance of even influencing the decision.²²⁴ The authors noted that this could lead people to believe that the process was fair “even though, by objective criteria, it is patently unfair.”²²⁵ An employee referendum could fool employees into thinking that their votes mattered when, in actuality, they did not. Given employees’ propensity to overestimate the power of their legal rights,²²⁶ the referendum may be a tool of keeping employees in the dark while extracting valuable information and post-combination acquiescence.

This is an overreaction. Employees should know full well that the vote is not binding on the company, and it would not be in management’s interest to encourage such a belief. After all, if the referenda defeats the combination but it goes through anyway, the legal reality will hit home. To the extent that management pretends to be interested in the referenda but does not really care, that expression of concern may be valuable in and of itself to employees. Even if it is merely symbolic, an expression of employees’ importance to the firm is useful and meaningful. Ultimately, a symbolic expression not only has its own meaning, but over time can deepen into a stronger current between management and employees. By establishing a mandatory procedure, the referendum proposal provides employees with a voice in the process that upgrades their status within the group. This increase in the procedural justice of the workplace not only improves the lot of workers, but also has further benefits for the firm and society.

B. Employee Performance and Compliance

Providing employees with a voice in the corporate combination process would give them a greater sense of fairness and procedural justice with regards to that process. Such a sense is a value in and of itself. But workers who perceive their workplaces are more procedurally just are more likely to work cooperatively, follow the firm’s leadership, and comply with ethical guidelines.

Getting employees to work cooperatively – that is, to work together for the good of the company – is an essential component to successful business. As self-interested actors, individuals will generally place their own needs above the needs of others. But in working for a firm, individuals are asked to engage

²²⁴ E. Allan Lind, Ruth Kanfer & P.Christopher Earley, *Voice, Control and Procedural Justice: Instrumental and Noninstrumental Concerns in Fairness Judgments*, 59 J. PERSONALITY & SOC. PSYCH. 952 (1990).

²²⁵ *Id.*

²²⁶ See, e.g., Pauline T. Kim, *Bargaining with Imperfect Information: A Study of Worker Perceptions of Legal Protection in an At-Will World*, 83 CORNELL L. REV. 105, 155 (1997) (offering evidence that workers systematically overestimate legal protections against arbitrary and unjust discharge); Pauline T. Kim, *Norms, Learning, and Law: Exploring the Influences on Workers’ Legal Knowledge*, 1999 U. ILL. L. REV. 447, 448 (1999) (concluding that workers do not distinguish between informal norms and enforceable legal rights).

in joint productive activity, in which the gains may not be easily partitionable between members. The notion that firm members must provide individualized investments in exchange for uncertain and nonseparable returns has been referred to as the “team production” problem.²²⁷ Although corporate law scholars have focused on agency cost theory in discussing the purpose of the firm, some theorists consider the puzzle of team production to be more important in explaining the law’s function.²²⁸

Recent scholarship has focused more specifically on the role of law in fostering or impeding the development of cooperative relationships within the firm. The need to develop cooperative behavior through trust may explain such corporate law doctrines as the duty of care in the face of the business judgment rule, the mandatory nature of the duty of loyalty, and problems with closely-held corporations.²²⁹ But trust may be highly dependent on the social context.²³⁰ Certain seemingly irrelevant provisions, such as the duty of care, can have important representational and relational power in fostering trust amongst members of the corporation. Scholars have argued that failure to take trust into account can have deleterious consequences to a firm or to society as whole.²³¹ Such observations are backed up by extensive social science findings about the importance of group cooperation.²³²

Perceptions that a process or institution is procedurally just have been shown to lead to increased cooperative behavior.²³³ In their study of employees, Tyler and Blader found that procedural justice assessments were more likely to predict discretionary cooperative group behavior, such as complying with work rules and norms, exerting full effort to get the job done, deferring to organizational authority, and going beyond job responsibilities to help others at the job, than were the employees’ perceptions of distributive

²²⁷ Blair & Stout, *supra* note 42.

²²⁸ *See, e.g., id.* at 249-50, 271.

²²⁹ Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001).

²³⁰ *Id.* at 1768-77.

²³¹ *Id.* at 1807-10; *see also* Marleen A. O’Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 954-57 (1993) (discussing the importance and fragility of trust in the workplace, and proposing methods to sustain it).

