Initiation Payments

Scott Hirst[*]

Many of the central discussions in corporate governance, including those regarding proxy contests, shareholder proposals, and other activism or stewardship, can be understood as a single question: Is there under-initiation of corporate changes that investors would collectively prefer?

This Article sheds light on this question in three ways. First, the Article proposes a theory of investor initiation, which explains the hypothesis that there is under-initiation of collectively-preferred corporate change by investors. Even though investors collectively prefer that certain corporate changes take place, the costs to any individual investor from initiating such changes through high-cost proxy contests, or even low-cost shareholder proposals, would outweigh the benefits to that investor.

Second, the Article puts forward a concrete, tractable, and readily implementable proposal that would eliminate any under-initiation by investors. If the problem is indeed that costs to an initiator exceed the benefits, the solution follows clearly: "Initiation payments" to investors that initiate corporate changes, contingent on the approval of the change by investors or managers, sufficient to increase the benefits to investors that initiate successful changes above their costs.

Third, the Article explains how the only requirement necessary for initiation payments to be implemented is that institutional investors support them. This means that whether initiation payments are actually implemented is effectively a test of whether institutional investors believe there is under-initiation and whether they have incentives to rectify it. Observing whether institutional investors support initiation payments will thus shed light not only on whether there is under-initiation, but also on the ongoing debate regarding the incentives of investment managers.

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For valuable comments on earlier drafts of this Article, I am indebted to Elisabeth de Fontenay, Jill Fisch, Marcel Kahan, and Holger Spamann. For many other helpful suggestions and discussions of this project, I am grateful to Iman Anabtawi, Oren Bar-Gill, Lucian Bebchuk, Bernie Black, Margaret Blair, Brian Broughman, Emiliano Catan, Jon Choi, John Coates, Alma Cohen, Paul Edelman, Ofer Eldar, Jesse Fried, Brian Galle, George Geis, Zohar Goshen, Louis Kaplow, Kobi Kastiel, Peter Molk, Yaron Nili, Menesh Patel, Alexander Platt, Gabriel Rauterberg, Morgan Ricks, Adriana Robertson, Ed Rock, Amanda Rose, Sarath Sanga, Steve Shavell, Roberto Tallarita, Randall Thomas, Rory Van Loo, David Walker, David Webber, Yesha Yadav, and Kathy Zeiler, and to participants in the American Law and Economics Association Annual Meeting, the BU Law Faculty Workshop, the BYU Winter Deals Workshop, the Cardozo School of Law Faculty Workshop, the Corporate Law Academic Webinar Series, the Harvard Law School Law & Economics Workshop, the Tulane Corporate Law Workshop, and the Vanderbilt Law & Business Workshop. For exceptional research assistance I thank Joseph Baron, Ashley Korkeakoski-Sears, Muhammad Mustafa, Woo Jin No, and Daniel Wilson. I also owe special thanks to the Journal of Corporation Law editorial team for their invaluable assistance with the publication of this Article.

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INTRODUCTION

In May 2021, Engine No. 1 won a proxy contest at Exxon Mobil Corporation.[1] Engine No. 1's success was stunning.[2] A small and newly-formed investment fund focused on environmental, social, and governance changes successfully influenced one of the world's largest publicly traded oil and gas companies to change in a way that a majority of its investors collectively preferred.[3]

Engine No. 1's victory stood out because victories like it are so rare. In 2020, of more than 5,000 public companies, only nineteen had proxy contests that went to a vote, and only ten of these were won by dissidents.[4] If the changes that Engine No. 1 proposed could succeed, why had other older and better-resourced investors not put forward such changes much sooner at Exxon—or at the many other companies where investors might have similar collective preferences? This question illustrates a much broader and deeper question, one that relates to the central relationship in corporate governance, between investors and the companies they invest in: Is there under-initiation of corporate changes that investors collectively prefer?

This Article sheds light on this question in three ways. First, the Article proposes a theory of investor initiation, which explains the hypothesis that there is under-initiation of collectively-preferred corporate changes. Second, the Article puts forward a concrete, tractable, and readily implementable proposal, "initiation payments," that would eliminate any under-initiation. Third, the Article explains how the adoption of initiation payments by investors—or their failure to do so—serves to test whether there is indeed under-initiation, and if there is, whether institutional investors wish to eliminate it.

The first contribution of this Article is to propose a theory of investor initiation. The theory is built on the recognition that different types of shareholder activism and key

1. Justin Baer & Dawn Lim, *The Hedge-Fund Manager Who Did Battle with Exxon—and Won*, WALL ST. J. (June 12, 2021), https://www.wsj.com/articles/the-hedge-fund-manager-who-did-battle-with-exxonand-won-11623470420 [https://perma.cc/2F5M-EY3E].

2. *See, e.g.*, Svea Herbst-Bayliss, *Little Engine No. 1 Beat Exxon with Just $12.5 Mln – Sources*, REUTERS (June 29, 2021), https://www.reuters.com/business/little-engine-no-1-beat-exxon-with-just-125-mln-sources-2021-06-29 [https://perma.cc/BVH9-PTHZ] ("Engine No. 1 in May shocked the oil-and-gas industry when Exxon shareholders . . . elected three of its four nominated directors to Exxon's board.").

3. *See, e.g.*, *id.*

4. For the number of listed companies in 2020, see *Comparison of the Number of Listed Companies on the New York Stock Exchange (NYSE) and Nasdaq from 2018 to 3rd Quarter 2022, by Domicile (in Trillion U.S. Dollars)*, STATISTA (Nov. 1, 2022), https://www.statista.com/statistics/1277216/nyse-nasdaq-comparison-number-listed-companies [https://perma.cc/E2HC-5YX7] (presenting evidence that there were 2,363 U.S. companies listed on the NYSE, and 2,790 listed on Nasdaq). For the number of proxy contests and dissident successes, see ACTIVIST INSIGHT, THE ACTIVIST INVESTING ANNUAL REVIEW 2021, at 12–13 (2021), https://www.activistinsight.com/research/Insightia_AIAR2021.pdf [https://perma.cc/RF2E-4J3D].

methods of investor stewardship share a common nature.[5] Proxy contests, shareholder proposals, and engagement are all methods of investor initiation—actions by investors intended to bring about changes in a corporation that investors holding a majority of the corporation's equity would collectively prefer, including in its business, operations, rules, or policies.[6]

Understanding these different phenomena as complementary methods of investor initiation prompts the question of whether the overall level of investor initiation is optimal—whether all changes that investors representing a majority of the equity capital of the company would collectively prefer (I refer to these as "collectively-preferred" changes).[7] This question is challenging to answer because we cannot know for certain until after a change is initiated whether investors representing a majority of its equity capital collectively support it. It is therefore uncertain whether changes that investors *do not* currently initiate would be supported by a majority of investors.

The Article considers the hypothesis that there is under-initiation of corporate change by investors, and articulates a straightforward theory for why this is likely to be the case. The Article posits that the source of under-initiation is the collective action problem inherent in all investor activities. This problem has long been understood.[8] What has not been previously articulated is *which* collectively-preferred corporate changes will not be initiated by investors, and why not. Answering these questions is necessary to design an effective solution that would overcome under-initiation, if it indeed exists.

Investors initiating corporate changes receive only a small fraction of any value increases that result, but bear a larger proportion of their costs.[9] Even for the investors that receive the largest fraction of any increases, activist hedge funds, the fraction is still very small—between 1% and 2%.[10] So the activist hedge fund will only be incentivized to initiate a corporate change that they expect to result in benefits that are 50 to 100 times the

5. Not all activities commonly referred to as "investor stewardship" fall within the category of investor initiation. Stewardship refers to the broad purpose of investment intermediaries' protecting and maximizing the value of their investments. *See, e.g.*, BLACKROCK, INVESTMENT STEWARDSHIP ANNUAL REPORT 7 (2020), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2020.pdf [https://perma.cc/5D3J-7NQD] (describing investor stewardship as "how we use our voice . . . to help maximize long-term shareholder value for our clients").

6. Investor initiation also includes engagement with directors requesting changes and other types of shareholder activism, such as withhold campaigns. For a discussion of withhold campaigns, see Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 902–14 (1993).

7. This Article follows Yaron Nili in considering different types of shareholder activism collectively, as a broad category, but goes further by also incorporating investor stewardship. *See* Yaron Nili, *Missing the Forest for the Trees: A New Approach to Shareholder Activism*, 4 HARV. BUS. L. REV. 157 (2014) (discussing shareholder activism by "treating activism as a collection of diverse models that differ by motives, tools, and structures").

8. For foundational works considering collective action problems, see, e.g., R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960); Harold Demsetz, *The Private Production of Public Goods*, 13 J.L. & ECON. 293 (1970). For an application of this theory to activity by investors, see Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECONOMICS 42 (1980).

9. Value here is intended to incorporate both financial value, but also non-pecuniary value. For an influential discussion of non-pecuniary value in corporations, see generally Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, J.L. FIN. & ACCT. 247 (2017).

10. *See infra* Section I.B.

cost of initiation.[11] And estimates of those costs are substantial—$11 million on average, with some recent contests costing as much as $25 million.[12] Of course, the activist hedge fund itself will only benefit if other investors support the change to the status quo (usually against management opposition), and if the change actually results in an increase in the share price of the company while the activist hedge fund retains its position. Because this will not always be the case, the expected returns must be even larger to justify initiating a change. Even the investors with the strongest incentives to initiate corporate changes will, therefore, only use high-cost methods such as proxy contests when they expect the increase in value from those changes to be extremely high.[13]

Straightforward logic suggests that the number of corporate changes that investors would collectively prefer, but that are not initiated, likely dwarfs the number of changes that are actually initiated. This is because only a very small proportion of collectively-preferred changes are likely to result in the value increases that financially incentivize initiation. The quantity of potential value-increasing changes that could be initiated likely declines as the value resulting from such changes increases.[14] The number of changes that would result in the very-high-value increases necessary to incentivize initiation by activist hedge funds is likely to be orders of magnitude smaller than the number of potential changes that investors would expect to result in lesser increases in the value of the company, but that would nonetheless still be collectively-preferred.[15]

Regulatory intervention and practices developed by investors have created low-cost alternatives for investor initiation, the most effective of which are shareholder proposals.[16] Thus, it is possible that investors could have incentives to initiate changes with shareholder proposals that investors would collectively prefer, but which would result in much smaller increases in the value of a corporation than from a proxy contest.[17] But regulatory constraints on the use of shareholder proposals prevent them from being used for changes to the company's business operations or its management. These are the very changes that have the greatest potential for increases in value, and thus create the greatest potential incentives for investors to initiate.[18] As a result, a "gap" is created between the changes initiable with low-cost shareholder proposals and the changes that investors have incentives to initiate using high-cost proxy contests—a "missing middle" of uninitiated corporate changes.[19]

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11. *See infra* notes 89–93 and accompanying text.

12. *See* Chris Isidore & David Goldman, *Procter & Gamble Declares Victory in Expensive Proxy Fight*, CNNMONEY (Oct. 10, 2017), https://money.cnn.com/2017/10/10/news/companies/procter-gamble-proxy-fight/index.html [https://perma.cc/4TP7-XG9M].

13. For a discussion of why other investors have weaker incentives, see *infra* notes 94–112 and accompanying text.

14. *See infra* notes 133–34 and accompanying text.

15. For a discussion of the possibility that investors might prefer value-reducing changes in the company, see *infra* Part I.

16. *See infra* Section I.C.

17. It is also possible that investors might collectively prefer changes that they expect to reduce the value of the corporation. *See infra* Part I and Section IV.A.4 (considering different aspects of this possibility).

18. *See* 17 C.F.R. § 240.14a-8 (i) (2021) (listing the matters with respect to which shareholder proposals can be submitted); *see also infra* notes 120–26 and accompanying text.

19. *See infra* Section I.C.

Because low-cost methods of investor initiation do not entirely eliminate the costs of initiation, the collective action problem remains. The largest investors rarely, if ever, use low-cost methods of initiation, even though they would benefit the most from corporate changes.[20] This is because they would bear private costs from initiation, sufficient to outweigh the modest benefits they would receive.[21] Instead, the great majority of shareholder proposals are initiated by investors with tiny stakes.[22] Even if these changes result in value increases, those increases cannot motivate small investors to expend resources initiating the changes, as their share of any collective benefits would be negligible. Rather, these investors are more likely to initiate corporate changes because they derive non-pecuniary private benefits, such as a sense of purpose or integrity from improving the company. These non-pecuniary benefits may outweigh the costs of initiation. If this is the case, it has two important implications. First, these investors will only initiate changes that reflect their own non-pecuniary preferences, presumably some subset of environmental, social, or governance matters.[23] They will have no incentive to initiate other changes that investors might collectively prefer. Second, satisfying initiating investors' non-pecuniary preferences will not cover the costs of investors' time or out-of-pocket costs.[24] They will therefore be limited in how many corporate changes they can initiate with shareholder proposals. Any collectively-preferred changes in excess of this limit will also go uninitiated.

The second contribution of this Article is to put forward a concrete and tractable proposal—initiation payments.[25] Initiation payments would eliminate under-initiation by investors—if it exists, and if it results from investors' costs of initiation exceeding their

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20. For a discussion of the failure of index fund managers to initiate shareholder proposals, see Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2101–05 (2019).

21. *See id.* at 2015 (discussing the negative consequences for investment managers of initiating shareholder proposals).

22. For a thorough discussion of the extent of low-cost initiations, see Kobi Kastiel & Yaron Nili, *The Giant Shadow of Corporate Gadflies*, 94 S. CAL. L. REV. 569 (2021).

23. *See infra* Section I.D.

24. *See infra* Section I.D.

25. While the design and scope of initiation payment are novel, they have roots in a long-dormant literature regarding proxy contest reimbursement that the Article seeks to reinvigorate and expand. Several articles in the 1950s argued for reimbursement of the expenses of investors undertaking proxy contests. *See, e.g.*, Daniel M. Friedman, *Expenses of Corporate Proxy Contests*, 51 COLUM. L. REV. 951 (1951); Franklin C. Latcham & Frank D. Emerson, *Proxy Contest Expenses and Shareholder Democracy*, 4 W. RSRV. L. REV. 5 (1952); Sidney W. Mintz, *Use of Corporate Funds to Pay for Proxies and Other Expenses in Fight over Corporate Management*, 8 INTRAMURAL L. REV. N.Y.U. 90 (1953). In the subsequent two decades, a small number of articles continued this theme. *See, e.g.*, Leonard S. Machtinger, *Proxy Fight Expenditures of Insurgent Shareholders*, 19 CASE W. RSRV. L. REV. 212 (1968); Melvin Aron Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489 (1970); Stephen H. Schulman, *The Costs of Free Speech in Proxy Contests for Corporate Control*, 20 WAYNE L. REV. 1 (1973). Most "recently," in a 1990 article, Lucian Bebchuk and Marcel Kahan analyzed the incentives that follow from proxy contest reimbursement rules in control contests. *See* Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CALIF. L. REV. 1071 (1990). Those types of contests have now been supplanted by shareholder activism. This Article also shares a common conceptual underpinning with a 2003 proposal by Stephen Choi and Jill Fisch, which advocated that issuers be required to provide vouchers to securities intermediaries to encourage them to undertake a variety of actions similar to those now referred to as stewardship. *See* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269 (2003).

benefits. If that is the case, the solution follows clearly. Initiation payments would incentivize investors to initiate collectively-preferred changes through shareholder proposals or proxy contests because, if they did so, they would receive an initiation payment sufficient for their total benefits to exceed their costs.[26]

The corporation provides a ready mechanism for sharing initiation payments pro-rata among investors. If investors collectively support the change (along with a payment to the initiator for initiating the change), then they would be better off if the payment caused investors to initiate such changes.[27] But this leaves two important design questions: which changes are collectively preferred and should therefore be rewarded with payments? And what amounts should initiators of those changes receive?

Corporate law already empowers investors to transact and approve certain corporate business by voting at shareholder meetings.[28] The Article proposes that eligibility for payments should be determined in the same way—initiators of changes that are approved, in whole or in part, by a vote of investors would be eligible for an initiation payment. An early stage of most investor initiation involves engagement with the directors or executives of the company to request that they make the proposed change.[29] Any settlement between the company and an initiating investor resulting from such engagement would also require an initiation payment, as though investors had approved the change.

Determining the appropriate amount of initiation payments is more challenging. It requires a tradeoff between payments that would offer optimal incentives for initiation and those that could be practically implemented with limited disputes or other transaction costs.[30] To offer an incentive for initiation, an initiation payment must offer some reward to investors in excess of their initiation costs. Because of the significant differences in cost structures between shareholder proposals and proxy contests, each requires different payment amounts and mechanisms.

Because shareholder proposals have relatively low costs, and little variability in those costs, a fixed payment offers a pragmatic solution that would eliminate the need to establish and verify on a case-by-case basis.[31] The Article proposes a fixed payment of $10,000 for initiating a successful shareholder proposal.[32] This is likely to be a relatively small expense to any public corporation, but it is likely to exceed the reasonable costs that most investors

26. *See infra* Section II.B.1.

27. *See infra* notes 153–55 and accompanying text. I discuss the possibility that such changes might not actually be welfare-enhancing for all investors in Section IV.A.4, including the possibility that there may be some changes where the welfare loss to investors that do not support the change is greater than the welfare gain to those that do.

28. *See* DEL. CODE ANN. tit. 8, § 216 (2021) (providing for votes of shareholders to transact business at shareholder meetings).

29. *See, e.g.*, Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 613 (2013) (describing proxy contest initiators communicating demands to company managers).

30. *See infra* Section II.B (discussing tradeoffs in initiation payment design).

31. *See infra* Section II.B.2.

32. This amount also determines which investors will initiate changes—that is, those with cost structures (including their cost of capital) that allow them to initiate changes they expect to be successful for less than $10,000.

would face in submitting a shareholder proposal and therefore would be sufficient to incentivize their initiation by a wide range of investors.[33]

Successful proxy contests are much more expensive, requiring substantial out-of-pocket costs paid to third-party advisors, and require considerable time, risk, and opportunity costs to initiate and conduct the proxy contest.[34] Their costs also exhibit much more variation, driven partly by whether the contest is settled or goes the distance to a vote.[35] Therefore, the Article proposes payments for proxy contests that include both reimbursement of third-party expenses and an additional fixed payment to cover initiating investors' time, effort, overhead, risk, and opportunity costs.[36] Because these costs are likely to increase as the contest progresses, the fixed payment would also progress in a series of stages, ranging from $200,000 if the contest is settled before the investor nominates directors to $750,000 if the contest goes to a vote and the initiator is successful.[37]

While these proposed amounts are based on estimates of investor costs, in some cases they will be insufficient. For that reason, they would only be *default* payments—investors could agree to greater (or lesser) amounts in a settlement agreement or by bundling a shareholder proposal requesting a higher payment. The proposals put forward to incentivize shareholder proposals and proxy contests are intended to be readily implementable, either together or separately. The Article therefore discusses the details of each of these mechanisms, as well as how disputes should be handled, and potential edge cases.

The incentive effects of initiation payments also offer an opportunity to overcome shortcomings in Rule 14a-8.[38] The Article proposes bylaws that would require companies to include shareholder proposals in their proxy statements even if they relate to the ordinary business of the corporation or electoral matters.[39] Because initiation payments might incentivize the initiation of shareholder proposals that investors do not collectively prefer, the Article proposes initiation penalties that would be payable by investors that put forward shareholder proposals that did not receive a threshold level of investor support.[40] While requiring initiation penalties would likely run afoul of Rule 14a-8, investors could agree to be subject to initiation penalties in return for the possibility of receiving an initiation payment.[41] The Article then considers who is likely to initiate corporate changes, which changes they are likely to initiate, and the effects of initiation payments on settlements, preemptive changes by managers, and the market for investor initiation.[42]

A significant advantage of initiation payments as a solution to under-initiation is that they could be implemented by private ordering, avoiding the substantial legal and political

33. *See infra* note 166 and accompanying text.

34. *See* RANDALL S. THOMAS, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL 2–22 (Randall S. Thomas & Catherine T. Dixon, eds., Aspen Law & Business 3d ed. 1998) (describing the substantial resources and personnel required for dissidents to solicit proxies).

35. *See* Gantchev, *supra* note 29, at 623 tbl.7 (estimating costs to initiators for progressive stages of proxy contests).

36. *See infra* Section II.B.3.

