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Toward Unifying Ownership and Control in the Public Corporation

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ARTICLES

TOWARD UNIFYING OWNERSHIP AND CONTROL IN THE PUBLIC CORPORATION

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In 1932, Adolf Berle and Gardiner Means published the seminal book, *The Modern Corporation and Private Property*. This work set forth the thesis that corporate law's central dilemma has been the separation of ownership and control in publicly held corporations. Over the years, the Berle-Means thesis has been tossed aside by critics who argue that economic forces compel managers to act as if the shareholders were in control and by those who welcome the idea that managers are able to exercise their more enlightened business acumen. On the other hand, those who share concerns over the separation of ownership and control have had little luck in getting anything done to bridge this gap.

In this Article, Professor Dent seeks to rejuvenate the debate over the separation of ownership and control. To this end, he proposes a theoretically simple, yet realistic and quite workable solution to this dilemma: take away managements' control of the proxy voting system and give control to the publicly held corporations' largest shareholders.

I. INTRODUCTION

Since Adolf Berle and Gardiner Means published *The Modern Corporation and Private Property*[1] in 1932, corporate law's central dilemma has been the separation of ownership and control in public corporations. On one side are shareholders, the ostensible owners; on the other side are corporate officers, the shareholders' ostensible fiduciaries. Between them is a black hole: the board of directors. In traditional legal theory, the shareholders select the board, which manages the corporation. Berle and Means, however, showed that in an increasing number of large companies, management was not chosen by shareholders, but was a self-perpetuating oligarchy.

Some deny that the Berle-Means thesis is significant; even if shareholders do not control corporate managers exactly as traditional theory posits, economic forces compel managers to behave as if they were so controlled. Others accept and welcome the Berle-Means thesis, pro-

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1. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

claiming that managers exercise more enlightened control of huge corporations than would investors. Most observers, however, concede that the separation of ownership and control leads to economic inefficiency and mistreatment of shareholders. To remedy these problems, innumerable proposals have been floated to reform corporate governance. The central battleground in the corporate governance debate is currently the American Law Institute's (ALI) Corporate Governance Project.[2] This battle has now deteriorated into trench warfare, with proponents and critics battling over such trivia as the difference between a "reasonable" and a "rational" standard of care.[3]

The ALI Project and the monitoring model of corporate governance it embraces have much to offer corporate law. Critics, however, level many weighty arguments against them. More important, even the Project's champions do not hail it as a panacea. The fatal flaw of the ALI Project and other reform efforts is their failure to remedy the separation of ownership and control. The ALI's reporters would activate outside directors to serve shareholder interests by assigning them duties backed by the threat of legal sanctions. Unfortunately, legal sanctions are at best a clumsy substitute for self-interest. Criticism of the ALI Project may therefore be well-founded. Rejecting the ALI proposals, however, merely returns us to the status quo: the law of corporate governance focused on a board of directors that does not, and apparently cannot, perform any significant function.

This Article seeks to hurdle this increasingly sterile debate and find new solutions to the corporate governance problem. In short, separation of ownership and control stems from management's domination of proxy voting. Although commentators recognize this, most accept it as inevitable; shareholders are too numerous, scattered and indifferent to coordinate their voting. So long as management controls proxies, corporate governance reform efforts are doomed. An effective shareholder franchise, however, would remedy the separation of ownership and control and, with it, most other corporate governance problems. This Article analyzes the corporate governance impasse and proposes to unite ownership and control by transferring control of proxy solicitations to a committee of a corporation's largest shareholders. The Article concludes that such a change would ameliorate or eliminate many of

2. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS [hereinafter ALI PROJECT]. Tentative drafts covering several parts of the proposed principles have been approved by the ALI members. Approval of the entire proposal is not expected for several years.

3. ALI PROJECT § 4.01(c) comment (Tent. Draft No. 4, Apr. 12, 1985); Manning, *A Chat With a Martian*, N.Y.L.J., May 26, 1988, at 5, col. 1 ("[P]articipants often display passionate preference for one articulation of principle and outraged rejection of another which to onlookers—and later generations—look much the same").

the gravest problems of corporate law relating to tender offers, ineffective boards of directors, skewed executive compensation, shareholder derivative suits, and de-equitization.

II. SEPARATION OF OWNERSHIP AND CONTROL: A TAXONOMY OF CORPORATE THEORY

A. The Berle-Means Thesis

Corporate law has long provided that shareholders, the real owners of the firm, choose a board of directors to "direct" their business.[4] Because shareholders could select the directors, it was presumed that the board would serve shareholder interests by maximizing firm profits; indeed, the law obliged directors to do so.[5] The board designates officers to "act as agents of the board and execute its decisions."[6] In this "received legal model,"[7] ownership and control are not materially separated; the officers are subservient to the directors and the directors are responsible to the shareholders.