²³² *See, e.g.,* TYLER & BLADER, *supra* note 214, at 23 (“It would be hard to overemphasize the importance of the level and type of cooperative behavior engaged in by group members in shaping the extent to which groups can function efficiently, effectively, and ultimately, successfully.”).

²³³ *See* Dennis W. Organ & Katherine Ryan, *A Meta-Analytic Review of Attitudinal and Dispositional Predictors of Organizational Citizenship Behavior*, 48 PERSONNEL PSYCH. 775, 791-95 (1995) (showing a robust correlation between job satisfaction, perceptions of firm fairness, and organizational citizenship behavior).

justice or outcome favorability.²³⁴ Research has also linked perceptions of procedural justice with other attitudes and behavior that are supportive and beneficial to the firm as a whole. Individuals are less likely to leave a group and are more committed to their group or organization when they perceive the group to be procedurally just.²³⁵ They are more likely to perceive the institution as acting legitimately.²³⁶ Ultimately, a whole host of behaviors beneficial to the firm correspond to the procedural justice of the firm. As Tyler and Blader note:

These results suggest that we know a considerable amount about how to encourage the types of cooperative behavior that are central to the effectiveness of groups. We can do so by creating structures that enact decision-making processes in ways that group members will experience as fair.²³⁷

Happiness with the fairness of the process leads to happiness with the outcome itself, which leads to greater acceptance of the outcome. One of the most robust findings about procedural justice is that individuals are more likely to comply with those outcomes, both in experimental and in real world settings, that they perceive as procedurally just.²³⁸ Procedural justice judgments have been found to be particularly important to adherence to an agreement over time.²³⁹ Much of this research has focused on responses to judicial or other dispute resolution procedures, but it applies as well in the context of group decisionmaking.

This research supports a common sense notion: workers are likely to do a better job if they believe their workplace treats them fairly and wants their

²³⁴ TYLER & BLADER, *supra* note 214, at 33, 80-85, & tbl.3.

²³⁵ *Id.* at 79 (citing ten different studies).

²³⁶ *Id.* (citing four studies).

²³⁷ *Id.* at 87.

²³⁸ LIND & TYLER, *supra* note 212 (discussing experimental support); ROBERT J. MACCOUN ET AL., ALTERNATIVE ADJUDICATION: AN EVALUATION OF THE NEW JERSEY AUTOMOBILE ARBITRATION PROGRAM (1988), available at: <http://www.rand.org/pubs/reports/2007/R3676.pdf> (same); Katherine M. Kitzmann & Robert E. Emery, *Procedural Justice and Parents' Satisfaction in a Field Study of Child Custody Dispute Resolution*, 17 LAW & HUMAN BEHAV. 553 (1993) (discussing results from actual field study); E. Allan Lind et al., *The Winding Road from Employee to Complainant: Situational and Psychological Determinants of Wrongful Termination Claims*, ADMIN. SCIENCE Q. (2000) (same); E. Allan Lind et al., *Individual and Corporate Dispute Resolution*, 38 ADMIN. SCIENCE Q. 224 (1993) (same).

²³⁹ D.G. Pruitt et al., *Long-term Success in Mediation*, 17 LAW & HUMAN BEHAV. 313 (1993); D.G. Pruitt et al., *Goal Achievement, Procedural Justice, and the Success of Mediation*, 1 INT'L J. CONFLICT MGMT. 33 (1990).

input.²⁴⁰ As discussed above, these results do not ride in ultimate control over the actual outcomes, or even the value of those outcomes. An employee referendum would provide employees with a way of participating in the transforming transaction. As a result, it will lead to better cooperation and compliance within the workplace.²⁴¹

C. Social Capital

In her recent book *Working Together*, Cynthia Estlund discusses the importance of workplace interaction to democratic life in a civil society.²⁴² In her view, the workplace is “the single most important site of both cooperative interaction and sociability among adult citizens outside the family.”²⁴³ The focus of Estlund’s book is the workplace’s role in creating bonds between individuals from different racial, ethnic, and religious groups, as well as between men and women. But her insights on the role of the workplace as an institution for civic life have important ramifications for this article’s referendum proposal.