37. *See id.*

38. 17 C.F.R. § 240.14a-8 (2023).

39. *See infra* Section II.C.1.

40. *See infra* Section II.C.2.

41. For a discussion of the main issues with Rule 14a-8, see note 191 and accompanying text.

42. *See infra* Section II.D.

hurdles that would be required for implementation by federal or state rules.[43] The Article puts forward two complementary ways that initiation payments could be practically and plausibly implemented—through either bundled initiation payment proposals or initiation payment bylaws.[44] Because initiation payment bylaws are themselves corporate changes, they could also be incentivized with initiation payments, making them effectively self-implementing.[45] Just as initiation payments would be self-implementing, they would also be self-adjusting—all that would be necessary to adjust initiation payment amounts or mechanisms is for a majority of investors to change their views about what the initiation payments should be. The dynamic and adjustable nature of initiation payments would thus provide a straightforward mechanism to reduce or eliminate potential costs that arise from initiation payments.[46]

The third contribution of this Article is to show how initiation payments can reveal important information about the under-initiation hypothesis and about institutional investors' incentives. If there is under-initiation, the single, critical requirement for initiation payments to succeed in overcoming it is institutional investor support. Whether institutional investors support initiation payments will depend on whether they consider that there is under-initiation of collectively-preferred corporate changes and whether they believe it is in their interests to rectify such under-initiation. By observing whether or not they support initiation payments, we can thus draw inferences regarding both questions.

The calculus of institutional investors deciding whether to support initiation payments is likely to incorporate both their conclusions regarding the effects of greater initiation on investor welfare generally, and their own private costs and benefits from initiation payments. The effect of initiation payments will be to incentivize the initiation of corporate changes that investors collectively prefer. At first glance, the effects on investor welfare of corporate changes that investors collectively prefer may seem self-evident. However, it is possible that investors' collective preferences might not accurately reflect their own welfare, and therefore that they may incorrectly reject welfare-improving changes, or approve welfare-reducing changes. Initiation payments won't reward corporate changes that are rejected, and so will not affect their initiation. But to the extent that investors erroneously approve welfare-reducing changes, incentivizing the initiation of such changes with initiation payments may be costly for investors.

The relevant analysis for whether initiation payments are good for investors on a net basis is thus whether the benefits from initiating corporate changes that investors collectively prefer that are *welfare-enhancing* would exceed the costs from initiating changes that investors collectively prefer but that are *welfare-reducing* ("false-positive" changes). There are three types of possible false-positive changes: (a) changes that reduce the welfare of investors opposed to the change more than they increase the welfare of investors supporting the change; (b) changes that reduce the welfare even of those investors supporting the change; and (c) changes that would have a small welfare benefit, but less than the costs of initiation and approval. The Article considers each of these possibilities and several reasons why the costs of false-positive changes could reasonably be expected

43. For a discussion of these hurdles, see *infra* Section III.A.

44. *See infra* Section III.B.1 (proposing bundled proposals) and Section III.B.2 (proposing initiation payment bylaws).

45. *See infra* Section III.C.

46. *See infra* Section III.D.

to be limited. But ultimately it will be up to institutional investors to form their own views on these questions.

One potential private benefit of initiation payments for institutional investors is that they may reduce pressure on institutional investors to initiate changes themselves. Currently, investment managers face pressure to be good stewards of their investments, which may include initiating collectively-preferred changes.[47] But they, more than others, bear significant private costs from initiating corporate changes.[48] Initiation payments would eliminate this dilemma. Corporate changes would be initiated by other investors, so investment managers would no longer face pressure to initiate those changes themselves. Instead, their role would be reduced to evaluating and voting on corporate changes initiated by others.

However, there is a countervailing cost, which might lead institutional investors to oppose initiation payments. With initiation payments, other investors would initiate changes that they expect institutional investors to support, and if institutional investors did indeed support those changes, they would be successful. This would strengthen institutional investors' role as the "deciders" of corporate changes.[49] However, it is not clear whether investment managers want this responsibility, or the direct and indirect costs it would entail. The direct costs to institutional investors of casting additional votes are likely to be relatively small, given that they already cast thousands of votes, and have well-developed guidelines and processes for doing so. However, acting as deciders is likely to create a new dilemma for institutional investors, between fulfilling their stewardship duties, and potentially offending some investors and regulators. It is thus possible that institutional investors may prefer that fewer corporate changes be initiated, thereby reducing the impact of this dilemma. This is potentially troubling, as it would mean that institutional investors would effectively limit the number of corporate changes that their own investors would prefer, which could go against their oft-repeated goal of being good stewards for their investors, and potentially also against their fiduciary duties.

Observing whether institutional investors support or oppose initiation payments will effectively function as a test of which of these incentives dominate their calculus. If an investment manager supports initiation payments, it would suggest that they believe that there is under-initiation of corporate change, that overcoming such under-initiation would benefit their investors, and that those benefits outweigh any private costs they themselves might incur as a result. If they oppose initiation payments, it could be for any of the reasons discussed above—they might believe that there is no under-initiation of collectively-preferred changes, that initiating collectively preferred changes might have greater costs than benefits for their investors, or they might believe that the private costs they would suffer from greater initiation would outweigh the benefits for their own investors. As a result, it will be difficult to draw a clear inference from institutional investor opposition to initiation payments. However, if institutional investors support changes that are currently

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47. *See infra* notes 274–89 and accompanying text.

48. *See, e.g.*, Bebchuk & Hirst, *supra* note 20, at 2059–71 (discussing investment managers' incentives to be excessively deferential); Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 101–04 (2017) (discussing private costs from opposing managers).

49. *See generally* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1814–15 (2020) (referring to institutional investors as "presumptive deciders").

initiated, and if they undertake stewardship actions seeking changes at corporations, those would seem to be inconsistent with the first two reasons for opposition, suggesting that the institution may oppose initiation because they are reluctant to take on additional responsibility as a decider.

Initiation payments may or may not resolve the problem of under-initiation. But by observing whether or not they do so, we stand to learn important information about under-initiation, and about institutional investors, which may help to resolve these important debates in corporate governance.

This Article is organized as follows. Part I puts forward a theory of investor initiation, including why investors may not have incentives to initiate collectively-preferred corporate changes, leading to under-initiation. Part II proposes initiation payments as a concrete and tractable solution to under-initiation, if indeed it exists. Part III explains how initiation payments can be implemented through private ordering, contingent only on the support of institutional investors. Part IV considers why institutional investors may or may not support initiation payments, and thus, how the implementation of initiation payments is effectively a test of whether institutional investors believe there is under-initiation and wish to rectify it.

I. THE UNDER-INITIATION HYPOTHESIS

This Part puts forward the hypothesis that there is under-initiation of corporate changes that investors would collectively prefer, and develops a theory why that is likely to be the case. A theory of under-initiation is important because a direct, empirical answer to the question of whether there is under-initiation is hard to come by. Ideally, we would observe the set of changes that investors would collectively prefer and compare them to the set that is actually initiated. But whether investors would collectively prefer a particular change can only be definitively determined if the change is voted on by investors, which presupposes initiation. We thus cannot know, definitively, how many uninitiated corporate changes investors would collectively prefer.[50]

Instead, this Part develops the under-initiation hypothesis from two well-understood theoretical claims. First, the agency costs of directors and executives. As Section A explains, directors and executives are charged with the management of the corporation, but they also have private incentives not to initiate all changes—and *only* such changes—that investors would collectively prefer. Management agency costs thus create the possibility for investor initiation of collectively-preferred corporate changes. Second, investor collective action problems. Investors bear much of the cost of initiation but receive only a fraction of the benefits. They thus lack incentives to initiate most corporate changes. Combined, these two theories lead to the hypothesis that there is a set of corporate changes that investors would collectively prefer but that are not initiated by managers, or by investors.[51] Sections B to E then explain how the under-initiation hypothesis applies to different types of investor initiation.

50. For an earlier discussion of the problems in determining the optimal number of initiations, see Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 737–42 (2007).

51. The alternative to the under-initiation hypothesis is that there is no under-initiation of corporate changes that investors would collectively prefer—either because managers initiate all such changes, or because certain investors have sufficient incentives to initiate any collectively-preferred changes that managers do not.

Before developing the under-initiation hypothesis, it is important to address the question—initiation of *what*? The focus of this Article is on the initiation of corporate changes that investors holding a majority of equity in the company collectively prefer (which I refer to as "collectively-preferred" changes).[52] A different approach (taken in earlier versions of this Article) could focus on corporate changes that increase the value of the company. Indeed, focusing on company-value-increasing changes is more consistent with our understanding of the fiduciary duties of directors, who are charged with managing the company, rather than satisfying investor preferences. I instead focus on collectively-preferred changes for three reasons.

First, considering changes that are collectively-preferred by investors will generally include those changes that increase the value of the company, but it also allows for the possibility raised by some scholars that corporations should maximize the welfare of their investors, or that they should maximize investors' portfolio values.[53] To be clear, this Article does not take a position on these claims, or even on how often they will conflict.[54] The set of changes that investors will collectively prefer is likely to be very similar to the set of changes that would increase the value of the company.[55] However, it is not necessary for this Article to assume that investors prefer all and only value-increasing changes. Some scholars have argued that some investors may prefer that corporations they invest in take actions that increase the investor's *welfare*, rather than the value of the company.[56] For most investors, their welfare from the corporation will generally be identical to the financial value the investor derives from the corporation. But investor welfare might also be maximized by social or environmental actions that sacrifice financial value. In addition, there may be some investors whose portfolio value would be maximized by the corporation taking actions other than those that would maximize the value of the corporation itself.[57] I

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52. Though it sidesteps the challenging issues described in this Section, the "investor-welfare" focus of this Article is not essential to the initiation payments proposal put forward in Part II. Instead, the proposal could be modified, *mutatis mutandis*, to apply to corporate-value-increasing changes. This would, however, amplify the issue of whether investors can correctly determine which changes are value-increasing, which is likely to be a stronger concern than the comparable issue discussed later in Section IV.A.4.

53. For the most prominent argument for considering investor welfare, see generally Hart & Zingales, *supra* note 9. For a recent analysis of the shareholder-value approach with shareholder preferences and portfolio value, see generally Robert P. Bartlett & Ryan Bubb, *Corporate Social Responsibility Through Shareholder Governance* (Eur. Corp. Governance Inst., Working Paper No. 682, 2023).

54. One possibility is that situations where investors prefer to reduce the value of the company are likely to be rare because investors will instead claim that potentially value-reducing changes actually increase the value of the company in the long term. For a discussion of this position, which they describe as "enlightened shareholder value," see Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 108–14 (2020).

55. This assumes that it is optimal to increase the value of the corporation. Recent years have seen increasing attention to the interests of various stakeholders in corporations, but most of these have argued that acting in the interests of those stakeholders also maximizes value for the corporation. *See, e.g.*, *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy that Serves All Americans'*, BUS. ROUNDTABLE (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans [https://perma.cc/TN3R-EMP6].

56. For a prominent example of such an argument, see generally Hart & Zingales, *supra* note 9.

57. For arguments consistent with the portfolio value maximization view, see, e.g., José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FINANCE 1513 (2018); Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2020); Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. CORP. L. 627 (2022).

do not take a position here on whether this is actually the case for any investors, and it is not necessary to for the Article to do so.

Second, focusing on investor preferences rather than value maximization allows for a concrete proposal because it sidesteps the problematic question of how investors (or even managers) could consistently know, ex ante, which changes would increase the value of the company. This can only be definitively determined well after the action is taken. This is not just an epistemological issue; any proposal to encourage value-increasing changes would face the practical challenge of identifying which changes are indeed value-increasing.

Finally, focusing on the collective preferences of investors leads to a clear decision rule where investors and managers conflict, one that is consistent with the rules and practice of corporate law. The views of investors and managers will often be consistent because investors will often favor deference to directors and executives regarding the management of the company. But if there are differences, who should prevail? If the dispute is regarding knowledge of what changes will increase value for the company, the answer is not clear. But although corporate law charges directors with managing the corporation, it also gives investors the ultimate power to influence the company in the direction they prefer through corporate democracy. This power underpins the legitimacy of directors' ability to manage the affairs of the corporation.[58] It is also practically important. These are practical changes capable of being voted on by investors. Investors are likely to take into account the views of directors and executives in forming their preferences. But if the change goes to a vote, investor preferences will ultimately determine whether they support the change.

A. Initiation of Corporate Change

Directors are charged with the management of the corporation, which they discharge by hiring executives who implement corporate actions, including corporate changes.[59] If directors and executives (collectively, "managers") do not manage the company in the way that investors collectively prefer, then investors may themselves initiate corporate changes, including changes in the directors or executives. This raises the question: will directors and executives manage the company in the way that investors prefer? That is, will managers initiate all corporate changes—and *only* such changes—collectively preferred by investors? If they do, there will be no need for investors to initiate *any* changes, and therefore, no possibility of under-initiation.

There are two theoretical and practical reasons to believe that executives are unlikely to initiate all and only collectively-preferred corporate changes. First, it may be difficult for directors or executives to identify all collectively-preferred changes.[60] In particular, whether a change would be welfare-increasing for investors may not be knowable at the time it is made. The difficulty of identifying which changes are and are not welfare-

58. *See, e.g.*, Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

59. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2020) ("The business and affairs of [companies] . . . shall be managed by or under the direction of a board of directors . . . .").

60. This includes the possibility that directors and executives might choose to maximize the value of the corporation even when doing so is in conflict with the preferences of investors. It is also possible that managers might intentionally choose to take actions that favor other stakeholders at the expense of investors, in a way that investors disapprove of.

increasing means that perfect management initiation—initiating all and only welfare-increasing changes—is extremely implausible. Through their role in overseeing the operations of the corporation, managers receive feedback about the effects of their actions and inaction.[61] It is possible that they could use this information to correct any welfare-reducing actions. If they perfectly correct any investor-welfare-reducing actions, then there will be no opportunity for investor initiation of collectively preferred changes.[62]

Second, for some changes, there will be agency costs—manager self-interest will conflict with investor preferences.[63] Most obviously, a change to remove and replace an underperforming chief executive officer (CEO) would not be in the self-interest of the CEO.[64] A significant change to move to an investor-preferred strategy might also signal a prior error in judgment on the part of the CEO that previously championed the strategy. CEO preferences to manage larger companies mean that it may be against their interests to spin off underperforming parts of the company and in their interest to over-pay for acquisitions, even though those would reduce the welfare of their investors.[65] And because of these agency problems, changes that reduce the autonomy of executives and directors may be in the interests of investors, even though such reductions would be against the self-interest of executives and directors themselves.[66]

If managers do not initiate a value-increasing change, due either to error or to agency costs, it is possible that investors could initiate that change. If managers initiate a non-preferred change, it is possible that investors could reverse that change. Because the management of the corporation is the province of directors and executives, most methods of investor initiation can be understood as a request for managers to make a certain change, backed by a threat to take action if they do not.[67] The threat is necessary because directors are likely to oppose the investor-preferred corporate changes, for the same reasons directors did not initiate these changes themselves—either because they err in assessing whether the

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61. For a critical discussion of management feedback from accounting systems, see generally Hanna Pitkänen & Kari Lukka, *Three Dimensions of Formal and Informal Feedback in Management Accounting*, 22 MGMT. ACCT. RSCH. 125 (2011).

62. I assume here that investors prefer corporate changes that they expect to maximize their welfare. Of course, it is possible that investors may have mistaken beliefs about what would be welfare-enhancing for them; I consider this possibility in Section IV.A.

63. For the foundational account of these management "agency costs," see generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). For discussions of management agency costs in corporate law, see, e.g., Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 898 (2005); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 679 (2007).

64. For a discussion of involuntary executive turnover, see generally Wei Shen & Theresa S. Cho, *Exploring Involuntary Executive Turnover Through a Managerial Discretion Framework*, 30 ACAD. MGMT. REV. 843, 843–52 (2005).

65. This has been referred to as "empire building" by executives. *See, e.g.*, Ole-Kristian Hope & Wayne B. Thomas, *Managerial Empire Building and Firm Disclosure*, 46 J. ACCT. RSCH. 591, 595–96 (2008) (reviewing literature regarding managerial empire building).

66. *See, e.g.*, Arnoud W. A. Boot & Anjan V. Thakor, *Managerial Autonomy, Allocation of Control Rights, and Optimal Capital Structure*, 24 REV. FIN. STUD. 3434, 3435 (2011) (explaining that managers endogenously value autonomy).

67. For an early description of this analysis, see John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003, 1028–32 (1993).

change would improve investor welfare, or because they have private incentives not to make the change.

Methods of investor initiation vary in the nature of that threat and how much pressure it creates.[68] The strongest pressure comes from replacing directors (or threatening to do so) with the investors' own nominees through soliciting investor proxies—a proxy contest.[69] However, this involves substantial costs to the investors.[70] Several alternative methods of initiation are weaker, but involve lower costs for investors, by reducing regulatory and practical burdens on investors.[71] Investors can also put forward shareholder proposals requesting that managers undertake the change, which—provided certain procedural requirements are met—must be included in the proxy statement of the corporation.[72] A still-weaker threat is a "withhold campaign," whereby investors do not initiate a specific vote but lobby other investors to "withhold" their votes from the re-election of the incumbent directors in uncontested elections.[73]

The fact that investors successfully initiate many corporate changes using these mechanisms demonstrates that managers do not initiate all, and only, collectively-preferred changes.[74] For instance, between 2015 and 2020, sixty-five proxy contests at U.S. companies resulted in investors electing at least one dissident nominee.[75] And between 2017 and 2020, 148 shareholder proposals were successful.[76] This demonstrates that investors believe that at least some investor-initiated changes are in their interests. But it doesn't tell us how many changes investors would collectively-prefer, or what proportion of these changes are *actually* initiated.

B. *The High Threshold for Proxy Contests*

The remaining sections of this Part show why investors do not have incentives to initiate all remaining collectively-preferred corporate changes. The two main mechanisms for initiating corporate changes are proxy contests and shareholder proposals. Different legal rules apply to each of these methods of initiation, resulting in different restrictions, and also different cost structures for initiators. I therefore consider each of these separately. This Section begins the analysis with proxy contests, which have the fewest restrictions, but the highest cost; Sections C and D add to this analysis a consideration of shareholder proposals, which have lower costs, but greater restrictions.

This Section articulates the hypothesis that investors will have incentives to initiate very few collectively-preferred corporate changes using proxy contests, which constitute

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68. This conceptualization is closely related to what John Pound described as the "political model of corporate governance." *See* Pound, *supra* note 67, at 1012–32.

69. For a discussion of proxy contests, see generally THOMAS, *supra* note 34, 2-22–25 (describing the substantial resources and personnel required for dissidents to solicit proxies).

70. *See infra* notes 77–83 and accompanying text (describing costs to shareholders of proxy contests).

71. *See infra* notes 117–18 and accompanying text (discussing shareholder proposals).

72. *See* 17 C.F.R. § 240.14a-8(b) (2021) (regulating shareholder proposals).

73. *See, e.g.*, Grundfest, *supra* note 6, at 902–14 (describing withhold campaigns).

74. That managers do not initiate *only* value-increasing changes follows from the fact that some value-increasing changes initiated by investors adjust or reverse changes initiated by managers.

75. ACTIVIST INSIGHT, *supra* note 4, at 13.

76. GEORGESON, 2020 ANNUAL CORPORATE GOVERNANCE REVIEW 16 (2020) (presenting data for successful shareholder proposals at S&P 1500 companies), https://www.irmagazine.com/research-reports/georgesons-2020-annual-corporate-governance-review [https://perma.cc/XK5K-T4Z8].

only a very small proportion of value-increasing changes. The reasoning is based on the long-understood collective action problem of the private provision of a collective good. This has been applied to costly actions by investors in other works; this Section summarizes the main theoretical argument before articulating the important implication for understanding the problem of under-initiation: investors will only initiate collectively-preferred changes using proxy contests when they expect those contests to result in private benefits to the initiating investor that are above an extremely high threshold, and there will be a correspondingly small number of potential changes above this threshold.

Nominating director candidates and conducting a proxy contest against incumbent directors imposes significant costs on the initiating investor.[77] The costs imposed include the expense of complying with the proxy rules promulgated by the Securities and Exchange Commission (SEC), which require the preparation of a lengthy proxy statement and filing all soliciting materials.[78] There are also substantial costs from the practical aspects of soliciting investors.[79] These are amplified by the fact that solicitations by investors are invariably opposed by managers, who have the corporate fisc at their disposal.[80] This effectively increases the amount the initiator must spend to overcome that opposition and convince other investors to support the change.

The levels of these costs will vary considerably, depending on whether the contest is resolved at an early stage or whether it goes to a vote. The estimated cost of a proxy contest that is settled after the initiating investor's initial demands is $2.94 million, and the estimated average cost of an initiation that ends in a proxy contest is $10.71 million.[81] But these are only averages; considerably higher costs are likely in many contests.[82] Those estimates were based on data from 2000 through 2007; the costs have likely increased substantially since that time. For example, since 2007, at least five contests have involved costs above this level, with the largest estimated to cost the initiating investor $25 million.[83]

A rational investor will only take on these (marginal) costs and initiate a corporate change if they expect to receive greater (marginal) benefits from doing so. Although there are other potential private benefits, I focus on the most obvious private benefit to an investor from initiating a corporate change: their financial benefit from an increase in the value of the company that results from the change.[84] That financial benefit is the investor's pro rata share of that increase. The investor will thus only initiate changes that are likely to

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77. *See supra* Section I.B.

78. *See* 17 C.F.R. § 240.14a-6 (2021) (requiring the filing of proxy statements and all soliciting materials).

79. *See* THOMAS, *supra* note 34, at 2-22–25 (describing the substantial resources and personnel required for dissidents to solicit proxies).

80. *See id.* at 21-9–24 (discussing management's expenses in proxy contests).

81. *See* Gantchev, *supra* note 29, at 623 tbl.7 (describing stage-specific costs of proxy contests).

82. *See id.* (estimating the upper bound of the 95% confidence interval as $22.14 million).

83. *See* ACTIVIST INSIGHT, PROXY FIGHTS 11 (2020), https://www.activistinsight.com/research/ACTIVISTINSIGHT_ProxyFights.pdf [https://perma.cc/YD98-TN3F] (listing recent proxy contest costs); Isidore & Goldman, *supra* note 12 (describing Trian Fund Management as having spent at least $25 million on "the most expensive proxy fight in U.S. history" at Procter & Gamble).

84. In Section I.D, I consider the likelihood that non-pecuniary benefits might incentivize investors to initiate shareholder proposals. This is also possible for proxy contests. However, it is much less likely because the pecuniary benefits would need to be exceedingly large to outweigh the costs of the proxy contest. One rare example could be Carl Icahn's failed proxy contest at McDonald's Corporation regarding its treatment of pigs. *See* Lauren Hirsch, *Icahn Loses Welfare Fight with McDonald's Over Pigs*, N.Y. TIMES, May 27, 2022, B.4.

result in value increases when their fraction of that increase is large enough to outweigh their private costs of initiation.

How large the aggregate value increase must be to reward investor initiation and thus depends on the investor's fractional share. And most investors' shares are tiny. The fractional share of any value increase received by a "principal investor" that manages their own investment is simply the proportion of the cash flow rights of the company that the investor holds, usually the proportion of the company's common stock.[85] But most investors that have a substantial stake in the company are or have been engaged in the management of the company and are likely to have close ties to the company's directors and executives. Most retail investors hold only a tiny proportion of a company's equity and will thus receive only a tiny proportion of the benefits of any change. An investor holding even a relatively large position of $50,000 in a $5 billion company holds only one-100,000th of the company's equity. To justify the investor initiating the change, the value increase to the company would have to be at least 100,000 times the costs to the investor (which I refer to as their "benefit-to-cost multiple").

The largest holders of corporate equity are investment intermediaries—including activist hedge funds and investment managers.[86] They are compensated as a percentage of the assets under management in their funds (their "fee percentage").[87] As a result, the proportion of any increase in the company's value that investment intermediaries receive is the interest in the company that their investors hold, *multiplied by* the intermediary's fee percentage. Different types of intermediaries differ in the magnitude of their holdings and fee structure, and so their overall interest in any collective benefits (or costs) will differ accordingly.[88]

The intermediaries with the greatest interest in the increase in value of their portfolio companies are activist hedge funds.[89] Their concentrated portfolios permit them to take large positions in corporations, often between 5% and 10% of a company's shares.[90] They also charge high fee percentages, generally referred to as "2-and-20"—a management fee of 2% of assets under management and a performance fee of 20% of any profits earned.[91] A typical hedge fund with such an arrangement and holdings between 5% and 10% therefore has a fractional interest in the corporation of between 1% and 2%, and thus a benefit-to-cost ratio between 50x and 100x.

This means that even the intermediaries with the greatest incentive to initiate corporate changes will only do so when the value created by those changes is extremely high. If a proxy contest involves expected costs of $15 million—well within the range described above—an initiation will only be cash-flow positive for a typical hedge fund

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85. *See* Bebchuk & Hirst, *supra* note 20, at 2051–52 (describing the "sole-owner" benchmark for value maximization).

86. Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 725–28 (2019).

87. *See* Bebchuk & Hirst, *supra* note 20, at 2052–56 (describing investment managers' fraction of value increases).

88. For evidence of different mutual fund fee structures, see generally Bryan Armour, Zachary Evens & Ben Johnson, *2021 U.S. Fund Fee Study*, MORNINGSTAR 1 (July 2022), https://www.morningstar.com/lp/annual-us-fund-fee-study [https://perma.cc/PT5B-2DU2].

89. *See* Bebchuk, Cohen & Hirst, *supra* note 48, at 104 (describing hedge funds' "[h]igh-powered incentives to increase value") (emphasis removed).

90. *See id.* at 105 (describing hedge funds' concentrated positions).

91. *See id.* at 104 (describing typical fee arrangements for activist hedge funds).

manager if it results in a change that increases the value of the company by more than $1.5 billion. The activist hedge fund manager would not have incentives to initiate any changes that they expected to result in value increases that were below this threshold.

There are reasons to believe the actual threshold for hedge funds to initiate corporate changes is likely to be higher still. For a hedge fund manager to initiate a change, it is not sufficient that the change will be cash-flow positive. The expected value increase for the company must also be greater than the required rate of return of the hedge fund's investors.[92] Since the returns from investing in an activist hedge fund are likely to be much riskier than simply investing in a broadly diversified portfolio, this is likely to raise the threshold value-increase for initiation substantially.[93]

And because activist hedge funds have the highest fractional interests in companies they invest in—and thus the strongest incentives to initiate corporate changes—every other investment intermediary will have *much lower* incentives to initiate corporate changes. Managers of the largest mutual fund complexes generally hold between 5% and 10% of each corporation.[94] But their fees are orders of magnitude lower than those of hedge funds, generally an average of less than 0.2% weighted across their various funds.[95] As a result, the range of their fractional interest in most corporations is between 0.01% and 0.02%, implying benefit-to-cost ratios of 5000x and 10,000x. While investment managers that predominantly use active management strategies have higher fees (often as much as 1%), they also manage substantially fewer assets.[96] Even if such a manager had as much as 1% of the company under management, its intermediary interest would still be 0.01%, and its benefit-to-cost ratio 10,000x.[97] And pension funds have even smaller interests because they tend to hold much smaller proportions of the shares of corporations.[98]

One countervailing reason that investment fund managers may be more willing to initiate corporate changes than the above calculus would suggest is if initiating corporate changes provides them with private benefits that are not shared with their investors. One type of private benefit is non-pecuniary—a positive feeling from furthering a sense of purpose or integrity by initiating changes.[99] However, such feelings are likely insufficient to incentivize investment managers to spend millions of dollars initiating proxy contests. A more significant source of private benefits is additional fee income that investment managers may derive from increasing the assets managed by their fund.[100]

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92. *See id.* at 106 (describing the need for hedge fund investors to earn sufficient risk-adjusted returns).

93. *See, e.g.*, *id.* at 106–07 (describing the limits of hedge fund activism).

94. For aggregate data on positions held by the "Big Three" investment managers in S&P500 companies, see Bebchuk & Hirst, *supra* note 86, at 733–35.

95. *See* Bebchuk & Hirst, *supra* note 20, at 2054–55 (comparing investment manager and hedge fund manager fee structures).

96. *See* Armour, Evens & Johnson, *supra* note 88 (comparing fees and assets under management of various investment managers).

97. For a description of the fee levels of various investment managers, see generally *id.* at 2–3.

98. Even the California Public Employees' Retirement System (CalPERS), the country's largest public pension fund, holds less than 1% of the shares of most corporations. *See* CAL. PUB. EMPS.' RET. SYS., 2018–2019 COMPREHENSIVE ANNUAL INVESTMENT REPORT (2019), https://www.calpers.ca.gov/docs/forms-publications/cafr-2019.pdf [https://perma.cc/SK9Z-DRXN] (reporting on CalPERS annual performance, the performance of its investments, and more financial metrics).

99. *See infra* Section I.D.

100. *See* Bebchuk & Hirst, *supra* note 20, at 2056–57 (discussing incentives from attempts to attract funds).

One way that investment managers could attract additional assets to their funds is if investors believe that the investment manager is likely to outperform rival investment managers.[101] If they do, they may attract funds from the many investors that base their expectations of future performance on past performance.[102]

However, investment managers that manage mutual funds will have very little ability to earn private benefits through performance.[103] The similarity of mutual funds means that it will be difficult to gain assets through initiation-related outperformance.[104] The mutual fund industry is characterized by many competing funds with very similar investment offerings, most obviously index funds, but also a significant number of actively managed funds that are "shadow indexers," which have a substantial proportion of their portfolio weightings very close to those in the index.[105] And even if a manager has a very different portfolio than its competitors, rules requiring disclosure of portfolio holdings mean the portfolio could be easily replicated.[106] If a competing fund has a similar composition, it will benefit from a corporate change in exactly the same way as the initiating investor's funds.[107] The possibility of gaining additional fund inflows is therefore not likely to be a significant incentive for investment managers to initiate high-cost corporate changes.

Potentially offsetting any private benefits for most investment managers are the private costs that they would bear.[108] The fact that investment managers are business organizations with other investments and other lines of business means they may accrue additional private costs from initiating corporate changes.[109] For investment managers with substantial business ties with corporations, those ties may create private costs to the investment intermediary.[110] Initiating corporate changes that directors and executives generally oppose may jeopardize these business relationships.[111] In addition, the other directors and executives of those corporations have substantial political power and could use it in ways that would negatively affect the businesses of investment managers.[112]

The result is that even activist hedge fund managers—the intermediaries with the largest interest and thus the smallest benefit-to-cost ratio—will only initiate corporate changes that are likely to result in very large increases in the value of the company. This is consistent with evidence that only a small number of companies each year are subject to

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101. To the extent that investors can easily exit an investment fund, the reverse is also likely to apply—if the fund under-performs its competitors, current investors may expect that situation to continue, and may exit the fund.

102. *See, e.g.*, Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FINANCE 1589, 1591 (1998) (describing mutual fund flows to high-performing funds).

103. *See* Bebchuk & Hirst, *supra* note 20, at 2057–59 (discussing the inability of investment managers to attract funds through stewardship investment).

104. *See id.* at 2057–58.

105. For the main work identifying "shadow indexers," see K. J. Martijn Cremers & Antti Petajisto, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, 22 REV. FIN. STUD. 3329 (2009).

106. *See* 17 C.F.R. § 240.13f-1 (2023) (requiring quarterly disclosure of investment adviser portfolios); 17 C.F.R. § 270.30b1-9 (2023) (requiring monthly disclosure of investment company portfolios).

107. *See* Bebchuk, Cohen & Hirst, *supra* note 48, at 97–100.

108. *See* Bebchuk & Hirst, *supra* note 20, at 2062–70 (describing incentives to be excessively deferential).

109. For a discussion of the private costs of investment managers, see Bebchuk, Cohen & Hirst, *supra* note 48 (regarding investment managers generally); Bebchuk & Hirst, *supra* note 20 (regarding index fund managers).

110. *See* Bebchuk & Hirst, *supra* note 20, at 2050–71.

111. *See id.* at 2062–65.

112. *See id.* at 2066–70.

attempts to initiate changes through proxy contests: Of more than 4000 U.S. public companies, only about 450 per year (or about 10%) are subject to demands by activist investors.[113] And of these demands, only a small percentage—about 12%—lead to a proxy contest. From 2014 to 2020, an average of 50 proxy contests were initiated each year (about 1% of all companies), and 21 per year actually went to a vote (about 0.5% of all companies).[114]

This has two implications. First, the very low number of initiations casts doubt on the claims made by some academics that the combination of activist hedge funds initiating changes and investment managers supporting those changes when they go to a vote leads to optimal levels of initiation.[115] As described here, even activist hedge funds are likely to refrain from initiating many collectively-preferred corporate changes, namely those that do not result in value-increases above their high thresholds for initiation.

Second, concerns that investors are likely to initiate changes that they do not expect to be value-increasing are unlikely to apply to proxy contests.[116] For the reasons explained in this Part, initiating changes using proxy contests is simply too costly to justify investors initiating even many changes that they expected to result in significant value-increases, much less changes that collectively prefer, but that would result in smaller increases in value.

C. The Missing Middle

Proxy contests, with their substantial costs to investors, are not the only way for investors to initiate corporate changes. Regulatory intervention, as well as practices developed by investors, have created low-cost alternatives for investor initiation. But, as this Section explains, these are far from perfect substitutes for proxy contests. Limitations on their use and effectiveness mean that they cannot be used for changes that are likely to result in substantial increases in the value of the company. The gap between the types of changes that can be implemented with these mechanisms, and the threshold for expected increases in company value at which investors have incentives to use proxy contests to initiate corporate changes, creates what I refer to as a "missing middle" of uninitiated corporate changes.

The most prominent and effective low-cost method of initiation—and the main focus of this Section—is shareholder proposals.[117] In specific circumstances, Rule 14a-8 requires companies to include shareholder proposals in their proxy statements, thereby eliminating the need for investors to solicit proxies themselves and their attendant costs.[118] If the

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113. ACTIVIST INSIGHT, *supra* note 83, at 3.

114. *Id.* at 10 (describing evidence that 350 proxy contests were initiated at U.S. companies from 2014 through November 2020, of which 147 went to a vote).

115. For the strongest version of such claims, see Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013).

116. For one articulation of these concerns, see Lipton & Savitt, *supra* note 50, at 743–47.

117. 17 C.F.R. § 240.14a-8 (2023).

118. *See generally id.*

proposals are supported by investors holding a majority—or even a substantial minority—of equity of the company, there is pressure on directors to follow the proposal.[119]

However, Rule 14a-8 cannot be used to initiate the changes that could result in the largest potential increases in corporate value.[120] Notably, it cannot be used for changes to the "company's ordinary business operations," which would include changes relating to the business or strategy of the company. Rule 14a-8 also cannot be used for matters relating to director elections, so it cannot be used to include a nominee in director elections, or to remove or disqualify incumbent directors.[121] These are the changes that are most often initiated using proxy contests and, by inference, those that are likely to result in the largest increases in the value of the company.[122]

In addition, even when shareholder proposals are used, the level of pressure they put on directors to implement the requested changes is far less than that of a successful proxy contest. The fact that directors have not already implemented a corporate change of their own volition suggests that pressure may be required to cause them to do so. Yet almost all shareholder proposals are precatory, meaning that directors are not required to implement them even where they are successful.[123] And for complex changes to the corporation, it may be necessary for a director nominated by the investor to oversee the change–to ensure the board implements it, and in a manner that is likely to be effective. But shareholder proposals submitted under Rule 14a-8 cannot be used to elect such a nominee.[124]

Other low-cost initiation methods are likely to create even less pressure on directors and executives to implement changes than shareholder proposals.[125] In particular, many investment managers refer favorably to their engagement with directors and the prominent role of engagement in their stewardship.[126] However, even where such "mere" engagement requests a change, it does not involve any threat to initiate a vote of shareholders if managers do not agree to the request, only that the initiator itself may not support directors or their proposals in future annual meetings. Even for the largest investment managers, the impact of such a loss of support would be less than any electoral threat that allows all investors to express their views.

The implication of these shortcomings of low-cost initiation is that they can only be used for changes such as environmental, social, and governance (ESG) changes, which are likely to lead to much smaller increases in the value of the company than those that would give investors financial incentives to initiate corporate changes. A substantial gap likely exists between the increase in value from these low-cost initiation methods and the value

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119. For a detailed examination of directors' responsiveness to successful shareholder proposals, see generally Yonca Ertimur, Fabrizio Ferri & Stephen R. Stubben, *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals*, 16 J. CORP. FIN. 53 (2010).

120. *See* 17 C.F.R. § 240.14a-8(i) (listing the matters with respect to which shareholder proposals can be submitted).

121. *See id.* § 240.14a-8(i)(7)–(8) (listing grounds allowing exclusion of shareholder proposals).

122. *See supra* Section I.B.

123. *See, e.g.*, Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 240–41 (2018) (discussing the effects of precatory proposals).

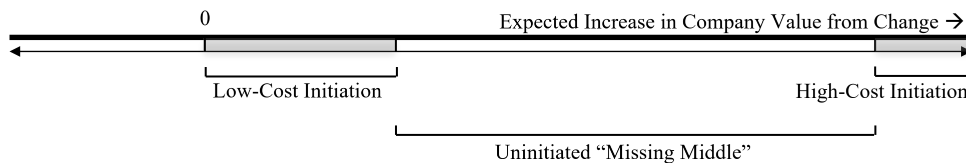
124. *See* 17 C.F.R. § 240.14a-8(i)(8).

125. One low-cost initiation method with a very limited threat is a withhold campaign. *See infra* note 73 and accompanying text.

126. *See, e.g.*, BLACKROCK, *supra* note 5, at 8 (describing BlackRock's engagement as a key tool for its investor stewardship activities).

threshold at which investors will generally have incentives to use high-cost-initiation methods such as proxy contests. Figure 1 illustrates these as regions on an axis representing the increase in company value that investors expect to result from implementing the change. Those changes that investors will generally have financial incentives to initiate using high-cost initiation methods (proxy contests) are to the right, above a very high threshold of expected value-increase. The changes that can be initiated using low-cost initiation methods (especially shareholder proposals) are between zero and a relatively low level of value-increase from the changes. Those in between are likely to remain uninitiated; these are the "missing middle."

Figure 1. Regions of Initiation



D. The Under-Initiation of Shareholder Proposals

Even for the set of changes that investors can initiate with shareholder proposals, and other low-cost methods, there is likely to be considerable under-initiation. Although Rule 14a-8 eliminates the need for proponents to solicit proxies, it does not eliminate all the costs associated with initiating corporate changes. The main cost of submitting shareholder proposals is the time of the individuals involved in researching, preparing, and submitting the proposal, engaging with the company, and responding to any no-action requests.[127] For proposals with novel elements or firm-specific aspects, or those involving considerable engagement or responses to no-action requests, the amount of time involved could be substantial.[128] The proponent must also travel to attend the company's annual meeting to present the proposal.[129] In addition to these direct costs, investment managers that initiate corporate changes, including through shareholder proposals, are also likely to face private costs.[130]

Since not all costs are eliminated by low-cost initiation methods, the collective action problem remains. Yet there *are* many shareholder proposals initiated each year, largely by

127. For a description of the no-action process, see 17 C.F.R. § 240.14a-8(j).

128. These costs could be lowered with experience in submitting proposals, and economies of scale from submitting many proposals. For two examples, see Lucian Bebchuk, Scott Hirst & June Rhee, *Towards the Declassification of S&P 500 Boards*, 3 HARV. BUS. L. REV. 157 (2013) (discussing the Shareholder Rights Project); *Boardroom Accountability Project*, OFF. OF THE N.Y.C. COMPTROLLER, https://comptroller.nyc.gov/services/financial-matters/boardroom-accountability-project/overview/ [https://perma.cc/AP6A-FAMW] (discussing the Boardroom Accountability Project).

129. *See* 17 C.F.R. § 240.14a-8(h) ("Either you, or your representative who is qualified under state law to present the proposal on your behalf, must attend the meeting to present the proposal.").

130. *See supra* notes 94–98 and accompanying text.

individuals, socially responsible organizations, and pension funds.[131] What incentive do these investors have to initiate corporate changes? It cannot be their share of net collective benefits; as previously discussed, these investors have, at most, tiny stakes and, therefore, a tiny interest in any net benefits to the company.[132] Given the enormous benefit-to-cost multiples, the relatively small value increases from these changes cannot justify even minuscule expenditures of time and effort.