Estlund argues that the workplace is a critical institution for the reinvigoration of civic life. Citing the recent literature on “social capital,”²⁴⁴ Estlund demonstrates that social capital is “linked to an array of social goods, including greater prosperity, health and well-being, safe neighborhood, and better government.”²⁴⁵ She argues, however, that social capital theorists have lamented the decline of civic institutions while overlooking the role of the

²⁴⁰ See SUROWIECKI, *supra* note 136, at 213 (“Similar results from both experimental and empirical studies show that allowing people to make decisions about their own working conditions often makes a material difference in how they perform.”).

²⁴¹ A sense of procedural justice does not only give employees a greater esprit de corps within the institution. Social science research suggests that employees are also more likely to follow the law and external ethical norms if they believe their workplace follows fair procedures. See Tom R. Tyler, *Promoting Employee Policy Adherence and Rule Following in Work Settings: The Value of Self-Regulatory Approaches*, 70 BROOK. L. REV. 1287, 1308 (2005) (finding that “people will comply with and, more strikingly, voluntarily defer to rules when they feel that they their organization’s rule-making authorities are following fair procedures when they exercise their authority and make managerial decisions”).

²⁴² CYNTHIA ESTLUND, *WORKING TOGETHER: HOW WORKPLACE BONDS STRENGTHEN A DIVERSE DEMOCRACY* vii (2003).

²⁴³ *Id.* at 7.

²⁴⁴ *Id.* at 114 (defining social capital as “connections among individuals – social networks and the norms of reciprocity and trustworthiness that arise from them and that help people accomplish things together”). Part of this quotation is taken from ROBERT D. PUTNAM, *BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY* 19 (2000). See also Deborah A. DeMott, *Trust and Tension Within Corporations*, 81 CORNELL L. REV. 1308, (1996) (discussing the role of law in creating circumstances that “tend to facilitate or discourage productive association among people”).

²⁴⁵ ESTLUND, *supra* note 242, at 115 (citing PUTNAM, *supra* note RP1).

workplace in fostering greater social capital. In Estlund's view, "the workplace [is] a central site of social capital building in contemporary society."²⁴⁶

If Estlund is correct, then the employee referendum could be an important way of encouraging and developing social capital amongst employees. As discussed above, employee referenda would foster a climate of greater procedural justice, leading to greater cooperation and trust within the firm. In essence, greater procedural justice has been shown to lead to greater social capital within the firm. In addition, part of social capital is so-called "civic skills" – "skills of communication, compromise, and collective decisionmaking, and a sense of political efficacy."²⁴⁷ As an exercise in corporate democracy, the referendum would facilitate the development of these skills. Estlund makes an eloquent plea for the importance of workplace discussions to the realm of public discourse.²⁴⁸ Arguing that the workplace is "a leading site of public discourse," Estlund describes how at the workplace, employees practice their deliberation skills, discuss topics of national importance, and reach across family and neighborhood boundaries.²⁴⁹ The employee referendum would facilitate all of these, in a forum that allows for direct participation on an issue of importance to the entire workforce.

Moreover, the employee referendum would mitigate some of the concerns that social theorists have about the workplace as an institution of civic life. For example, theorists are concerned with the instrumental and hierarchical context in which managers can rule the workplace.²⁵⁰ Estlund herself recognizes that "[t]o the extent that the workplace is a major site for the formation of social capital, it contributes very unequal portions of those assets to individuals and groups at different rungs of the socioeconomic ladder."²⁵¹ She counters: "These concerns are mitigated but not dissolved by trend towards greater collaboration and less rigid hierarchies in the workplace."²⁵² The referendum is an opportunity for collaboration and equality: all get to vote, and each vote has the same weight. It would thus mirror the democratic institutions that social theorists are hoping to nurture.

There is another way in which benefits from employee referenda may spill out beyond the firm and into the public at large. These referenda may serve to reinvigorate the discussion about possible new channels for employee-

²⁴⁶ ESTLUND, *supra* note 242, at 116.

²⁴⁷ *Id.*

²⁴⁸ *Id.* at 118-23.

²⁴⁹ *Id.* at 118-19.

²⁵⁰ *Id.* at 117. See also Mark Barenberg, *Democracy and Domination in the Law of Workplace Cooperation: From Bureaucratic to Flexible Production*, 94 COLUM. L. REV. 754 (1994).

²⁵¹ ESTLUND, *supra* note 242, at 117.