Instead, these investors must receive some private benefit from initiating corporate changes. This is likely to be non-pecuniary—a sense of purpose or integrity from improving the company. If this benefit is greater than the cost of an investor's time and any out-of-pocket costs, it can create a rational incentive for them to initiate corporate change.

That investors initiate low-cost proposals because of non-pecuniary incentives has two important implications. First, those investors will lack incentives to use low-cost methods to initiate changes that investors collectively prefer but that do not result in non-pecuniary benefits. Initiating changes aimed at improving the strategy or operations of the company could be expected to result in less of a sense of purpose than initiating environmental, social, or governance changes. If so, those changes could go uninitiated.

Second, non-pecuniary benefits do not pay the bills. They do not cover the cost of investors' time or their out-of-pocket costs. Like any other consumption good, the initiation of such changes will thus be limited by the level of financial resources the investor is able or willing to devote to it. The resource constraints of these investors create an upper limit on the number of collectively-preferred proposals they can initiate. Any changes in excess of these limits will also go uninitiated.

E. The Landscape of Under-Initiation

Together, the missing middle region of collectively-preferred but uninitiated changes, combined with the collectively-preferred changes that low-cost initiators do not or cannot afford to initiate, comprise the under-initiation hypothesis. Straightforward logic suggests that the number of collectively-preferred changes that are *not* initiated will likely dwarf the number that *are* initiated.

This follows from the fact that there are likely to be many more collectively-preferred changes that would create little or no increase in value than those that would create huge increases in value.[133] That is, the quantity of potential changes is likely to decline as the

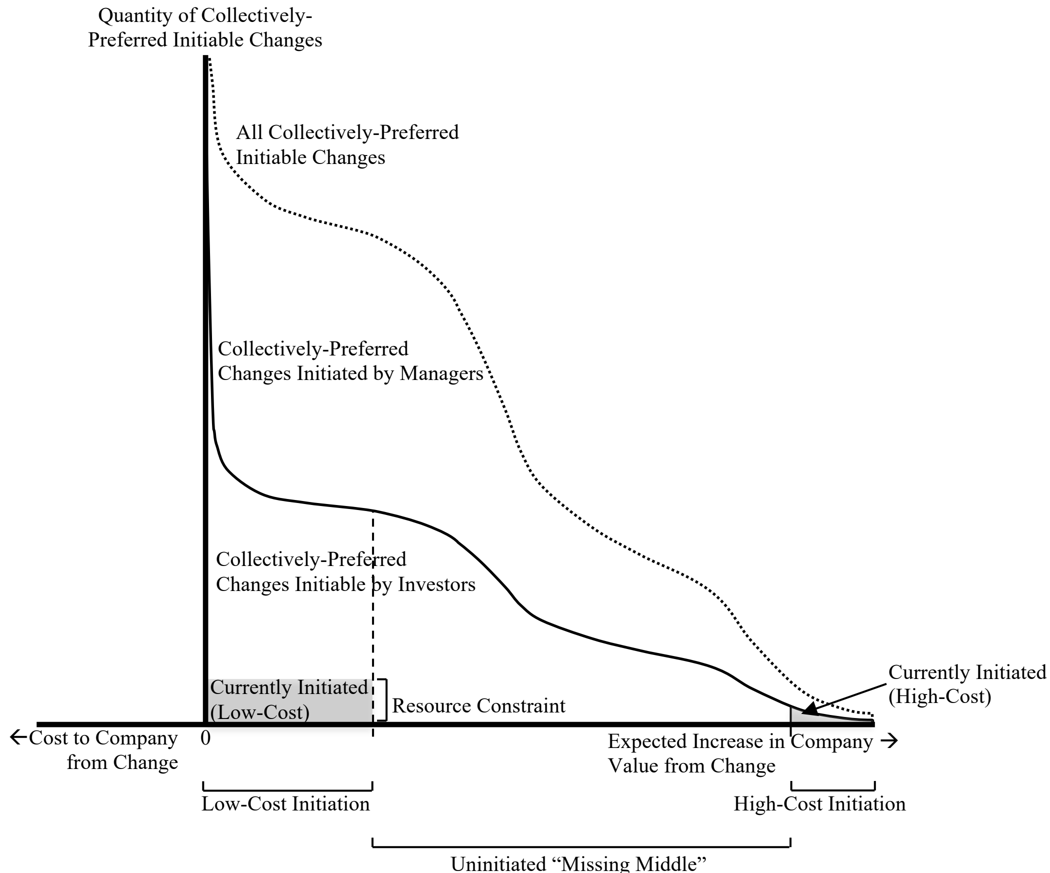
131. A summary of the 2021 proxy season indicates that, of the 733 shareholder proposals submitted during the 2021 proxy season, four individuals were responsible for submitting 175 proposals (24%), socially responsible investors submitted 214 proposals (29%), public pension funds submitted 77 proposals (11%), religious organizations submitted 52 proposals (7%), and labor unions submitted 25 proposals (3%). 2021 PROXY SEASON REVIEW: PART 1, SULLIVAN & CROMWELL LLP 1, 4–5 (July 27, 2021), https://www.sullcrom.com/SullivanCromwell/_Assets/PDFs/Memos/sc-publication-2021-Proxy-Season-Review-Part-1-Rule14a-8.pdf [https://perma.cc/2RG4-9QBH]; *see also* Kastiel & Nili, *supra* note 22, at 589–609 (discussing these investors and their motives).

132. *See supra* Section I.B.

133. The number of changes that could *reduce* the value of the company is likely to be larger still—there are innumerable ways that the company could spend money that would not increase its value, thus decreasing the value of the company on a net basis.

value that would result from the change increases.[134] Figure 2 shows a hypothetical function of the number of potential collectively-preferred changes as a declining function of the expected increase in the value of the company from the change.[135] Subtracting those that are likely to be initiated by managers results in the solid line, those that are initiable by investors.[136]

Figure 2. Quantities of Initiation and Under-Initiation of Collectively-Preferred Corporate Changes



Superimposing the regions from Figure 1 onto Figure 2 shows that, because of the declining quantity function, the number of high-cost changes that are actually initiated are

134. The number of value-reducing changes (those to the left of the origin) is essentially unbounded, as there are likely to be inordinate ways that the value of the company could be reduced. However, because investors have limited liability, the limit to the amount the company's value can be reduced is equal to the current value of the company (though this is not illustrated in Figure 2).

135. The function is deliberately illustrated as non-linear to indicate that we have no knowledge about any of its characteristics other than its decreasing function.

136. The proportions of all collectively-preferred initiable changes that are initiated by managers and that are initiable by investors will depend on the effectiveness of the forces leading managers to initiate changes collectively preferred by investors (and only such changes).

likely to be relatively small compared to the uninitiated missing middle and to changes that could be initiated by low-cost methods. The resource constraint discussed in Section D means that the number of collectively-preferred changes that are initiable by low-cost methods, but that are not likely to be initiated, is potentially very substantial. Together, this leads to the hypothesis that the number of corporate changes actually initiated by investors (those in the shaded regions in Figure 2) is likely to be dwarfed by the number of collectively-preferred changes that investors could initiate but do not (the unshaded areas under the solid line).

The corollary of the areas of under-initiation illustrated in Figure 2 is that there are three factors that would reduce under-initiation: (1) reducing the threshold for initiating proxy contests by incentivizing their initiation; (2) incentivizing greater initiation of shareholder proposals; and (3) removing the upper constraint on low-cost initiation, by reforming shareholder proposals.[137] Part II addresses each of these solutions.

II. INITIATION PAYMENTS

This Part puts forward a concrete and tractable proposal that would reduce or overcome under-initiation: initiation payments. Part I described how under-initiation arises from the collective action problems of investors. This Part explains how initiation payments would overcome the collective action problem of investors. Three effects of the initiation payment proposal correspond to the three factors that would reduce under-initiation. Section B explains how initiation payments for proxy contests would reduce the high value-increase threshold for their initiation and how initiation payments for shareholder proposals would incentivize greater initiation of such proposals. Section C explains how improving shareholder proposals through initiation payments would allow low-cost initiation to fill the missing middle.[138]

Because initiation payments are intended to be a practical proposal that could realistically be implemented, they are designed to work within the existing legal regime (Section A). Accepting existing legal rules as given effectively rules out solutions centered around eliminating the private costs of initiation, since that would require redesigning the shareholder voting system in fundamental ways, or substantially changing the shareholder proposal system.[139] Either would be both practically and politically unrealistic.[140] Instead, this Part takes those rules as given and proposes a solution to under-initiation that could be implemented without regulatory or state law intervention.

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137. These potential solutions contrast with the solution suggested by a traditional agency cost analysis: implement arrangements that would cause directors and executives to initiate all (and only) collectively-preferred corporate changes.

138. On a broader scale, incentivizing investor initiation through these changes would also incentivize directors and executives to initiate changes ex ante. *See infra* Section II.D.3.

139. For further discussion of the relevance of reducing the costs of initiation, see *infra* Section IV.A.4.

140. For a discussion of the challenges faced by the SEC in implementing proxy access—which was intended to facilitate shareholder nomination of directors—see Grant M. Hayden & Matthew T. Bodie, *The Bizarre Law and Economics of* Business Roundtable v. SEC, 38 J. CORP. L. 101, 103–08 (2012).

A. Current Initiation Payments

Current legal rules already permit initiation payments.[141] But, as this Section explains, current initiation payment arrangements suffer from two critical shortcomings. As a result, current initiation payments do not provide an incentive to initiate corporate changes, and they are insufficient to overcome under-initiation.

Current legal rules permit directors to make initiation payments but do not require them to do so.[142] No state or federal statutes govern initiation payments.[143] Instead, legal rules relating to initiation payments have been creatures of common law and an extension of basic common law principles regarding directors' power to manage corporations.[144] Common law principles permit directors to use the corporation's assets for proper corporate purposes, which have been interpreted to include paying expenses incurred in connection with proxy contests.[145] But because there is no requirement to make initiation payments, such payments are only made at the directors' discretion.

These arrangements result in two critical shortcomings. First, they do not require that initiation payments be made for all (and only) collectively-preferred changes. Directors currently make payments only for successful (or settled) proxy solicitations. Initiation payments, therefore, do not cover shareholder proposals or other low-cost initiation methods, which do not involve solicitations.[146] This means that initiation payments have zero incentive effect on the initiation of corporate changes using shareholder proposals or other low-cost methods.

Second, the initiation payments that are currently made are less than the private costs of initiation. Even when directors do make payments for successful proxy contests, those payments only reimburse costs associated with the proxy solicitation in that contest.[147] Solicitation expenses are only a subset of the private costs incurred by the initiating investor—they do not cover the costs or efforts involved in undertaking the research necessary to identify the proposed change or the costs of the substantial time the investor must devote to initiating the change, negotiating with managers, and conducting a proxy contest.[148] Solicitation expenses also do not provide any reward or excess returns to the investor above the investors' out-of-pocket costs. Payments thus do not reward the investor for taking the risk that the initiation will be unsuccessful or cover any of the costs of prior unsuccessful initiations. As a result, if payments were the only reward for initiation, the investor would have a negative expected return from initiating campaigns. So, unless investors expect other returns from initiation (such as returns from their pro rata share of successful corporate changes), rational investors will not enter (or stay in) the business of researching and initiating corporate changes.

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141. *See infra* notes 143–46 and accompanying text.

142. THOMAS, *supra* note 34, § 21.03–04.

143. *See id.* Thomas notes one very limited exception, relating to proxy contest expenses, contained in section 12(3) of the Public Utilities Holding Act of 1935, 15 U.S.C. § 791(e) (2012).

144. *See generally* THOMAS, *supra* note 34, § 21.03–04.

145. *See id.* § 21.03(A) (listing courts that have done so).

146. *See id.* § 21.03–04 (discussing proper uses of corporate funds).

147. *Id.*

148. For a consonant definition of solicitation expenses, see Instructions to Item 1(b), 17 C.F.R. § 240.14a-101 (2021).

These shortcomings make clear two obvious ways that initiation payments must be improved if they are to overcome under-initiation. First, they must apply to low-cost initiation—particularly shareholder proposals—as well as to proxy contests. Second, the payment amounts must not only exceed the investors' private costs from initiation—payments must also offer some reward above and beyond such costs, so that payments sufficiently incentivize initiation.

B. Improving Initiation Payments

The optimal structure of initiation payments is straightforward because it follows directly from the theory of under-initiation described in Part I. Investors do not currently have incentives to initiate value-increasing changes because their private costs from doing so exceed their benefits (including both their private benefits and their share of collective benefits). Conversely, investors *would* have an incentive to initiate value-increasing changes if they were to receive some sufficient initiation payment for doing so.[149] The initiation payment should be made for collectively-preferred changes that investors initiate, and *only* for collectively-preferred changes (to avoid incentivizing changes that investors do not favor).[150] To incentivize the initiation of collectively-preferred changes, the payment must be greater than the net costs to an investor of initiating such a change.[151] If so, the investor's aggregate benefits from initiation will be greater than their private costs, and they will have an incentive to initiate the change.[152]

The corporation provides a ready mechanism for sharing the initiation payment pro rata among investors.[153] By definition, investors holding a majority of the equity in the corporation prefer collectively-preferred corporate changes, and so those investors would be better off if the investor initiated the change. A majority of investors would also therefore be better off (compared to the situation where the change was not initiated) if the corporation made the initiation payment, and thus investors shared the cost of the initiation payment amongst themselves pro rata. Having the corporation make the initiation payment to the initiator does just that.[154] The effect is that part of the collective benefit from the

149. For a related proposal to provide securities intermediaries with vouchers (akin to payments), see Choi & Fisch, *supra* note 25, at 314–44.

150. This is comparable to payments to whistleblowers and for qui tam suits and attorneys' fees in class actions only being made where there is recovery by the agency or the plaintiffs. *See, e.g.*, Yehonatan Givati, *Of Snitches and Riches: Optimal IRS and SEC Whistleblower Rewards*, 55 HARV. J. ON LEGIS. 105 (discussing whistleblower rewards); Sugarland Indus., Inc. v. Thomas, 420 A.2d 142, 149–53 (Del. 1980) (describing attorneys' fees in class action awards).

151. For a discussion of this design principle with respect to whistleblower payments by the IRS and SEC, see Givati, *supra* note 150, at 131–32.

152. Technically, an initiation payment would only need to be greater than the private costs to an investor from initiating corporate changes *less* their private benefits from initiating the change. However, determining the amount of private benefits would be practically difficult, and is unnecessary in order for initiating payments to incentivize initiation of collectively-preferred changes.

153. This is consistent with the understanding of the corporation as a nexus of contracts. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

154. This follows from the investors in the corporation being the residual claimants on the assets of the corporation. *See, e.g.*, Easterbrook & Fischel, *supra* note 153, at 1437.

corporate change is used to create a private net benefit for the initiator, making the initiation optimal both privately and collectively, and overcoming the collective action problem.[155]

The design of initiation payments presented below attempts to answer two core questions, in a practical and workable manner: Which initiations of corporate changes should receive payments? And how much should those payments be? Appropriate payment levels are likely to vary between shareholder proposals and proxy contests; they are discussed separately below.

1. Which Initiations Should Receive Initiation Payments?

There is a straightforward and well-established criterion to determine which corporate changes are collectively-preferred by investors representing a majority of the equity of the corporation, and should therefore receive an initiation payment: those that are approved by a shareholder vote. Corporate law already empowers investors to transact and approve certain corporate business by voting at shareholder meetings.[156] Which initiations are eligible for payments could be determined in the same way—changes that are approved by a vote of investors would be eligible for an initiation payment.[157] As with any approach, this involves a tradeoff. Because the requirement for approval by investors would be a majority of votes cast at a shareholder meeting, it is possible that a vote of investors may not represent the aggregate collective preferences of all investors in the corporation. It is also possible that investors' preferences might not match their own actual interests. These issues are considered in Section A. Nonetheless, a vote of investors is an obvious and pragmatic criterion for eligibility, given that this is the process already followed for most corporate changes approved by investors.

A refinement to this approach is necessary to cover the situation where managers agree to make a corporate change without submitting it to a vote of investors.[158] This group of changes is important because, in equilibrium, they are likely to represent a significant proportion of the changes initiated by investors.[159] If investors did not receive appropriate initiation payments for these changes, then they would not be incentivized to initiate them. Any settlement between the company and an initiating investor should therefore include an initiation payment as though the change had been approved by investors.

If directors do not agree to make initiation payments for settled changes, then the question of whether the investor should receive the initiation payment should go to a vote of all investors, even if the corporate change does not. This would prevent directors from trying to reduce incentives for initiation without introducing the need for dispute resolution.

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155. The solution presented here is analogous to the "tax-transfer" solution in the public goods literature. *See, e.g.*, Robin Boadway, Pierre Pestieau & David Wildasin, *Tax-Transfer Policies and the Voluntary Provision of Public Goods*, 39 J. PUB. ECON. 157, 158–60 (1989).

156. *See* DEL. CODE ANN. tit. 8, § 216 (2021) (providing for votes of shareholders to transact business at shareholder meetings).

157. This is the same pragmatic solution as that proposed for proxy contest reimbursements by Lucian Bebchuk and Marcel Kahan. *See* Bebchuk & Kahan, *supra* note 25, at 1085. In this case, the "in part" would cover proxy contests where at least one of the nominated directors was elected.

158. For a discussion of such settlements, see generally Lucian A. Bebchuk et al., *Dancing with Activists*, 141 J. FIN. ECON. 1 (2020).

159. *See, e.g.*, ACTIVIST INSIGHT, *supra* note 83, at 10 (presenting evidence that 113 of the 350 proxy contests between 2014 and 2020 (32%) were settled).

Investor voting on the payment could be achieved through a shareholder proposal or a management proposal requesting the payment.[160]

An additional refinement relates to the level of approval required for payment. While the intuitive threshold is 50% of the votes cast, there may be reasons to lower the threshold for full or partial payment below 50%. Specifically, shareholder proposals that receive substantial minority support often lead to managers implementing some version of the proposed change. Incentivizing these by making full or partial payment if they reach, for example, 40% support, may be value-increasing for the company. This is not a necessary part of the proposal put forward here, but rather, it could be added if investors supported doing so.[161]

2. *Initiation Payments for Shareholder Proposals*

The second important dimension of an initiation payment system is *how much* to pay investors that initiate corporate changes. As discussed in Section B, the critical aspect of the payment amount is that the payment (plus the investor's private benefits) must exceed the costs to the investor of initiating the corporate change.[162] Because the costs of shareholder proposals and proxy contests differ substantially, this Section focuses exclusively on initiation payments for shareholder proposals, and Section 3 addresses initiation payments for proxy contests.

The exact quantum of costs and benefits to investors may be difficult for the investor to calculate or for the company to verify. Out-of-pocket costs may be readily calculable and verifiable, but many other important costs are not. These include the value of the time of individuals involved and the overheads involved in running an enterprise that initiates changes.[163] Even more challenging to calculate is the opportunity cost to the investor of initiating the corporate change.

These challenges make it difficult to calculate initiation payments based on the investor's actual costs of initiation.[164] To avoid these issues and to greatly simplify the mechanics of initiation payments, I propose the pragmatic approach of using a fixed payment amount.[165] This is feasible for shareholder proposals because there is likely to be

160. This may not be permissible under Rule 14a-8, which only permits each shareholder to submit one proposal unless the payment proposal is considered inextricably intertwined with the proposal requesting the corporate changes. *See* 17 C.F.R. § 240.14a-8(c) (2021).

161. This could be done using the amendment mechanism described in Section III.D.

162. For the payment to be optimal for all investors, it should be less than the aggregate benefit to the company from the change, net of all the costs of initiation. However, due to the difficulty of establishing the aggregate benefit to the company from the change, satisfying this constraint would be realistically unworkable.

163. Overheads (such as rent paid on office space) may be difficult to allocate to a particular change, especially if initiating corporate changes is only one of the investor's business activities.

164. One solution to this problem would be to take a "cost-plus" approach, similar to that historically used by governments in "sole-source" contracts. However, such an arrangement would create many potential issues, including incentivizing expense inflation, and creating a considerable likelihood of payment disputes. For a discussion of cost-plus contracts and the potential issues they raise, see generally Stefan Reichelstein, *Constructing Incentive Schemes for Government Contracts: An Application of Agency Theory*, 67 ACC. REV. 712 (1992).

165. The advantages of fixed-price contracts have led to a shift in their favor (and away from cost-plus contracts) in government contracting. *See* Government Contracting—Memorandum for the Heads of Executive

limited variation in costs between changes, or between investors. A fixed payment can therefore be set at a sufficient level such that it would be greater than investors' costs in the great majority of cases.

The amount of the fixed payment can be determined by estimating the *likely* costs to initiators of initiating corporate changes. This estimation need not consider the particular costs that might be faced by *every* initiator; so long as a reasonable number of initiators could initiate changes for less than the fixed amount, then they can be expected to do so. Out-of-pocket costs for a shareholder proponent include travel to the annual meeting and some additional ancillary costs (such as mailings); they are unlikely to exceed $2,500. Most shareholder proposals are likely to involve no more than ten to twenty hours of work on the part of an investor. Even estimating generously, the total cost of most proposals is thus likely to be less than $10,000. A $10,000 payment is therefore likely sufficient to incentivize most potential proponents to initiate value-increasing changes.[166]

3. *Initiation Payments for Proxy Contests*

One critical way in which proxy contests differ from shareholder proposals is that their costs are both higher and more variable. As a result, unless a fixed payment is set extraordinarily high, it is likely to be insufficient to incentivize the initiation of many collectively-preferred changes.[167] An alternative approach that takes into account the drivers of initiating investors' costs in proxy contests is therefore necessary.

Investors' costs in proxy contests can be divided into those that involve payments to third parties and those that reflect their own internal costs. Third-party payments include those to lawyers, proxy solicitors, public relations teams, financial printers, and Broadridge. Current initiation payments allow reimbursement of these expenses. This practice should continue, because it reduces the need to account for much of the variation in proxy contest expenses with a fixed payment.

The major change that this Article proposes is that, in addition to reimbursement of expenses paid to third parties, an initiating investor should receive an additional, fixed initiation payment. The fixed payment is intended to reward the investor's internal costs in initiating the corporate change—their time, effort, overhead, risk, and opportunity cost. These costs are likely to increase as the proxy contest progresses.[168] This Article proposes that the fixed payment should progressively increase through three different stages of initiation, as the initiation passes different trigger points.[169] Each level of payment would

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Departments and Agencies, 74 Fed. Reg. 9755 (Mar. 4, 2009) ("[T]here shall be a preference for fixed-price type contracts. Cost-reimbursement contracts shall be used only when circumstances do not allow the agency to define its requirements sufficiently to allow for a fixed-price type contract."). For a discussion of the trend towards fixed-priced contracts, see Chong Wang & Joseph G. San Miguel, *Are Cost-Plus Defense Contracts (Justifiably) Out of Favor?*, 2 J. GOVERNMENTAL & NONPROFIT ACCT. 1, 2 (2013).

166. One enhancement to this proposal would be to increase the payment amount for shareholder proposals that propose novel changes or require considerable firm-specific research, since such proposals are likely to take additional time to prepare.

167. *See supra* notes 81–83 and accompanying text (discussing the high costs of proxy contests).

168. *See* Gantchev, *supra* note 29, at 611.

169. There will likely be some overlap between the various stages. For example, the initiator is likely to continue learning more about the company through the course of their engagement with managers, and their engagement with managers is likely to continue after they have begun electioneering.

be designed to cover the costs likely to be incurred by most initiating investors in the stages that the contest passed through. To concretize my proposal, below I estimate amounts that are likely to satisfy this criterion. However, the proposed amounts are not critical for the proposal. I also explain how these amounts could be adjusted if they are implemented and later prove to be too high or too low.

The lowest level of fixed payment would be made if the investor's efforts to engage with directors and managers led them to agree to a settlement of the contest, including some implementation of the change. Initiating investors reaching this stage have spent time and effort researching and investigating the company to identify the potentially value-increasing changes and engaging with the directors. For an activist hedge fund, a typical change is likely to require several hundred hours of work by a team including various analysts and a portfolio manager, whose total annual compensation will vary from $100,000 to $3 million. A rough estimate for the value of this time is $100,000.[170] Including overheads, risk, and opportunity cost, I propose that a reasonable fixed payment for this stage would be $200,000.

A higher level of initiation payment would be made if directors only agreed to the settlement after the investor had nominated directors for election or after the investor filed its preliminary statement. Nominating directors requires the investor to spend additional time engaging with directors and working with advisors and the director nominees themselves. However, there may not be significant increases in the level of risk and overhead taken on by the investor. I therefore propose that the fixed payment at this stage be $300,000. Preparing and filing a preliminary proxy statement requires considerable time and effort working with advisors; thus, the fixed payment—if there is a settlement after the investor has filed its preliminary proxy statement—would be $400,000.

The highest level of fixed payment would be made if the contest goes to a vote and at least one of the initiating investor's nominees is elected. In this case, the investor would have spent several additional months electioneering to convince other investors to support their nominee. Given the intensive effort required, that investor would receive a fixed payment of $750,000. Of course, if the investor withdrew their nomination, or if it went to a vote and none of their nominees were elected, the investor would not receive any payment.

If investors anticipate spending more time and effort than that estimated above, the payments may not be sufficient to incentivize them to initiate corporate changes. To avoid this problem, these would be *default* payments. Investors could agree to greater (or lesser) amounts with the company's directors. Alternatively, as discussed below, an investor could include in their proxy solicitation a binding proposal that they receive a specified higher payment, which would be effective if the proposal is approved.[171]

Initiation payments structured in this way would have a significant effect: Potential initiators would know, ex ante, that they would receive some excess return above their

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170. This estimate is based on 100 hours of time for an analyst, 100 hours for a senior analyst, and 50 hours for a portfolio manager—at $200, $375, and $875 per hour, respectively—the total of which is $101,250. Hourly costs are calculated based on the midpoint of annual compensation for each level listed in *Hedge Funds (HFs): An Overview of Hedge Funds, Including Key Functions, Top Companies, and Careers & Salaries*, MERGERS & INQUISITIONS, https://www.mergersandinquisitions.com/hedge-funds [https://perma.cc/W57D-P652].

171. For a discussion of bundling such a proposal with a proposal for a corporate change, see *infra* Section III.B.1.

expenses if their change were agreed to or approved. Yet the changes necessary to implement these payments are relatively modest. Directors already have the discretion to agree to settlements with investors, including reimbursement of solicitation expenses.[172] And investors sometimes bundle proposals regarding payments in proxy contests.[173] The main change necessary would be in the norms regarding what payments would be supported by investors, and therefore agreed to by directors.

4. Disputes and Edge Cases

The initiation payments proposed above are intentionally designed to minimize the possibility of disputes. The category for reimbursable expenses is well defined, leaving little room for disputes regarding whether an amount is reimbursable. There is no need to determine difficult-to-measure costs, such as opportunity costs or the costs of individuals' time.[174] Nonetheless, other categories of disputes may arise, and it is also worthwhile to consider two "edge cases" that may arise from the application of the proposed arrangements.

One potential source of disputes relates to whether the costs claimed for reimbursement accurately reflect those that were actually incurred. To reduce the likelihood of such disputes, I propose that to be eligible for reimbursement, costs must be listed with particularity in a securities filing by the initiating investor, ideally its proxy statement (assuming the contest is not settled before the investor files its proxy statement).[175] This would have the effect of making any false or misleading statement regarding costs subject to penalties under Rule 14a-9,[176] and would thus substantially reduce the likelihood of a false statement.[177]

One edge case that may arise is if multiple investors seek to initiate substantially the same change. A straightforward solution would be a priority rule that allows only one of the changes to proceed, such as the first initiated.[178] However, this would require adjudication by the company and creates the possibility for disputes regarding which change was first initiated, and whether the changes are substantially the same. To avoid such disputes, I instead propose that both initiations should be allowed and that the same payment rules apply to each.[179] While it is possible that each would be approved, it is more likely that investors (guided by their own policies or recommendations from proxy

172. *See supra* notes 143–46 and accompanying text; for a discussion of settlement dynamics in hedge fund activism, see Bebchuk et al., *supra* note 158.

173. For an example of a bundled reimbursement proposal in a proxy contest, see Costa Brava Partnership III L.P., Definitive Proxy Statement (Schedule 14A) 31 (Sept. 29, 2006).

174. *See supra* Section II.B.2.

175. Proxy statements in contested solicitations are required to disclose the total estimated to be spent and the total expenditures to date, in furtherance of the solicitation, including many specified types of expenditures (though these are not required to be itemized). 17 C.F.R. § 240.14a-101(b)(4) (2021).

176. Note that Rule 14a-9 only applies to false or misleading statements or omissions with respect to *material* facts. *Id.* § 240.14a-9. It is possible that the payment amounts may not be large enough to be material.

177. This would have a side benefit of making transparent to investors the costs that would be payable if they approve the change.

178. For an analogous priority rule for Rule 14a-8 shareholder proposals, see *id.* § 240.14a-8(i)(11) (allowing exclusion of proposals that duplicate a previously submitted proposal).

179. Rule 14a-8(i)(11) prevents this eventuality by allowing the exclusion of a later-filed, duplicative proposal. *See id.*

advisors) would choose one or the other to support, such as the first filed or the change initiated by the most reputable investor. If this were the case and the initiating investors were aware of it, then at least one of them would have a strong incentive to negotiate—either with the company or the other initiator—to withdraw one of the shareholder proposals.[180] If investors developed a clear approach of favoring first-filed proposals or proposals from certain reputable proponents, then it would be clear to each of the multiple proponents submitting proposals which one is likely to prevail, and the other(s) would have incentives to withdraw their proposals.[181]

A different edge case is if an investor initiates a change that the company has already planned but has yet to announce. Here, again, it is likely that some settlement could be reached between the company and the proponent.[182] If there was some disagreement, the proposal could proceed to a vote. As before, if it was obvious that the plan was already underway, directors and managers could make that clear, and if investors believed them, they would vote against the proposal. If the investor makes clear that the proposed change is different from what the management had initially planned, then they could make that clear to investors, and if they agree, investors may support the proposal. Either way, it would be up to investors to decide.[183]

C. *Improving Shareholder Proposals*

The central pillar of this Article's proposal for overcoming under-initiation is initiation payments. Initiation payments would lower the threshold for initiating high-cost proxy contests and reduce or eliminate the under-initiation of proxy contests. But without further arrangements, initiation payments would not remedy the constraints on Rule 14a-8 shareholder proposals that prevent them from being used to initiate higher-value-increasing changes, resulting in the missing middle. This Section therefore proposes two extensions of the arrangements described above, whereby initiation payments could be used to overcome the constraints of shareholder proposals submitted under Rule 14a-8. A similar approach to that proposed here could also be used to overcome other issues with shareholder proposals, though such applications are beyond the scope of this Article.

1. *Relaxing Shareholder Proposal Constraints*

The major constraint of Rule 14a-8 with respect to higher value-increasing changes is that companies are not required to include in their proxy statements shareholder proposals relating to the ordinary business of the company or electoral matters.[184] However, there is no reason that directors and executives cannot voluntarily choose to include such

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180. This might also involve an agreement among the proponents to share any resulting initiation payment in some proportion.

181. One reason why they might have an incentive to do so is if there is an initiation penalty for initiating corporate changes that receive less than a specified level of support, as I later propose in Section II.C.2.

182. For example, if the pre-existing plan is satisfactory to the proponent, the proposal could be withdrawn with some agreed-upon payment. Regulation FD is likely to require that the initiating investor agree to keep the information confidential. *See* 17 C.F.R. § 243.100(b)(2)(i) (requiring certain disclosures to be made publicly available unless made "to a person who owes a duty of trust or confidence to the issuer").

183. For a general discussion of the effects of initiation payments in promoting such investor control, see *infra* Section IV.B.3.

184. *See supra* notes 120–22 and accompanying text.

proposals.[185] A corporation's bylaws could therefore be amended to require directors to include shareholder proposals that meet the other requirements of Rule 14a-8, even though the proposals relate to the ordinary business of the company or director elections (and would thus otherwise be excludable).[186]

2. Initiation Penalties for Initiating Value-Reducing Changes

The Rule 14a-8 shareholder proposal regime has been criticized in the past for allowing the submission of changes that investors are unlikely to collectively prefer. Initiation payments could worsen this problem. If there is no cost to submitting a proposal, and considerable possible benefit, some initiators might "spam" corporations with shareholder proposals in the hope that a small proportion might be approved, and be rewarded with initiation payments.[187] Because the initiation of shareholder proposals imposes costs on the company and on other investors, it is possible that the costs of such submissions might outweigh the benefits in bringing about the initiation of the few collectively-preferred changes.

Initiation of changes that are unlikely to be collectively preferred could be reduced by the converse of an initiation payment: an initiation penalty. So long as the amount of the penalty was greater than the private benefit to the investor from initiating the change, it would disincentivize them from doing so.

In the same way that successful proposals would receive initiation payments, proposals that receive very low levels of support could be subject to initiation penalties. What should be the amount of the penalty, and the threshold level of investor support below which an initiation penalty would be applied? I proposed that the amount of the penalty be the same as the initiation payment for shareholder proposals: $10,000. The SEC's resubmission thresholds for Rule 14a-8 proposals provide useful benchmarks for the appropriate threshold. Rule 14a-8 does not require the inclusion of proposals that were previously submitted once and received less than five percent support.[188] I propose that the same threshold level be used for initiation penalties.

Levying an initiation penalty *after* the election creates potential challenges with enforcement. Instead, as a precondition for submitting a shareholder proposal, I propose that initiators of shareholder proposals would be required to deposit $10,000 with an escrow agent on specified terms. The terms would provide that the amount (net of escrow fees) would be forfeited to the company if directors or executives did not agree to the proposal and if the proposal did not receive a minimum of five percent of votes cast at the shareholder meeting. The escrowed amount would be repaid to the initiating investor (less the escrow fees) if the proposal was withdrawn before the proxy statement was filed or if it received more than the minimum level of votes.[189]

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185. For a discussion of management agenda-setting, see generally Scott Hirst & Adriana Robertson, *Hidden Agendas in Shareholder Voting*, 39 YALE J. ON REGUL. 1218 (2022).

186. *See* 17 C.F.R. § 240.14a-8(i)(7)–(8) (detailing rules for excluding shareholder proposals relating to ordinary business operations and elections).

187. Such a strategy is unlikely to be profitable for proxy contests, given their high cost.

188. 17 C.F.R § 240.14a-8(i)(12).

189. More specifically, the arrangement would require the initiating investor to provide a letter to the company from a nationally-recognized escrow agent, attaching an executed escrow agreement under which the

Regrettably, there is considerable doubt whether such a requirement would be permitted under Rule 14a-8.[190] While there is no precedent on this issue, such a precondition would seem to run counter to the clear obligations imposed by Rule 14a-8, to include a shareholder proposal if it meets the conditions in Rule 14a-8, and only those conditions.[191] And, if this approach cannot apply to Rule 14a-8 proposals, it cannot prevent value-reducing proposals submitted pursuant to that rule. But there is nothing to prevent a company from imposing this requirement as a precondition for the possibility of a shareholder proposal receiving an initiation payment. Doing so would avoid the possibility that initiation payments could also incentivize the initiation of changes that investors are unlikely to prefer.

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This Section has effectively proposed the creation of an alternative, privately ordered shareholder proposal regime that would overcome several shortcomings of Rule 14a-8.[192] If a company implemented this regime, investors initiating changes at that company using shareholder proposals would have the possibility of (a) using Rule 14a-8 simpliciter without the possibility of an initiation payment or penalty; or (b) using the alternative regime described here, with the risk of an initiation penalty if the proposal received very low support, but also the possibility of an initiation payment if it was agreed to or approved. As well as the benefits described above, this proposal would have a significant side benefit. The investor's choice of whether to risk an initiation penalty would signal to other investors whether the initiating investor believed the change would receive substantial support. This would give other investors an easy heuristic for their voting—they could simply vote against any changes for which the initiating investor was unwilling to risk an initiation penalty. Even though the initiation payment requirement could not be applied to Rule 14a-8 proposals, this signal may thus have a substantial effect on reducing the cost to investors of considering those changes, and also assuage those concerned about the potential cost of shareholder proposals.[193]

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investor had escrowed at least $10,000 and providing that it would (a) be paid to the company (less defined escrow fees) if (i) the company provides a letter from the investor withdrawing the proposal from consideration, or (ii) at the company's meeting, the proposal receives less than the defined proportion of the votes cast for or against the proposal (as set out in the company's Form 8-K), and (b) otherwise be repaid (less escrow fees) to the investor.

190. *But see* Mark Uyeda, Comm'r, SEC, Remarks at the Society for Corporate Governance 2023 National Conference (June 21, 2023), https://www.sec.gov/news/speech/uyeda-remarks-society-corporate-governance-conference-062123 [https://perma.cc/8ZMK-NKGE] (advocating greater private ordering of shareholder proposals, and arguing that "section 14(a) does not specifically preempt state corporate law . . .").

191. *See* 17 C.F.R. § 240.14a-8 (describing "when a company must include a shareholder's proposal in its proxy statement").

192. For a broader discussion of overcoming the shortcomings of SEC regulations through private ordering, see generally Scott Hirst, *The Case for Investor Ordering*, 8 HARV. BUS. L. REV. 227 (2018).

193. For concerns about the costs of shareholder proposals as expressed by an SEC Commissioner, see Hester M. Peirce, Comm'r, SEC, Statement at Open Meeting on Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8 (Sept. 23, 2020), https://www.sec.gov/news/public-statement/peirce-14a-8-09232020 [https://perma.cc/3VUC-QG83].

D. The Likely Effects of Initiation Payments

Before moving on to consider how initiation payments could be implemented, it is worthwhile to consider the likely effects of initiation payments. This is also critical for evaluating whether they are likely to be supported by investors or not (which is the focus of Part IV). It is difficult to make predictions, especially about the future. Therefore, this Section limits itself to some general and tentative predictions regarding who is likely to respond to initiation payments, and the changes they are likely to initiate, based on the structure of the initiation payments proposed, existing institutions, and other investor incentives.

1. Who Is Likely to Be Incentivized by Initiation Payments?

Like current initiation patterns, the question of who is likely to be incentivized to initiate corporate changes by initiation payments can be analyzed in terms of high-cost initiation and low-cost initiation. One likely effect of initiation payments is improving the returns to those who are already initiating corporate changes. This is likely to reduce the value-increase threshold necessary for an activist hedge fund to earn a sufficient return on a corporate change. Some existing hedge funds are therefore likely to initiate changes that may not have had sufficient expected returns before. An additional $750,000 payment is likely to have more of an incentive effect on smaller hedge funds than larger hedge funds.

As well as incentivizing existing players, the possibility of an initiation payment is likely to cause entry into the field by other competitors. Raising and managing the large amounts of capital held by a hedge fund would no longer be necessary to profit from the initiation of a corporate change. Others that considered a $750,000 payment a sufficient reward for the time and risk to undertake a successful campaign could also be expected to attempt to initiate corporate changes. They would only need to identify a corporate change that investors would collectively prefer. Corporate analysts would be well placed for such a role, and could team up with various advisors—lawyers, bankers, proxy solicitors—to assist with the operational aspects of initiation, as the latter's fees would be reimbursed if the contest is successful. Alternatively, some of those advisors might choose to join the market for initiation themselves.

A similar mix of existing players and new entrants is likely to characterize the effects of initiation payments on low-cost initiation. Shareholder proponents that currently submit many proposals that receive substantial support—including notable gadflies and public pension funds—could afford to submit many more proposals if they received initiation payments when their proposals were successful. But there are few barriers to entry for shareholder proposal submission, and the skills in identifying and submitting successful proposals are likely to be relatively easy to acquire, or to already exist in the hands of those that have advised in the field. Therefore, it is likely that others familiar with the process—such as lawyers and governance experts—could begin submitting large numbers of shareholder proposals, either as an initiative of their existing organizations, or under new shingles.

2. What Are They Likely to Initiate?

There is an easy answer to the question of what changes are likely to be initiated: more of the same changes that are successful at the moment. Many successful types of

governance changes initiated with shareholder proposals—such as moving companies with classified boards to annual elections and removing supermajority provisions—would also be successful at the companies where they have not yet been proposed, resulting in initiation payments for the proponent. But once these low-hanging fruit are picked, proponents will likely identify and propose other corporate governance changes, and possibly environmental and social changes, that institutional investors are likely to support.

Changes initiated with proxy contests are harder to predict. Likely, these would include strategy changes and management changes at underperforming companies. This may also include encouraging underperforming companies to put themselves up for sale.