²⁵² *Id.*

firm relations across society.²⁵³ In the late 1980s and early 1990s, when states were passing corporate “constituency” statutes, some believed that the statutes were important simply for their symbolic value.²⁵⁴ As one commentator argued:

. . . [T]he fact that half of the states have enacted legislation that recognizes that employees are stakeholders in their firms is an important event, if only for its symbolic value. The very enactment of such statutes suggests that employees’ interests are beginning to receive serious attention in the public mind. It therefore suggests the possibility that effective means of protecting them can be developed in the future.²⁵⁵

As I have argued above, I believe that employee referenda would have substantial informational and participatory benefits to employees. But they would also have a symbolic meaning to the public at large: employees matter. The referendum is not intended to be a “camel’s nose under the tent” leading to a binding employee referendum down the road. But it is supposed to be one piece of a new approach to employer-employee relations that will recast those relations for a new century. The referendum proposal may stimulate other ways in which relations between managers, directors, shareholder and employees can be restructured for the greater fairness and efficiency of corporate law and society as a whole.

IV. IMPLEMENTATION

Parts II and III of this paper discuss the benefits in implementing a system of non-binding employee referenda for corporate combinations. This part concerns the costs of implementation. There are a myriad of ways of setting up a system of referenda. But such a system will inevitably impose some costs on businesses. Employees must register their votes, and then the firm must tabulate and announce the results. These processes take employee time and firm resources. These costs must be weighed against the benefits in deciding the wisdom of implementing the plan. Below are some initial thoughts on how the referenda could be constructed to keep costs as low as possible while still retaining the key elements.

²⁵³ Cf. Cynthia L. Estlund, *The Ossification of American Labor Law*, 102 COLUM. L. REV. 1527 (2002).

²⁵⁴ See, e.g., Stone, *Constituency Statutes*, *supra* note 169

²⁵⁵ *Id.* at 71.

A. Bright Line Rules

In order to keep the process as straightforward as possible, the legislation should be crafted to match up with bright-line rules that firms could easily follow in holding the referenda. First, the definition of “employee” is a source of some controversy, as temporary employees, employees of subcontractors, and independent contractors all may be considered “employees” depending on the statute or state common law in question.²⁵⁶ In order to ease administration, firms should count as employees those workers whom they count as employees for tax purposes.²⁵⁷ Both the company and the IRS are likely to keep accurate and up-to-date records of a company’s employees. Introducing a different standard is likely to cause further confusion and delay.

In addition, states should set a flexible but easy to calculate timeline for holding the vote. There must be enough time after the announcement for employees to process and share information about the transaction, but it must be sufficiently before the shareholder vote to allow for shareholders and directors to respond to the results.²⁵⁸ Perhaps the proposal could require that the referenda not be held less than thirty days after the announcement, but its results must be announced at least thirty days prior to the shareholder’s vote. If the latter requirement were not followed, shareholders would have the right to petition a court for a delay in the vote in order to meet the thirty-day period.²⁵⁹

B. Distribution and Election Costs

Beyond these bright line rules, companies should have considerable flexibility in establishing the process through which employees would vote. This flexibility will enable companies to experiment with the process and develop the most cost effective means of processing the votes.

The cost of running an employee referendum might initially seem comparable with the costs of conducting elections over shareholder proposals, which have been estimated at \$87,000 per proposal.²⁶⁰ However, \$37,000 is

²⁵⁶ Compare *Nationwide Mutual Insurance Company v. Darden*, 503 U.S. 318, 323-24 (1992) (discussing the common law control test for employee status) with *Secretary of Labor v. Lauritzen*, 835 F.2d 1529, 1534-35 (1987) (discussing the “economic realities” test under the Fair Labor Standards Act). See STONE, *supra* note 173, at 67-86 (discussing the changing nature of employment).

²⁵⁷ See, e.g., I.R.C. §§ 3306, 3121, 3401-04 (2006) (defining employees for purposes of federal taxes).

²⁵⁸ Cf. DEL. CODE ANN. tit. 8, § 251(c) (2007) (providing that shareholders must receive proxy materials at least 20 days before the vote).

²⁵⁹ The right would be akin to shareholders’ rights to call an election if the corporation has failed to hold one. See *id.* § 211(c).