Although this Article considers proxy contests and shareholder proposals separately, some convergence in these categories is likely. If an initiation payment bylaw allowed shareholder proposals that went beyond those submissible under Rule 14a-8, shareholder proposals could suggest changes in strategy, operations, or management. Some of these may be relatively easy to identify. If directors refused to implement shareholder proposals that were successful after being included in the company proxy, proponents of those proposals would have a significant chance of success in a proxy contest.

3. *Settlements and Preemptive Corporate Changes*

The above discussion assumes that investors would actually initiate these changes, and that they would need to see them through to a vote. However, one very likely result of initiation payments is that directors and executives would settle changes that investors initiate when they expect them to be successful in a vote.[194] In addition, if potential initiators can predict which changes are likely to succeed (and be rewarded) at particular companies, the directors and executives of those companies likely can too. Merely implementing initiation payments is, therefore, likely to lead many management teams to preemptively initiate changes that investors otherwise would. This suggests that, in many cases, the benefits of initiation payments are likely to be realized without any payments needing to be made.

4. *The Market for Initiation*

Although it is difficult to predict specific changes and initiators, it is not difficult to predict that initiation payments would result in the creation of a market for investor initiation of collectively-preferred corporate changes. If the market price—initiation payments—is set sufficiently high, multiple investors will compete to initiate successful changes. This competition can be expected to bring at least four benefits traditionally associated with markets.[195]

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194. Settlements already represent a substantial proportion of proxy contest outcomes. *See supra* note 159.

195. For recognition of the benefits of markets in other areas of corporate governance, see, for example, Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965) (introducing "a study of the market for corporate control"); Oren Bar-Gill, Michal Barzuza & Lucian Bebchuk, *The Market for Corporate Law*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 134, 158–59 (2006) (discussing the market for corporate law created by states competing to produce optimal rules for corporate governance); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 1–52 (1993) (lauding the market approach to creating corporate laws).

Information Discovery. The market for investor initiation is likely to improve the speed and accuracy with which information about corporate changes is discovered and acted upon. Initiation payments would give potential initiators strong financial incentives to identify potential changes, and to determine whether they are likely to be collectively-preferred (and thus rewarded).

Innovation. Once low-hanging changes have been initiated, initiation payments would reward innovations by investors in the types of changes initiated and the methods by which they are initiated. Current rules do not incentivize investors to devote resources to innovation, as it is rarely financially rewarded. Innovation might lead to the proposal and discussion of corporate governance mechanisms proposed by other scholars.[196] Other innovations could overcome shortcomings in SEC regulations, through "investor ordering" of legal rules.[197] Indeed, implementing an alternative arrangement for shareholder proposals that overcomes perceived limitations of Rule 14a-8 is an example of such innovation.[198]

Consumer Surplus. Competition among investors for initiation payments is also likely to create a surplus for the consumers of initiation, other investors. This may take the form of higher quality initiation, or lower initiation costs.[199] That is, as more changes are initiated, initiation payment bylaws (or bundled proposals) could be adjusted to reduce initiation payments.

Satisfaction of Consumer Preferences. The broader message of the market for investor initiation is that it would result in the corporate changes that are initiated adjusting towards those that would be successful. Initiation decisions—and thus, corporate changes—would follow the collective preferences of investors, and would update dynamically to reflect changes in those preferences.[200]

III. IMPLEMENTING INITIATION PAYMENTS

Part II discussed how initiation payments can incentivize investor initiation of collectively-preferred changes through shareholder proposals and proxy contests. This Part considers how initiation payments should be implemented. Because of the substantial legal and political hurdles that implementation by federal or state rules is likely to face (Section A), this Part instead puts forward a practical and plausible proposal for implementing investor initiation by private ordering (Section B). This would depend only on institutional

196. For examples of board-related reform proposals that could be implemented through investor initiation, see, e.g., Ronald J. Gilson & Reiner Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 883–92 (1991); Kobi Kastiel & Yaron Nili, *"Captured Boards": The Rise of "Super Directors" and the Case for a Board Suite*, 2017 WIS. L. REV. 19, 50–57; Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: An Introduction*, 74 BUS. LAW. 351, 358–66 (2019).

197. *See generally* Hirst, *supra* note 192.

198. *See supra* Section II.B.4.

199. This would also require initiation payment bylaws to provide means of resolving disputes among competing initiators. Analogous mechanisms exist for shareholder litigation, such as processes for assigning lead plaintiff responsibilities—and hence, rewards—to the most capable plaintiffs and attorneys. Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4(a)(3) (2010); *see also* Hirt v. U.S. Timberlands Serv. Co., No. CIV.A. 19575, 2002 WL 1558342, at *2 (Del. Ch. July 3, 2002) (listing and establishing factors the Delaware Chancery Court considers in assigning lead plaintiffs).

200. This would also require such preferences to be communicated. *See About the Investor Stewardship Group*, INV. STEWARDSHIP GRP., https://isgframework.org [https://perma.cc/G7CW-NXRW].

investors supporting initiation payments. If institutional investors support initiation payments, they would effectively be self-implementing (Section C), and also self-adjusting (Section D).

A. Initiation Payments as Federal or State Rules

Implementing initiation payments through federal proxy rules would have a degree of coherence, since those rules effectively create many of the costs of proxy solicitation and the limitations on shareholder proposals that contribute to under-initiation.[201] Having the SEC regulate initiation payments would also have several advantages, including its experience in developing and reviewing regulations with input from affected parties,[202] and as an enforcer and an arbiter.[203] But it is doubtful whether the SEC has the power to implement initiation payments and penalties. Payments from companies to their shareholders have traditionally been governed by state law, especially payments regarding solicitations.[204] The Supreme Court has read the SEC's ability to regulate such matters narrowly, requiring express Congressional approval.[205] Several of the SEC's rules effectively requiring corporate governance arrangements have been successfully challenged in the past, albeit on different grounds.[206] The SEC is therefore likely to be reticent to require such rules absent explicit congressional authorization.[207]

Implementing initiation payments through state corporate law would sidestep the legal hurdle to federal initiation payments, but would face its own substantial practical and political challenges. State corporate laws already permit initiation payments, but do not require them.[208] But directors and managers have no incentive to implement initiation payments without external pressure.[209] State corporate law rules could instead be amended

201. *See* 17 C.F.R. § 240.14a-4 (2023) (regarding solicitations); § 240.14a-8 (2023) (regarding shareholder proposals).

202. For a discussion of the SEC's rulemaking process, see, e.g., Jonathan S. Sack & Penina Moisa, *The SEC's Rulemaking Process: Long-Haul or Short-Cut?*, N.Y. L.J. (Jan. 20, 2022), https://www.law.com/newyorklawjournal/2022/01/20/the-secs-rulemaking-process-long-haul-or-short-cut [https://perma.cc/P9QJ-QVS2].

203. One particularly relevant way in which the SEC plays this role for investor initiation is in issuing no-action letters under Rule 14a-8. *See, e.g.*, Reilly S. Steel, Note, *The Underground Rulification of the Ordinary Business Operations Exclusion Notes*, 116 COLUM. L. REV. 1547, 1551–58 (2016) (examining the Rule 14a-8 no-action letter process).

204. *See, e.g.*, Hall v. Trans-Lux Daylight Picture Screen Corp., 171 A. 226, 227 (Del. Ch. 1934) (permitting payments in contests that involve issues of corporate policy); THOMAS, *supra* note 34, at 21.03[B] (summarizing proxy contest expense reimbursement rules).

205. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477–78 (1977) (stating that the Court was "reluctant to recognize a cause of action" where "Congress did not expressly provide [one]").

206. *See, e.g.*, *id.* at 479 (referring to corporations as "creatures of state law," and investors expect that "state law will govern the internal affairs of the corporation"); Bus. Roundtable v. SEC., 905 F.2d 406, 406–14 (D.C. Cir. 1990) (citing *Santa Fe Indus.*, 430 U.S. at 479) (holding that the SEC could not bar national securities exchanges and national securities associations from listing stock of corporations with dual-class capitalization structures).

207. For a discussion of similar reticence to regulated dual-class share structures in the wake of judicial resistance, see Scott Hirst & Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 B.U. L. REV. 1229, 1240–41 (2019).

208. *See, e.g.*, DEL. CODE ANN. tit. 8, § 113 (2022); MODEL BUS. CORP. ACT § 2.06(c)(2) (AM. BAR ASS'N 2016).

209. *See supra* note 67 and accompanying text.

to require initiation payments, or to make initiation payments the default rule for corporations.[210] State courts could also require initiation payments where investors successfully initiated changes. This is arguably consistent with their recognition of the central importance of the shareholder franchise to corporate law.[211] The potential flexibility of a judicial doctrine requiring initiation payments also offers an advantage over the inflexibility of a statutory provision, which would be difficult to draft in a way that covers all possible circumstances.[212]

However, the history and nature of state corporate law suggest that there is very little realistic likelihood of state legislators or judges requiring initiation of corporate changes that investors collectively prefer. State corporate law has generally afforded considerable discretion to directors and managers of the corporation[213] and imposed few mandatory requirements.[214] Recent developments in state corporate law have tended toward allowing greater director discretion, rather than imposing additional constraints.[215] This is consistent with the political realities of state law.[216] Commentators have long recognized the incentives of states to cater their corporate laws to the preferences of corporate insiders.[217] State corporate laws have thus developed in a way that provides greater protection to directors and managers, including protection against corporate changes.[218] Requiring initiation payments (or making them the default) would go against both these trends by

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210. Having initiation payments as the default is consistent with prior work showing that it is preferable to set default corporate law rules in the direction that is more restrictive of directors and executives. *See* Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 492 (2002) (arguing for default arrangements that are more restrictive of corporate managers).

211. *See, e.g.*, Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."). *See also supra* note 58 and accompanying text. Failure by directors to make payments for successful initiation could be understood as an inequitable attempt to weaken the shareholder franchise by disincentivizing initiation. *See id.* at 659–64; Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 438–40 (Del. 1971).

212. This basic point follows from the theory of incomplete contracts. For an overview of this theory, see Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RSRV. L. REV. 187, 188–95 (2005).

213. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (discussing "the managerial prerogatives of Delaware directors under Section 141(a)"); *see also* DEL. CODE ANN. tit. 8, § 141(a) (2022) (providing that the business and affairs of corporations shall be managed by or under the direction of the board of directors).

214. *See, e.g.*, Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1553 n.16 (1989) (listing mandatory terms in the Delaware General Corporation Law).

215. *See, e.g.*, DEL. CODE ANN. tit. 8, § 113 (2022) (taking a flexible approach with respect to reimbursement of proxy solicitation expenses); *see also* Salzberg v. Sciabacucchi, 227 A.3d 102, 137 (Del. 2020) (taking a flexible approach to the adoption of exclusive forum provisions by Delaware corporations). A possible exception to this trend has been Delaware's recent prohibition on fee-shifting bylaws, which effectively prevents directors from adding greater disincentives for investors to initiate lawsuits against the company. See DEL. CODE ANN. tit. 8, §§ 102(f), 109(b) ("The bylaws may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in § 115 of this title.").

216. For an important work discussing these realities, see generally Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005).

217. *See generally* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

218. *See* Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 959 (Del. 1985) (allowing a board of directors to defend the corporation against a hostile offer); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985) (giving directors substantial power to reject takeovers initiated by investors).

decreasing both the flexibility and protection offered to directors. The likelihood of state legislators or courts doing so seems limited at best.

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This Section suggests that federal or state rules implementing initiation payments are unrealistic. Instead, the remainder of this Part focuses on how investors could implement initiation payments themselves, through private ordering.

B. Privately Ordered Initiation Payments

This Section proposes two alternative—and potentially complementary—methods whereby initiation payments could be implemented by private ordering: bundled initiation payment proposals, and initiation payment bylaws.

1. Bundled Initiation Payment Proposals

One straightforward way of implementing initiation payments by private ordering is simply by bundling a shareholder proposal or a proxy contest with a separate proposal requesting that the company make an initiation payment to the initiator. Bundled payment proposals are not new, at least not for reimbursement of solicitation expenses in proxy contests. Investors initiating proxy contests have occasionally included such proposals in their soliciting materials in the past.[219] However, to my knowledge, this approach has never been used to request payment of an amount *in excess* of the costs incurred by an investor undertaking a proxy contest. In addition, because of the limitations of Rule 14a-8, this approach has not previously been used for shareholder proposals.[220]

The great advantage of adopting initiation payments in this manner is that they would require only that initiators have bundled such additional proposals with their proposed change (and that other investors supported them).[221] Initiators soliciting their own proxies could therefore immediately adopt this approach themselves. In addition, if adjustments to the initiation payment level were necessary, future initiators could simply change the amount they requested in the bundled proposal, accelerating adjustments and reducing error costs.

But this approach involves two significant shortcomings. First, not having a rule that would *require* an initiation payment if the proposal was successful means initiators cannot be certain that they will receive a payment if they successfully initiate a corporate change. There is some risk that the change will be approved, but the initiation payment will not pass; or that the payment proposal will pass, but directors will refuse to follow it. This risk will reduce investors' willingness to initiate changes they expect to be value-increasing.

A second shortcoming is that this arrangement cannot be used for Rule 14a-8 proposals. Rule 14a-8 limits proponents' submissions to a single proposal.[222] A proposal requesting payment would likely constitute a second proposal, allowing the company to

219. For an example of a bundled reimbursement proposal in a proxy contest, see, e.g., Costa Brava P'ship III L.P., Definitive Proxy Statement (Schedule 14A), at 31 (Sept. 29, 2006).

220. *See infra* notes 222–23.

221. *See infra* Section III.C.

222. *See* 17 C.F.R. § 240.14a-8(c) (2021).

exclude it from the company's proxy statement.[223] Bundling a second proposal would be possible for shareholder proposals where an investor solicits their own proxies. It would also be possible if the company adopted an initiation payment bylaw requiring directors to include a broader set of shareholder proposals than Rule 14a-8, including bundled payment proposals. But that would negate the main advantage of a bundled proposal—its simplicity and immediacy of implementation. Bundled payment proposals are thus better thought of as complements to initiation payment bylaws of the kind proposed in the next section.

2. *Initiation Payment Bylaws*

Given the limitations of bundled payment proposals, this Section proposes a more comprehensive method for implementing initiation payment through private ordering—"initiation payment bylaws." An initiation payment bylaw would require the corporation to pay an initiation payment to an investor that either initiates a shareholder proposal that is approved by a vote of shareholders or that nominates at least one director that is elected. Payment would also be required if the directors of the company agreed to make the change requested by the initiator. The bylaw would also stipulate how the level of payments would be determined, how payments would be disclosed, and how disputes regarding payments would be resolved. To prevent the possibility of directors unilaterally repealing the initiation payment bylaw, it would provide that shareholder approval would be required in order to repeal it, or to amend it in such a way as to make it harder to obtain an initiation payment.[224]

Initiation payment bylaws could be put in place either with or without an accompanying charter provision that explicitly permitted such an arrangement.[225] An initiation payment bylaw would be considerably easier to implement without a charter amendment, which would require approval by the board of directors.[226] The advantage of a charter provision is that it would eliminate any uncertainty regarding the permissibility of the initiation payment bylaw.[227] That uncertainty arises because of the tension between the parts of state corporate law that give broad leeway for bylaws, and those parts that stipulate that the directors shall be responsible for managing the corporation.[228] It is thus possible that a bylaw (without a charter provision) that curtailed directors' discretion on whether or not to make an initiation payment may be inconsistent with their rights and

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223. *See* Julian Ellis, Student Article, *The "Common Practice" of Bundling: Fact or Fiction?*, 91 DENVER L. REV. ONLINE 105, 106–14 (2014) (discussing the SEC's interpretation of its anti-bundling rules).

224. For an example of the rules relating to bylaw amendments, see DEL. CODE ANN. tit. 8, § 109(a); *see also* Albert H. Choi & Geeyoung Min, *Contractarian Theory and Unilateral Bylaw Amendments*, 104 IOWA L. REV. 1, 11–21 (2018) (discussing current practices of amending corporate bylaws).

225. An initiation payment provision could also be contained entirely in the charter. However, such an arrangement offers few, if any, advantages over a bylaw accompanied by permission in the charter.

226. *See*, DEL. CODE ANN. tit. 8, § 242(b)(1) (requiring a board resolution for a charter amendment). This requirement would prevent self-implementing initiation payments of the kind described in Section III.C.

227. *See* DEL. CODE ANN. tit. 8, § 141(a) ("The business and affairs of [the corporation] . . . shall be managed by or under the direction of a board of directors, *except as may be otherwise provided . . . in its certificate of incorporation*.") (emphasis added).

228. *See* DEL. CODE ANN. tit. 8, §§ 109(b), 141(a). For a comprehensive discussion of the appropriate role of bylaws in Delaware corporate law, see Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 CALIF. L. REV. 373 (2018).

powers.[229] However, while there is no definitive caselaw on this question, it is likely that an initiation payment bylaw would be permissible under state law. The only decision casting doubt on the permissibility of an initiation payment bylaw arose in the context of a *proposed* bylaw.[230] The Court in that case indicated that the situation would likely have been different had the bylaw already been adopted.[231] In addition, the adoption by Delaware and many other states of provisions explicitly permitting reimbursement for proxy solicitation expenses suggests that initiation bylaws would also be permissible.[232] Those provisions, as currently written, are likely too narrow to support initiation payments that provide a reward beyond solicitation expenses or that require the inclusion of shareholder proposals that go beyond Rule 14a-8.[233] But they demonstrate the legislature's clear willingness to allow payments if adopted in a bylaw, which would likely extend to permitting initiation payment bylaws.[234]

C. Self-Implementing Initiation Payments

The likely resistance of directors and executives to implementing initiation payments makes it important not only that initiation payments can be privately ordered, but also that they can be privately ordered *by investors*.[235] The most straightforward and cost-effective method for investors to implement initiation payment bylaws is through shareholder proposals submitted under Rule 14a-8. There is precedent for such proposals. Several proxy reimbursement bylaw proposals have been put forward using Rule 14a-8, suggesting that investors may be willing to put forward initiation payment bylaw proposals in the same way.[236] Although Rule 14a-8 proposals are normally precatory, it may be possible that a successful precatory proposal is sufficient to convince directors to implement an initiation

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229. *See* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 238 (Del. 2008) (finding that a bylaw requiring reimbursement of solicitation expenses would violate Delaware law by committing the directors of the company "to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders"). More generally, see Christopher M. Bruner, *Managing Corporate Federalism: The Least Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 7–10 (2011); Jill E. Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 BROOK. L. REV.1637, 1658–61 (2016); Ben Walther, *Bylaw Governance*, 20 FORDHAM J. CORP. & FIN. L. 399 (2015) (discussing this tension between Sections 109 and 141(a)).

230. *CA, Inc.*, 953 A.2d at 229 (discussing the procedural history of the case).

231. *Id.* at 238 (stating that if the bylaw had been adopted, the Court would "start with the presumption that the Bylaw is valid and, if possible, construe it in a manner consistent with the law" and would "'exercise caution [before] invalidating corporate acts based upon hypothetical injuries'").

232. *See* DEL. CODE ANN. tit. 8, § 113; MODEL BUS. CORP. ACT § 2.06(c)(2) (AM. BAR ASS'N 2016).

233. *See* DEL. CODE ANN. tit. 8, § 113 (permitting provisions for "reimbursement . . . of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors").

234. This is also consistent with the preference of state law for permissive rules, as discussed in Section III.A.

235. *See* Hirst, *supra* note 192, at 243–45 (discussing "investor ordering").

236. Between 2006 and 2010, AFSCME submitted 15 proxy reimbursement proposals using Rule 14a-8. *See* GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 27–34 (2010); GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 24, 29, 31 (2009); GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 23–24, 30 (2008); GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 22, 29 (2007); GEORGESON, ANNUAL CORPORATE GOVERNANCE REVIEW 22–23 (2006) [hereinafter 2006 GEORGESON REVIEW]. These include the proposal to CA, Inc. that was the subject of the AFSCME litigation. *See* CA, Inc., 2008 WL 3291033 (SEC No-Action Letter July 17, 2008). Professor Lucian Bebchuk also submitted a proxy reimbursement proposal using Rule 14a-8. *See* 2006 GEORGESON REVIEW, *supra*, at 34, 37.

payment bylaw.[237] Directors may choose not to implement it, or to implement it in a weakened form.[238] But if so, Rule 14a-8 could also be used to put forward mandatory bylaws, which would overcome these issues.[239]

But relying on Rule 14a-8 proposals to implement initiation payments has two significant limitations. First, there is the familiar collective action problem described in Section D. Even assuming that investors are willing to submit Rule 14a-8 proposals for non-pecuniary reasons, they are subject to resource constraints, which will limit the number of companies at which they can submit such proposals.

Second, as discussed in Section 1, Rule 14a-8 proposals likely cannot be bundled.[240] Thus, it is not possible to use initiation payments to incentivize the submission of an initiation payment bylaw under Rule 14a-8. The result is that Rule 14a-8 could be a partial mechanism for implementing initiation payments at some companies, subject to the willingness of proponents to submit such proposals. But they are unlikely to be a complete solution.

The limitations of Rule 14a-8 for implementing initiation payments can be avoided if investors solicit their own proxies for an initiation payment bylaw proposal.[241] Most importantly, this would allow an investor to bundle a proposal to implement an initiation payment bylaw with a request for an initiation payment if it is successful. Bundled payment proposals have been included in solicitations for proxy contests in the past.[242] But the private costs of soliciting proxies have made it uneconomic to solicit proxies for a shareholder proposal without a director nomination.[243] Even though there is little precedent for such a solicitation, if the initiator expects the proposal to be successful, the prospect of an initiation payment means the private cost ceases to be a constraint.[244]

Bundling proposals in this manner would effectively make initiation payment bylaws self-implementing. Just as initiation payments overcome under-initiation, they can also be used to incentivize the initiation of shareholder proposals by implementing initiation payment bylaws. Initiation payment bylaws are themselves a corporate change. Therefore,

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237. For example, similar pressure was sufficient to cause companies to switch from plurality to majority voting. *See* Stephen J. Choi et al., *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119, 1124–29 (2016).

238. *See* Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329, 347–48 (2010).

239. *See* 17 C.F.R § 240.14a-8(d) (2020). Considerable parsimony would be required in drafting an initiation payment bylaw within Rule 14a-8's 500-word limit. *See id.* at 341–42 (discussing a similar problem with proxy access bylaws). But this is unlikely to be insurmountable. For examples where entire proxy access bylaws were drafted in less than 500 words to meet this requirement, see Wells Fargo & Co., Definitive Proxy Statement (Schedule 14A) (Mar. 15, 2012) (containing, in Item 6, a proposal for a proxy access by law of 405 words); CitiGroup, Inc., Proxy Statement (Schedule 14A) (Mar. 12, 2010) (containing a 137-word proposal for a proxy access bylaw by AFSCME). While a reimbursement bylaw would be more complex than a proxy access bylaw, it would clearly be possible to propose such a bylaw in fewer than 500 words, especially considering that the two examples of proposed proxy access bylaws listed here were well within this limit.

240. *See supra* notes 222–23 and accompanying text.

241. For a discussion of shareholder proposals "outside the ambit of Rule 14a-8," see THOMAS, *supra* note 34, at § 16.05.

242. For an example of a bundled reimbursement proposal, see Costa Brava P'ship III L.P., *supra* note 219.

243. *See supra* notes 81–83 and accompanying text (discussing the costs of soliciting proxies).

244. Indeed, the novelty of this approach means that the first few such campaigns would likely draw outsized attention, putting greater pressure on directors to adopt the initiation payment bylaw.

if a shareholder proposal requesting an initiation payment bylaw is expected to be successful, and an investor is expected to receive an initiation payment (greater than their private costs) for submitting such a proposal, the initiator would rationally choose to do so.

This discussion has assumed that initiation payments bylaws are permissible without an explicit charter provision.[245] Initiation, and self-initiation, would become more challenging if state courts were to require such a provision. Initiation, and self-initiation, *would* still be effective where they led directors to approve charter amendments to add such a provision.[246] Historically, directors have generally been willing to approve charter amendments following successful precatory proposals.[247] However, in a small number of companies, directors may refuse to do so.[248] If so, it would be necessary to conduct a proxy contest to replace some of the board of directors in order to implement initiation payments. Of course, a bundled initiation payment proposal could be used to incentivize investors to initiate such a proxy contest if they expected it to be successful.

The single, critical, requirement for privately ordered initiation payments is institutional investor support. One important implication of self-implementation is that institutional investor support is not only *necessary* for their success, it is also *sufficient*. Institutional investor support is necessary because, collectively, institutional investors hold substantial majorities of shares of most U.S. corporations.[249] If these investors support initiation payments, they will pass if put to a vote. And because the initiator of a self-implementing proposal will also receive an initiation payment, rational investors can be expected to initiate such proposals. Therefore, if institutional investors support initiation payments, then they will be implemented at all companies where institutional investors hold a majority of outstanding shares. The size and breadth of institutional investor portfolios make this the great majority of companies.

If institutional investors support initiation payment bylaws, then it may not be necessary for bylaw proposals to be voted on, or possibly even initiated.[250] If managers expect that initiation payment bylaw proposals will pass, many will settle with investors initiating such proposals and agree to implement initiation payment bylaws themselves.[251] And at some companies, the likelihood that an investor will initiate an initiation-payment bylaw which would then be settled or approved will lead the directors to preemptively implement such a bylaw themselves, obviating the need for an investor to actually initiate the bylaw.

The sufficiency of institutional investor support for their implementation makes initiation payments very different from other potential solutions for the under-initiation of corporate change. Solutions that also require director or executive support are unlikely to

245. *See supra* notes 228–34 and accompanying text (discussing Delaware law relating to bylaw requirements).

246. For evidence of preemptive director approval with moves to annual elections, which require directors to initiate a charter amendment, see Bebchuk, Hirst & Rhee, *supra* note 128.

247. *See id.* at 166–71 (discussing negotiated outcomes to shareholder proposals).

248. This would effectively prevent a charter amendment, which requires a resolution of the board of directors. *See* DEL. CODE ANN. tit. 8, § 242.

249. *See* Bebchuk, Cohen & Hirst, *supra* note 48, at 91–93.

250. *See infra* Section II.D.3 (discussing settlements and preemptive changes by managers).

251. For many examples of such settlements with respect to annual elections, see generally Bebchuk, Hirst & Rhee, *supra* note 128.

succeed, given their likely opposition.[252] Solutions that depend on legislative, regulatory, or judicial intervention rely on convincing those policymakers to implement the solution, against the opposition of managers and their powerful, well-funded lobby groups.[253] But all that is necessary for initiation payments to succeed is for institutional investors to recognize their benefits.

D. Self-Adjusting Initiation Payments

Just as privately ordered initiation payments would be self-implementing, they would also be self-adjusting. Adjustments to initiation payments are also corporate changes, so the same logic explained with respect to self-implementation would also make initiation payments self-adjusting. All that is necessary to adjust initiation payment amounts or mechanisms is for a majority of investors to change their views about what those amounts or mechanisms should be.

Consider a potential amendment to an initiation payment bylaw that institutional investors supported, such as an increase (or decrease) in the amount of the default payment. Investors will have an incentive to initiate an amendment to the bylaw, either with a shareholder proposal or by soliciting proxies; because institutional investors support the change, it will be approved, and the investor will be rewarded with an initiation payment.

The adjustment mechanism for changes that do not require amendments to initiation payment bylaws is even more direct. If a majority of investors change their collective views and initiating investors become aware of the change, the adjustment will be implemented. Consider the situation where several large institutional investors revise their views on a particular corporate change, such as requiring disclosure of certain carbon emissions, so that a majority of investors now support the change they had previously not supported. As soon as initiating investors become aware of the shift in investor support, they will have incentives to initiate changes of that nature.[254]

This has two important implications. First, by their very nature, initiation payments would be extremely dynamic and responsive to the views of investors—much more than other corporate governance mechanisms. As a result, any significant unforeseen costs resulting from initiation payments could be quickly remedied, simply by sufficient institutional investors recognizing those problems and changing their views accordingly.

Second, facilitating communication between institutional investors and initiating investors has the potential to significantly improve the feedback loop for investor initiation. It would reduce the incidence—and thus also the cost—of investors initiating changes that are subsequently rejected, and it would increase the speed with which investors initiate changes that are likely to be approved. If they support initiation payments, institutional

252. *See supra* Section I.A (discussing management opposition to investor initiation).

253. For a discussion of the vigorous opposition by director and executive groups to proxy access, which would also have encouraged investor initiation, see Bebchuk & Hirst, *supra* note 238, at 330–34.

254. The change in investor views could be communicated by investment managers through amendments to their voting guidelines, or through an investor forum such as the Investor Stewardship Group that aggregates the views of multiple investment managers. For a description of the Investor Stewardship, see *About the Investor Stewardship Group*, INV. STEWARDSHIP GRP., https://isgframework.org [https://perma.cc/G7CW-NXRW].

investors should thus also consider creating or improving forums or mechanisms for communicating their collective views on corporate changes to initiating investors.[255]

IV. INSTITUTIONAL INVESTORS AND INITIATION PAYMENTS

The fact that institutional investor support for initiation payments is the sole condition for them to be implemented, and thus for under-initiation to be eliminated, has an important implication. Whether or not institutional investors choose to support initiation payments—and thus, whether they are implemented—becomes an important test of whether institutional investors believe that there is under-initiation, and of their incentives regarding investor initiation of corporate change.

Institutional investors will be forced to reckon with the likely benefits and costs of initiation payments, and whether to support them when they are put forward. Because initiation payments can be implemented by private ordering, there will be no structured regulatory consideration of costs and benefits for investors to rely on. Instead, institutional investors will have to weigh the costs and benefits of initiation payments themselves. This Part is intended to be a starting point for such an analysis.

This Part outlines two types of costs and benefits for institutional investors from initiation payments, and hence, greater investor initiation. These lead to competing hypotheses about whether institutional investors will or will not support initiation payments. Section A considers the question of whether investor initiation of collectively-preferred corporate changes is likely to be good for investors in general. If institutional investors do not believe initiation payments to be in the interests of investors generally, they have good reason not to support initiation payments. Section B considers the private costs and benefits for institutional investors from initiation payments, separate from their effects on investors generally. Section C explains how these considerations map to the likely decisions of institutional investors, and thus, the inferences that can be drawn from the choices of institutional investors that we eventually observe, either to support or reject initiation payments. It also relates those inferences to the broader debate among scholars regarding the extent to which institutional investors support corporate changes that would be in the interests of their own beneficial investors.

A. The Costs and Benefits of Initiation Payments for Investors

At first glance, the effects on investor welfare of the initiation of corporate changes that investors collectively prefer may seem self-evident. If investors collectively prefer certain changes, then their welfare should be improved if those changes are initiated. However, this Section introduces the possibility that investors might make erroneous (or non-representative) decisions about their own welfare, and thus, which changes to approve or reject.[256] This creates four potential scenarios: (1) investors (correctly) approving changes that are actually good for investors; (2) investors (correctly) rejecting changes that

255. Current efforts include the Investor Stewardship Group, *id.*, and the Council of Institutional Investors. *See About CII*, COUNCIL INSTITUTIONAL INVS., https://www.cii.org/about [https://perma.cc/5Q4T-25T9] (describing the Council of Institutional Investors).

256. This creates a difficult issue of how we know what is actually in investors' best interests. This is difficult for two reasons. First, many investors in a company are likely to have very disparate interests. Second, whether the change is consistent with those interests often cannot be known for a long time.

would be bad for investors; (3) investors (erroneously) rejecting changes that would be good for investors; and (4) investors (erroneously) approving changes that would be bad for investors. Sections 1 to 4 consider the effects of initiation payments under each of these scenarios in turn, and compare them to the counterfactual where there are no initiation payments—and thus no additional incentives for investor initiation beyond the status quo. The focus of these Sections is on the welfare effects of investor initiation on investors, as that is likely to be of the greatest relevance to institutional investors' decision calculus. However, Section 5 briefly considers some questions regarding the welfare effects of corporate changes on *non-investors*.

1. Approving Beneficial Corporate Changes

The major potential benefit of initiation payments for investors is straightforward, and is the main claim put forward in Part II. If there is under-initiation of corporate changes that those holding a majority of corporate equity would collectively prefer, then initiation payments would lead to the initiation of those corporate changes. Because a majority of investors prefer those changes, they would support them if they were initiated and went to a vote, resulting in greater pressure on directors and executives to implement those changes, and thus a greater likelihood of those changes occurring. In the condition where changes that investors prefer (and support) are actually good for investors, then increasing the likelihood of those changes occurring is clearly also good for investors.[257]

2. Rejecting Harmful Corporate Changes

If initiating investors make accurate predictions of which changes other investors are likely to support, then initiation payments will not affect the welfare of investors in situations where investors (correctly) reject corporate changes that they do not prefer. Such rejections would not result in any payment to initiating investors, and so the possibility of initiation payments would not affect potential initiating investors' decisions regarding whether to initiate the change.

It is possible that initiation payments could lead to more initiations of corporate changes, if initiating investors erroneously believe that those changes are supported by investors. Since the initiation and approval process will also impose costs on the company and on investors, this might result in reductions in investor welfare. However, to the extent that these initiations occur at all, they are likely to be short-lived. The costs of initiating changes that are not supported (including initiation penalties for shareholder proposals) are likely to cause any initiating investors seeking initiation payments to update their analysis regarding which changes are likely to be supported.[258] The extent of erroneous initiation

257. The initiation and approval processes are likely to impose some costs on the company and investors. I include these in the calculus of the changes that are "good for investors." One potential edge case that might occur is that a change could have a small positive benefit for investors, but the quantum of that benefit may be *less than the cost of initiation and approval*. I classify these types of changes as those that are not "good for investors," and thus consider them along with other erroneous approvals in Section IV.A.4.

258. Initiation payments won't affect the initiation decisions of investors who submit shareholder proposals that they do not expect to be successful because of non-pecuniary benefits.

decisions could also be reduced by better communication and aggregation of investor preferences.[259]

3. *Rejecting Beneficial Corporate Changes*

Rejecting corporate changes that would actually be good for investors would reduce investor welfare. These can be understood as "false-negative" or "Type II" errors. However, because these changes are rejected, they will not result in initiation payments. Therefore, initiation payments will not make the false-negative problem any worse than it is under the status quo.[260]

4. *Approving Harmful Corporate Changes*

The main condition under which initiation payments could be costly for investors is if they lead to the initiation and approval (either by investors or by directors) of corporate changes that actually reduce investor welfare. These can be understood as "false-positive" or "Type I" errors. There are three different ways that false-positive errors could occur.

a. *Majority vs Minority Preferences*

One type of welfare-reducing change could arise where investors representing a substantial proportion of equity capital in the corporation oppose a change that is nonetheless approved.[261] If that is the case, it is possible that the reduction in welfare to those opposed to the change outweighs the benefits to those that support the change.

This is more of a theoretical problem than a practical one. It is not clear that there is a group of investors who would regularly expect to be on the losing side of shareholder votes. And even if there was, it would be difficult or impossible for them to show that their welfare losses outweigh those of approving shareholders, simply because it will be difficult to establish the magnitude of *any* investors' welfare gains or losses from the change.[262]

b. *Erroneous Investor Decisions*

A second type of false-positive problem could arise if investors representing a majority of the company's equity were consistently wrong about which changes would

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259. For a discussion of the importance of communicating institutional investor preferences, see *supra* note 255 and accompanying text.

260. There is also a possibility that initiating investors who recognize that these changes would be good for investors might initiate those changes and spend additional resources attempting to convince investors of their benefit. This is especially likely to be the case if initiation payments were offered for changes that narrowly fail, for example, those that receive more than 40% support from investors.

261. It is possible that investors representing a majority of equity capital could oppose a change that is nonetheless approved because some investors are unlikely to vote. Successful votes require the support of more than half of the shares voted. Thus, it is possible (a) that a change could be successfully approved by a narrow margin, and (b) the number of shares that were not voted that would have opposed the change is greater than the number that were not voted that would have supported it, by a greater margin than the margin of success. While this is theoretically possible, it would be difficult to determine whether this has actually occurred, as the preferences of those that did not vote will likely remain unknown.

262. To the extent that welfare gains or losses are non-pecuniary, it may also be difficult to even compare welfare gains and losses from different investors.

actually improve their own welfare. If both investors and managers are wrong about this, then management would initiate such changes whether or not there were initiation payments. So, the most relevant scenario is where managers know what is actually best for investors and investors do not. If that is the case, initiation payments would cause an investor to initiate the change, and it would be approved. This also suggests investors would need to make two errors—the substantive error regarding whether the change is in their interests, and an error in deciding not to believe management's arguments regarding why the change is *not* in their interests. Where directors and executives sincerely believe a proposed change is against investors' interests, they will have strong incentives to communicate that to investors, and to convince them to reject the change—both to safeguard investors' interests and because the change is also likely to be against their own interests. Many investors already give directors the "benefit of the doubt,"[263] or are excessively deferential to corporate managers. This suggests that they may be more likely to vote against these welfare-reducing changes, reducing the magnitude of the problem.[264]

If investors did nonetheless consistently vote for welfare-reducing changes against management recommendations—if investors were consistently wrong, or biased towards approving investor-welfare-reducing changes—this would represent a problem that went far beyond the proposal in this Article. Indeed, it would implicate the fundamental parts of corporate law and corporate governance that provide for shareholder voting in corporations. While scholars have suggested that investors may have biases towards being excessively deferential to managers, a serious case has not yet been made for systematic errors or biases that would lead investors to regularly approve changes (against management recommendations) that would reduce their own welfare.

Even if investors were to consistently support welfare-reducing corporate changes, the mechanisms of investor voting may reduce the magnitude of the problem. Directors and executives are likely to continue to point out investors' errors in approving those changes. Institutional investors regularly review and revise their own voting guidelines based on the outcomes they have achieved in the past. If investors considered that initiation payments were leading to types of corporate changes that were not welfare-increasing, those investors could change their policies to vote against those corporate changes in the future. This would make those changes less likely to pass, reducing the incentive for investors to initiate such changes.

A potentially pernicious version of the false-positive problem arises if directors and executives either approve welfare-reducing changes initiated by investors,[265] or if they preemptively implement such changes. This could occur if directors and executives expected investor campaigns to impose significant private costs on them, such that they would be better off agreeing to the change, even though the campaign would ultimately be unsuccessful. If this were to occur, it could be overcome by modifying the initiation

263. Vanguard, BlackRock, and State Street take this view. *See* European Corporate Governance Institute (ECGI), *Rethinking Stewardship*, YOUTUBE (Oct. 23, 2020), https://www.youtube.com/watch?v=mtMulZ9AOfE [https://perma.cc/PVS2-4934] (containing a statement by Richard Lacaille, CIO of State Street Global Advisors, that "some of the things that have been suggested as legitimate aims for stewardship, are really better described as roles of the board"); Bebchuk & Hirst, *supra* note 20, at 2059–71.

264. Bebchuk & Hirst, *supra* note 20, at 2059–71.

265. A variation on this problem could occur if managers agreed to *excessive* payments to investors as part of settlements for either value-increasing or value-reducing changes.

payment rule. Settlements approving welfare-reducing changes could be avoided by requiring that director settlements be approved by a vote of shareholders. And investors could initiate changes to reverse any value-reducing changes preemptively implemented by directors and executives.

c. Small-Benefit Changes That Are Net Costly With Initiation Costs

A special case of welfare-reducing corporate changes occurs if the change itself would be welfare-enhancing for investors, but in such a small quantum that is less than the cost of the initiation and approval process. Shareholder activism has been criticized on account of the time and effort directors and executives spend responding to requests for changes, which could distract them from managing the business of the corporation.[266] Other costs include the out-of-pocket costs that directors and executives incur in responding to changes, the costs investors incur informing themselves about corporate changes and evaluating them in advance of a vote, and the cost of the initiation payment if the change is approved.

However, there are three reasons why this may not present a substantial problem. First, as discussed above, many of the changes are likely to be approved by managers without going to a vote, and may even be initiated by managers themselves.[267] If so, the small-quantum benefits would still be positive. Second, investors could solve this problem simply by incorporating these costs into their voting calculus and voting to reject the changes.[268]

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266. *See* Lipton & Savitt, *supra* note 50, at 743–44; Theodore N. Mirvis, Paul K. Rowe & William Savitt, *Bebchuk's "Case for Increasing Shareholder Power": An Opposition*, 120 HARV. L. REV. F. 43, 44–47 (2005); Bernard S. Sharfman, *The Risks and Rewards of Shareholder Voting*, 73 SMU. L. REV. 849, 882–84 (2020).