²⁶⁰ Amendments to Rules on Shareholder Proposals, 17 C.F.R. 240 (1998) (Release No. 34-40,018) (describing 80 firms reporting on proposal inclusion determination costs and 67 reporting on printing and other direct costs). Robert Romano has thus argued that limiting or eliminating

estimated as expense for deciding whether to include the proposal or not.²⁶¹ As for the \$50,000 in printing, distribution, and tabulation costs, those costs would be substantially smaller for an employee referendum. Because the company has a direct connection to its employees, it can use interoffice to distribute the materials; in the alternative, materials may be distributed electronically for more savings. Similarly, the vote need not be conducted at polling stations with paper ballots during work hours; instead, the company could use a website to collect and tally the votes. As Internet access continues to grow and expand across the population, the ability to coordinate the distribution of information together with the actual voting will mean fairly low costs for conducting the employee referendum online.²⁶²

C. State Law Enactment

Much has been written about the advantages and disadvantages of our state, as opposed to federal, system of corporate law.²⁶³ Because mergers and acquisitions are controlled by state law, the employee referendum makes sense as a creature of state law. It is designed to work within that system and be a part of the corporate combination process. Although it may, perhaps, be possible for such a requirement to be imposed through federal law,²⁶⁴ it would

shareholder proposals could save companies over a billion dollars. Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 248 (2001) (“The savings to firms from eliminating the subsidy for shareholder proposals that fail to receive at least 40% of the votes ranges, across the differing historical capitalization rates, from \$1.9 billion to \$293 million.”).

²⁶¹ Amendments to Rules on Shareholder Proposals, *supra* note ARSP.

²⁶² SUROWIECKI, *supra* note 136, at 207 (noting that “dramatic improvements in information technology have made the diffusion of information to large numbers of employees feasible and cost-effective”).

Ideally, the technology would balance the need for a secure ballot with an effort to make sure that the firm could not check to see how individual employees voted. This technology has already been implemented for employee shareholders, who often receive their proxy materials electronically. See D. Craig Norlund, *Electronic Dissemination of Disclosure Documents*, Practising Law Institute, Corporate Law and Practice Course Handbook Series, PLI Order No. B0-006E, January-February, 1999, at *77 (“The fastest growing audience for electronic proxy material and annual report distribution is employee stockholders.”). Such materials must allow for employee shareholders to vote confidentially so as to avoid retaliation for their votes.

²⁶³ For a recent summary of the literature on corporate law federalism, see Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99, 103-09 (2006).

²⁶⁴ It may be necessary to enact such referenda through federal law if they would otherwise be preempted by federal law. The most likely candidate for preemption would be the National Labor Relations Act (NLRA). The NLRA protects collective activity on the part of workers. See 29 U.S.C. §§ 157, 158(a)(1) (2006). If a state were to provide its own remedies for employees who had been fired or otherwise discriminate against because of their vote, such remedies might conflict with the NLRA’s remedies and thus be subject to preemption. See *San Diego Building Trades Council v. Garmon*, 359 U.S. 236 (1959) (holding that states cannot regulate conduct that is at least arguably protected or prohibited by the NLRA). However, states have traditionally be

be an overlay on top of a distinct legal regime. And it would be subject to criticism as a federal intrusion upon state practices of corporate governance.

Implementing the referenda through state law has functional advantages as well. Since the referenda has not been tried anywhere, it is by its very nature an experimental project. In Justice Brandeis's memorable phrase, states serve as "laboratories" of democracy and "try novel social and economic experiments without risk to the rest of the country."²⁶⁵ This notion has come to life in corporate law.²⁶⁶ States could implement the referenda in a variety of different ways and determine, by looking at others, which practices work best.²⁶⁷

CONCLUSION

In closing, let us revisit the opening quote from the email by Robert Hughes to Gerald Levin. In retrospect, the email may be spiteful and vindictive, but it is also well-founded. The merger with AOL was indeed disastrous.²⁶⁸ But the email was written not in January 2000, or even January 2001, but in 2002, well after the initial hopes of the merger had been shown to be unfounded. With the benefit of hindsight, Hughes can declaim against the combination with effective bitterness. But what did he think in 2000?