267. *See supra* Section II.D.3.

268. A potential issue with investors' consideration of initiation and approval costs is that some of them are "sunk" before investors vote on whether to approve the change. Rational investors should thus disregard these costs in their calculus and approve the corporate change if the marginal future change in the value of the corporation from the change is positive. If a corporate change results in only a very small future value increase, the aggregate effect of the change may be negative if it was sufficiently costly to initiate and approve. This sunk cost problem is not specific to investor initiation but applies to all shareholder voting decisions. However, if investor initiation were to substantially increase the number of such decisions, it could exacerbate this problem.

Yet, the sunk nature of approval and initiation costs presents less of a problem than might appear. It only applies to the limited set of costs from the approval process, such as management distraction and investors costs, and does not include the costs to the initiator of initiating corporate changes. The latter are not sunk from the perspective of voting investors because they will only accrue to those investors if the company makes an initiation payment in the future, which will only occur if investors vote to approve the change. As a result, sunk cost problems will only arise where the benefit from a corporate change is even smaller, such that it is more than zero but less than approval and evaluation costs. And reducing the quantum of those costs further, discussed below, would also reduce the number of corporate changes where sunk costs pose a problem.

Investors can also overcome what remains of the sunk cost problem by incorporating their expectation of *future sunk costs* into their calculus. Larger investors that have long-term holding periods can rationally anticipate the effects of their voting decisions on future initiation, and therefore, on the amount of future sunk costs. Future sunk costs could be reduced by not voting for corporate changes that have very low positive value, lower than the expected costs of approval. Investors considering initiating corporate changes in the future would then take into account the reduced likelihood of success of those changes, and in many cases, decide not to initiate them. Large investors, of the kind that matter most for the approval of corporate changes, as well as the proxy advisors that assist them with voting decisions, have voting guidelines and heuristics for evaluating and revising those

Third, the initiation and approval costs of increased initiation may decline over time, thus reducing the number of small-quantum positive changes that are actually costly net of initiation costs. Indeed, a normative corollary of the discussion in this Article is that reducing the costs of initiation and approval should be a goal of the corporate governance system. Reducing initiation costs would increase the number of welfare-enhancing corporate changes that could be initiated, and it would also increase the aggregate benefit from corporate changes to investors. Investors can and should contribute to this process. One way to do so would be approving corporate changes designed to reduce the costs of initiation and approval. Initiation payments would facilitate this process, by encouraging the initiation of bylaws proposals that would reduce initiation costs, which investors could then approve. For instance, these could include bylaws that limit the cost of management distraction by capping the amount the corporation would pay for expenditures opposing investor-initiated corporate changes.

5. Non-Investor Costs and Benefits

The focus of this Section has been on how corporate changes—incentivized by initiation payments—would affect the welfare of investors. This is the most relevant consideration from a practical point of view, as investors themselves will determine whether to implement initiation payments. Any consideration of general welfare effects beyond investors is likely to be beside the point, as it is unlikely to influence the decisions of investors regarding whether to support initiation payments. However, this Section makes three brief comments about the likely general welfare effects of initiation payments *beyond* investors.

First, even if general welfare effects differ from the effects on investor welfare, there is some possibility that investors will internalize many of the costs and benefits of those changes on society as a whole, including stakeholders inside or outside the corporation. One reason is because other stakeholders *may also be investors*. Employees in the company may hold stock in the company. Investors are also part of the community. However, the weighting of their holdings as investors will be different from their interests as other stakeholders.

Second, investors may choose to take into account the effects of corporate changes on stakeholders other than themselves. Many have made the argument that corporations—and their investors—should consider outside stakeholders. Part of the reasoning for this is that it would increase the value of the company, and therefore create value for investors. To the extent this is the case, this is simply synonymous with investors' financial interest. But even if furthering the interests of external stakeholders is not in the financial interests of the company or investors, some investors may have non-pecuniary preferences for considering broader social interests. The need to take these into account is the reason why this Article has been framed broadly: to encompass *all* investor preferences, rather than their purely financial interests.

Finally, there is a difficult epistemological challenge with any claim that doing what is best for investors is bad for society as a whole. It is likely to be difficult to show that the

guidelines periodically based on new voting developments. These investors and proxy advisors already observe the results of their past votes and adjust their voting policies accordingly; adjustments to their voting calculus to avoid the effects of sunk approval costs could easily be incorporated into this process.

costs to other stakeholders outweigh the benefits that accrue to investors directly (and the potential benefits to other stakeholders, such as from improving the functioning of the capital markets). To do so, it would be necessary to quantify and compare these sets of costs and benefits. Given the limited data available on these costs and benefits, this is likely to be particularly challenging.

* * *

Putting these various categories together, the critical question for determining whether initiation payments are likely to be good for investors is whether the benefit of initiation (and approval) of changes that are welfare-increasing for investors is greater than the several possible categories that might lead to initiation (and approval) that investors erroneously believe to be welfare-enhancing. The above analysis has put forward several reasons why the costs of the false-positive problem could reasonably be expected to be limited. But ultimately it will be up to institutional investors to form their own views on this question.

B. The Costs and Benefits of Initiation Payments for Institutional Investors

Implementation of initiation payments depends on a particular group of organizations, institutional investors, which control the majority of equity capital in most corporations, and especially on investment managers, which are the largest institutional investors. This Section thus analyzes the relevant considerations for institutional investors in determining whether to support initiation payments—first the likely benefits to their own investors, and then what is likely to be in their own private interests.

1. Benefits to Their Own Investors

The first set of considerations for institutional investors are second-order versions of the analysis put forward in Section A regarding the effects of initiation payments on investor welfare in general. If the benefits from reducing under-initiation exceed the costs of investors' erroneous approval of welfare-reducing changes, investor initiation will serve the interests of institutional investors' own beneficiaries. If institutional investors believe that to be the case, then their support for initiation payments would be consistent both with their views of themselves as "stewards" of their clients' investments,[269] and with their fiduciary duties to act in the interests of those clients.[270]

If initiation payments enhance the value of their clients' investments, that would also have modest financial benefits for institutional investors. By increasing the value of their assets under management, it would increase the fees they receive, even though their small fee percentages mean that those increases may be relatively small.[271]

To the extent that institutional investors' clients recognize the benefits that initiation payments would provide, institutional investors may feel pressure from those clients to support them. If their clients and potential clients can discern the extent to which

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269. *See, e.g.*, BLACKROCK, *supra* note 5.

270. *See* TransAm. Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) (recognizing that the Investment Advisers Act of 1940 creates federal fiduciary standards to govern the conduct of investment advisers).

271. *See supra* note 100 and accompanying text.

investment managers support actions to increase value, they may threaten to shift their investments to investment managers that are more supportive of welfare-increasing changes, or away from less supportive investors.[272]

2. *Reducing Initiation Pressure*

A second benefit for institutional investors from initiation payments is that any pressure they may feel to initiate corporate changes would be relieved. Recent years have seen a vigorous debate among scholars, policymakers, and industry participants about the appropriate "investor stewardship" behavior of investment managers.[273] The largest investment managers may face pressure from their own investors and from others to be good stewards of their investments, or at least to be seen as such.[274] One of the ways that they have been urged to do this is, effectively, by initiating value-increasing corporate changes.[275]

However, if investment managers were to initiate corporate changes, they would face considerable costs. Most investment managers hold very broad portfolios, with stakes in thousands of companies.[276] Initiating changes at even a modest fraction of them would be a gargantuan task.[277] It may also impose substantial costs on the investment manager, which would be difficult to pass on to clients.[278] Perhaps most importantly, investment managers bear substantial private costs from initiating corporate changes, more than other investors.[279]

Initiation payments would eliminate this dilemma. Corporate changes would be initiated by other investors, so institutional investors would no longer face pressure to initiate corporate changes themselves or to bear the costs of doing so. Instead, their role would be reduced to evaluating and voting on corporate changes initiated by others.

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272. Bebchuk & Hirst, *supra* note 20, at 2072–73 (discussing the possibility of investors choosing investment managers based on the perceived quality of their stewardship).

273. For important recent contributions to this debate, see generally Gilson & Gordon, *supra* note 115; Bebchuk, Cohen & Hirst, *supra* note 48; Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17 (2019); Kahan & Rock, *supra* note 49, at 1776; Bebchuk & Hirst, *supra* note 20.

274. *See* Bebchuk & Hirst, *supra* note 20, at 2057–58 ("[S]ome index fund investors might well have a preference for investing with an index fund manager whose stewardship activities they view favorably.").

275. *See* Bebchuk & Hirst, *supra* note 20, at 2119–22 (exploring ways to encourage index fund managers to increase their investment in stewardship activities).

276. For instance, Vanguard held positions in more than 12,000 companies in 2020. *See* VANGUARD, INVESTMENT STEWARDSHIP 2020 ANNUAL REPORT 9 (2020), https://corporate.vanguard.com/content/dam/corp/advocate/investment-stewardship/pdf/policies-and-reports/2020_investment_stewardship_annual_report.pdf [https://perma.cc/V42E-TQZ4].

277. For instance, the Norwegian Finance Initiative—which is affiliated with one of the world's largest asset owners, the Norwegian Government Pension Fund Global—has sought to understand "how institutional investors can affect corporate governance at scale." *See New Research Project to Examine the Evolution of ESG Preferences of Large Institutional Investors*, EUR. CORP. GOVERNANCE INST., https://www.ecgi.global/news/new-research-project-examine-evolution-esg-preferences-large-institutional-investors [https://perma.cc/NB9P-GS9A] (describing a research project sponsored by Norges Bank aiming to investigate "how institutional investors can affect corporate governance at scale").

278. *See* Bebchuk, Cohen & Hirst, *supra* note 48, at 98 (describing how passing such costs on to investors by increasing costs are likely to lead investors to switch to competing investment managers).

279. *See supra* notes 107–08 and accompanying text.

Initiation payments would also sidestep proposed solutions to improve investment manager incentives to undertake stewardship or initiation changes.[280] Investment manager incentives arise from a complex regulatory and institutional environment.[281] Changing those incentives would include changing the rules and market structures that shape those incentives, to force investment managers to restructure their businesses.[282] Investment managers and their executives could be expected to strongly disfavor these changes, and to use their political influence to resist them. Initiation payments would eliminate the need to change investment manager incentives around initiation.[283] As discussed in Section 3, initiation payments would simplify the stewardship role of investment managers, to simply setting voting policies, and then voting on corporate changes initiated by others.

Of course, the extent to which this is actually of benefit to institutional investors depends on how much pressure they feel to initiate corporate changes. While this Section has suggested reasons why they might feel pressure to initiate corporate changes, it is also possible that these institutional investors believe that their current stewardship activities satisfy the need for them to initiate corporate changes, and they therefore feel no pressure to initiate any further changes.

3. Investment Managers as the Deciders

Initiation payments would strengthen the role of investment managers as the deciders of corporate changes. Investors who initiate changes would consider whether investment managers—who will generally determine the outcome of shareholder votes—would support the change if it went to a vote. Initiators are therefore likely to look to investment manager policies and previous voting decisions on possible changes. If these changes are not settled by directors and executives, institutional investors may have to vote on more matters than they would without initiation payments. On the one hand, this would give investment managers greater influence over the corporations they invest in. On the other, it is not clear that investment managers want this responsibility, which may impose additional costs on them.

Professors Kahan and Rock have argued that we should "let shareholders be shareholders."[284] These and other scholars argue that institutional investors play a valuable role in the corporate governance system by voting on—and effectively deciding—matters initiated by others.[285] Initiation payments would strengthen and extend the key mechanism that these scholars view as positive and beneficial—as Professors Kahan and Rock have

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280. For proposals aimed at changing investment manager incentives, see Bebchuk, Cohen & Hirst, *supra* note 48, at 94–104, 107–10; Bebchuk & Hirst, *supra* note 20, at 2050–71, 2075–2116.

281. For a discussion of many of these factors and their complexity, see generally Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2564 (2021).

282. A recent instance of investment managers using such power is BlackRock's public relations campaign responding to claims regarding the anticompetitive effects of common ownership. *See Common Ownership*, BLACKROCK, https://www.blackrock.com/corporate/insights/public-policy/common-ownership [https://perma.cc/24T9-6YDW].

283. It would also benefit policymakers by sidestepping what would otherwise have been a herculean task.

284. For the argument that we should "let shareholders be shareholders," see Kahan & Rock, *supra* note 49.

285. *See* Gilson & Gordon, *supra* note 115, at 896–902, 916–17; Kahan & Rock, *supra* note 49, at 1776, 1814.

put it, letting the "deciders" decide.[286] Indeed, Professors Gilson and Gordon have described how the agency costs of institutional investors require "a new set of actors" to complement their activities.[287] Initiation payments would incentivize exactly that. By incentivizing changes across the broad breadth of institutional investors' portfolios, initiation payments are also consistent with Professor Gordon's argument that diversified institutional investors should focus on addressing "systematic risk elements" in their portfolios.[288] However, none of these authors address how investment managers are likely to react to an expansion of their role as deciders.[289]

An expanded "decider" role could bring with it both direct and indirect costs for institutional investors. The direct costs for investment managers of having to cast additional votes are likely to be relatively small. Because they already cast votes at essentially all the shareholder meetings of their portfolio companies, they already have extensive guidelines and well-established internal processes that make their voting decisions efficient and cost-effective.[290]

Indirect costs to institutional investors from acting as deciders may be more significant. Voting decisions by investment managers are publicly observable, as are their voting policies.[291] Acting as deciders could create a dilemma for investment managers: supporting corporate changes may create private costs, while not supporting corporate changes may be viewed as inconsistent with their stewardship obligations and claims, by their own investors and by others. To limit the extent of this dilemma, these investment managers may prefer that fewer corporate changes are incentivized and initiated, which would mean that they would have fewer obligations to express their positions. That is, they may be reluctant deciders, and thus prefer that initiation payment bylaws fail.

Of course, this would suggest, troublingly, that investment managers might prefer to avoid incentivizing the initiation of changes that they expect to increase the value of their portfolios, and thus their own clients' investments. Even if this were actually the case, it is not clear that investment managers would risk taking public actions that clearly go against their oft-repeated goal of improving value for their own investors,[292] and potentially against their fiduciary duties,[293] especially if that fact were clearly pointed out. To do so, investment managers would need to develop a convincing narrative that initiation payments were against the interests of their own investors, which may be difficult.

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286. *See* Kahan & Rock, *supra* note 49, at 1814–15 (referring, approvingly, to institutional investors as "presumptive deciders," and advocate "letting shareholders be shareholders").

287. Gilson & Gordon, *supra* note 115, at 896–902.

288. *See* Gordon, *supra* note 57, at 629.

289. Marcel Kahan and Ed Rock have explained, convincingly, that investment managers are already the "deciders" of corporate changes, because of their substantial voting power. *See* Kahan & Rock, *supra* note 49, at 1780–81, 1814–15. However, it is not clear that investment managers desire this role.

290. *See, e.g.*, Bebchuk & Hirst, *supra* note 238, at 2089–91 (describing the voting processes of the Big Three investment managers).

291. *See* 17 C.F.R. § 270.30b1-4 (2021) (requiring investment companies to disclose their voting records annually).

292. *See, e.g.*, BLACKROCK, *supra* note 5, at 8 (describing BlackRock's goal of enhancing long-term value).

293. *See* SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 194 (1963) (interpreting 15 U.S.C. § 80b-6 (1940)).

C. Interpreting Institutional Investor Responses to Initiation Payments

An important contribution of initiation payments is that whether they are implemented effectively functions as a test of institutional investors' incentives, and their views about under-initiation.[294] That is, observing whether investment managers support or oppose initiation payments would allow us to make important inferences about much-debated questions of investment manager incentives, and about under-initiation.

If an investment manager supports initiation payments, we can infer three things. First, it suggests that they believe that there is under-initiation of collectively-preferred corporate changes. Second, we can infer that they believe that it would be beneficial for their investors if there were greater initiation of these corporate changes. Third, it also means that they prioritize potential benefits to investors from the increase in initiation of collectively-preferred changes over any private costs they may incur. This may be because these costs are actually small, or they believe that there will be substantial benefits to investors, or that there would be costs from *not* supporting initiation payments (such as from appearing to be bad stewards).

If an investment manager opposes initiation payments, it could mean any of three things. First, they may believe that there is no under-initiation of collectively-preferred corporate changes by managers. Second (and relatedly), they may believe that the costs to their own investors from increasing initiation of collectively-preferred changes are greater than their benefits.[295] Third, they may accept that there are benefits to their own investors from incentivizing initiation, but nonetheless oppose initiation payments because of the private costs that they would cause from expanding their "decider" role.

If an investment manager opposes initiation payments, then it will not be possible to definitively determine which of these reasons motivated their opposition. However, it is possible to make some comments about which of the three arguments are likely to be more plausible. In particular, the claim that there is no under initiation by managers is undermined by the fact that there are a number of corporate changes put forward each year by shareholder proposals and proxy contests that a majority of investors support.[296] For these changes to have been successful, many investment managers must have determined that they were consistent with investor preferences. In addition, many investment managers undertake engagement with directors and executives as part of their stewardship activities, which in some cases includes encouraging corporate changes. If managers initiated these changes themselves this would be unnecessary. The fact that an institutional investor has supported changes initiated by investors, or has encouraged changes by directors and executives, would suggest that they do not believe that managers initiate *all and only* collectively-preferred changes. It would also suggest that they believe that supporting investor-initiated changes can be in the interests of their investors. If that is the case, then

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294. Such a test requires that the initiation payments proposal be brought to the attention of institutional investors, which is one aim of this Article. It is possible that, rather than oppose initiation payments, institutional investors could simply try to ignore them. That could be easily remedied if initiation payment proposals were to be put forward by investors, effectively requiring institutional investors to determine whether they would support such proposals or not.

295. It is possible that the investment manager might believe that all collectively-preferred corporate changes are already being initiated. However, the arguments made in this Article would make it difficult for a reasonably informed investor to hold this position. *See supra* Part I.

296. *See supra* notes 74–76 and accompanying text.

it is possible that opposition to initiation payments could more plausibly be explained by the "reluctant decider" rationale.

CONCLUSION

This Article has proposed a concrete, tractable, and readily implementable solution to the problem of under-initiation of collectively-preferred corporate changes. If there is indeed under-initiation, initiation payments would eliminate it. Initiation payments for settled or successful proxy contests and for shareholder proposals would incentivize investors to use those mechanisms to initiate collectively-preferred corporate changes. Initiation payments could also be used to overcome key constraints on such initiation in Rule 14a-8.

These three types of changes could be implemented separately, but together they would target all three of the factors that give rise to under-initiation. Initiation payments for proxy contests would incentivize their use to initiate changes that would result in value increases below the very high threshold currently required for activist hedge funds. Initiation payments for shareholder proposals would eliminate the under-initiation of collectively-preferred changes that results from the non-pecuniary nature of current benefits to most initiating investors. And using initiation payments for private ordering of shareholder proposal submissions would allow them to be used for changes relating to the business or management of companies, while disincentivizing their use for value-reducing changes.

Implementing initiation payments through corporate bylaws would make them a realistic possibility, avoiding the legal and practical hurdles of implementation through federal or state rules. And because initiation payment bylaws are themselves corporate changes, they could also be incentivized with initiation payments, making them effectively self-implementing.

All that is necessary for initiation payments to be implemented is institutional investor support. The implementation of initiation payments thus serves as a test of institutional investor views regarding the under-initiation hypothesis, and also of their incentives to eliminate under-initiation. Institutional investor support for initiation payments would signal that they believe there are collectively-preferred corporate changes that are currently not initiated, that their own investors' welfare would be improved by overcoming such under-initiation, and that the benefits from doing so would outweigh any private costs to the institutional investors themselves from enhancing their "decider" role. If, on the other hand, institutional investors oppose initiation payments, it could be because they believe that there are no collectively-preferred changes that management does not initiate, or that the costs to their own investors from greater initiation would outweigh the benefits to those investors. But it is more likely because the responsibility of becoming "deciders" would bring with it private costs that would outweigh any benefits to their own investors from greater initiation.

Initiation payments may or may not resolve the problem of under-initiation. But by observing whether they do so, we stand to learn important information about under-initiation, and about institutional investors, which may help to resolve these important debates in corporate governance.