This "what-if" demonstrates the possibilities for the employee referendum. If employees, along with the shareholders, had overwhelmingly approved the merger, then it would be much harder for Hughes and those like him to center their anger on the CEO. Instead of feeling justly vengeful, Hughes might have to look inward, first, to see how he and his fellow employees voted. Given the apparent stock price boost that the merger seemed to have in store for Time Warner shareholders, employees might have voted for

given great deference in establishing their own systems of corporate governance. *See Santa Fe v. Green*, 430 U.S. 462, 477-80 (1977). Given that the vote would be part of the state's scheme of corporate law, state corporate law interests should outweigh any potential overlap the referendum has with NLRB processes.

²⁶⁵ *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

²⁶⁶ Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 *YALE J. ON REG.* 209 (2006).

²⁶⁷ *Cf.* David Zaring, *Best Practices*, 81 *N.Y.U. L. REV.* 294 (2006). Moreover, as corporations are governed by their state of incorporation, the experiment's subjects are free to leave if they wish to opt out – the "genius" of American law. ROMANO, *supra* note 10. A mass desertion, however, seems extremely unlikely, given the low costs.

²⁶⁸ It is interesting to note that the two principals behind the merger (Time Warner CEO Gerald Levin and AOL CEO Stephen Case) are not only no longer with the company, but have removed themselves to the edges of corporate America. *See* Lillian Ross, *Spa Man*, *NEW YORKER*, July 9, 2007 (reporting that Case owns a spa in Arizona called Miraval); Seth Stephenson, *The Believer*, *N.Y. MAG.*, July 16, 2007, at 24, 26 (reporting that Levin is presiding director of Moonview Sanctuary, a "holistic healing institute" with a full-time staff of fewer than twenty people).

the merger to support their 401(k) and stock option plans. Having bought into the merger from the beginning, perhaps they would have given less resistance to it and would have made the transition smoother and ultimately more successful.

Or perhaps employees would have voted against the merger. After-the-fact accounts bristle with Time Warner employees who were horrified at the merger and never thought it would work.²⁶⁹ If they truly were against the merger from the start, employees could have put a splash of cold water on a process that was all heat and light. Directors, shareholders, and the media would have asked why, and would have found business-judgment concerns, employee-centered concerns, or concerns about managerial opportunism – or all three. These doubts might have led to more questions about whether the proposed combination was as good an idea as was touted. Even if the merger had gone through, perhaps the company, its shareholders, and the media would not have been so optimistic about the immediate future, and the subsequent downturn would have been less crushing. Moreover, having been given a say in the process, employees may have been more receptive to the combination and may have worked to make it more successful.

This is speculation. But behind the speculation about this particularly ill-conceived merger lies the possibility for a different future. Economic, psychological, and corporate law research suggests that employees may have the information and the interest in participating formally in their company's decisions to combine with another. The employee referendum would be a straightforward yet significant way of bringing them into the conversation.

²⁶⁹ See, e.g., MUNK, *supra* note 62; SWISHER, *supra* note 1.

APPENDIX

Proposed changes to Delaware Law
(Changes to existing statute in **bold**)

DEL. CODE ANN.
TITLE 8

§ 251. Merger or consolidation of domestic corporations and limited liability company

...

(new c) At least 30 days after the adoption of the agreement, the corporation shall hold a non-binding referendum in which all employees [as defined by state tax law] shall vote on the agreement. The results of this referendum must be announced publicly at least 30 days prior to the holding of the special stockholders meeting in subsection (d).

(c) **(new d)** The agreement required by subsection (b) of this section shall be submitted to the stockholders of each constituent corporation at an annual or special meeting for the purpose of acting on the agreement. Due notice of the time, place and purpose of the meeting shall be mailed to each holder of stock, whether voting or nonvoting, of the corporation at the stockholder's address as it appears on the records of the corporation, at least 20 days prior to the date of the meeting. The notice shall contain a copy of the agreement or a brief summary thereof, as the directors shall deem advisable. **The notice shall include the results of the employee referendum in subsection (c).** At the meeting, the agreement shall be considered and a vote taken for its adoption or rejection. If a majority of the outstanding stock of the corporation entitled to vote thereon shall be voted for the adoption of the agreement, that fact shall be certified on the agreement by the secretary or assistant secretary of the corporation. If the agreement shall be so adopted and certified by each constituent corporation, it shall then be filed and shall become effective, in accordance with § 103 of this title.