Berle and Means demolished this theory. They argued that in large public companies, managers had seized control from the shareholders, the ostensible owners.[8] Their insight was not original,[9] but Berle and Means, addressing a public receptive because of the stock market crash and the onset of the Depression, made it an axiom of corporate theory. Separation, they posited, resulted not from a conspiracy of managers, but from the pattern of stock ownership in public companies. Each shareholder owned few shares and lacked the means or inclination to participate actively in electing directors. The managers, who had both

4. M. EISENBERG, THE STRUCTURE OF THE CORPORATION 1 (1976). The classic statutory formulation was that "the business of a corporation shall be managed by its board of directors." W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 137 (5th ed. 1980). This requirement, which is not inevitable, seems to have grown out of practice and has not been universal. From 1862 to 1929, British law did not require a board. Kessler, *The Statutory Requirement of a Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696, 703-04 (1960). Many state statutes now permit closely held corporations to eliminate the board. *See, e.g.*, DEL. CODE ANN. tit. 8, § 351 (1983).

5. R. CLARK, CORPORATE LAW 679 (1986). In general, directors who fail to maximize profits are liable for breach of fiduciary duty. *See* H. HENN & J. ALEXANDER, LAW OF CORPORATIONS 621-63 (3d ed. 1983). Some limited exceptions are permitted, such as charitable contributions. *See id.* at 474-76.

6. M. EISENBERG, *supra* note 4, at 1.

7. The phrase is Professor Eisenberg's. M. EISENBERG, *supra* note 4, at 1.

8. A. BERLE & G. MEANS, *supra* note 1, at 4-5, 84, 86-88, 114.

9. Adam Smith first noted the phenomenon of managerial seizure of corporate control. A. SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 700 (E. Cannan ed. 1966). *See also The Separation of Ownership and Management*, in R. BROOKINGS, INDUSTRIAL OWNERSHIP AND MANAGEMENT (1925); T. VEBLEN, THE THEORY OF BUSINESS ENTERPRISE 157, 174-75 (1904).

means and motive, easily induced shareholders to elect a board subservient to the managers.[10] The directors, qua directors, did not direct.[11] Thus were ownership and control separated.

Berle and Means precipitated what remains the central controversy in corporate law.[12] Their thesis suggested that managers enjoy broad discretion in running public companies. Unconstrained by shareholders' demands for maximum profits, managers might be lazy or divert profits from shareholders to others, principally themselves.[13] This implied that economic production was inefficient.[14] It also implied that investors were being mistreated, which not only was unfair, but also meant that capital markets were inefficient.[15] Corporate law theory has since grappled with this problem, producing three kinds of responses: one denies that corporate managers have significant discretion; a second concedes discretion and applauds it; and a third concedes discretion but deplores it, and seeks to eliminate discretion by reforming corporate governance.

B. Rejecting the Separation Hypothesis: Executive Groups and Neoclassicists

Some commentators deny any significance to the Berle-Means thesis of separation and managerial discretion. These critics fall generally into two schools: business executives and neoclassical economists. The former group is represented by the Business Roundtable,[16] corporate lawyers and a few academics whose battle cry is: "If it ain't broke, don't fix it." In their view, separation of ownership and control, if it exists at all, has not impaired corporate performance; American companies are

10. A. BERLE & G. MEANS, *supra* note 1, at 4, 47-63, 84-89.

11. Although Berle and Means did not expressly make this point, it was consistent with their theory and had been noted before they wrote that non-officer directors, or outside directors, did not control management. Since the start of this century, critics have bewailed ineffectual directors. *See* Dwight, *Liability of Corporate Directors*, 17 YALE L.J. 33 (1907). *See also* Note, *Liability of the Inactive Corporate Director*, 8 COLUM. L. REV. 18 (1908). Directors who are also officers, inside directors, are effective, but as officers rather than as directors. Outside directors were, and still are, ineffective. *See infra* text accompanying notes 89-110, 118-19.

12. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 15 (1986). To celebrate the 50th anniversary of *The Modern Corporation and Private Property*, the Hoover Institution sponsored a conference on the continuing debate over the book. *See Conference: Corporations and Private Property*, 26 J. L. & ECON. 235-496 (1983).

13. A. BERLE & G. MEANS, *supra* note 1, at 7, 119-25, 222-27 & 230-35 (discussing self-dealing and inside trading).

14. *Id.* at 8-9.

15. If managers are free to shirk responsibility and divert profits, investors will be loathe to purchase corporate shares, and there will be sub-optimal investment in stock. *See infra* notes 173-74.

16. STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" (1983) [hereinafter BUSINESS ROUNDTABLE STATEMENT].

soundly managed. Reformers, they claim, misread corporate actions by viewing them with hindsight and ascribing all unsuccessful risk-taking to managerial mistakes. They portray corporate executives not as enjoying the broad discretion and carefree existence suggested by Berle and Means, but rather as beleaguered by powerful interests, including labor, suppliers, consumers, political activists and government bureaucrats. They argue that few managers shirk responsibility or divert profits, that managers who do so are usually punished or fired by fellow managers, and that outside directors furnish further discipline in the rare cases where it is needed.

The second group that belittles the Berle-Means thesis consists of neoclassical economists. While conceding that shareholders rubber stamp managements' board nominees, they claim that economic forces compel managers to maximize profits[17] as shareholders would if they controlled the firm. As a corollary, they posit evolution of corporate forms through survival of the fittest: "[a]bsent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs."[18] Thus, "there is no systematic defect in corporate governance."[19] Product and capital markets, they claim, provide restraint. So do managers' compensation schedules: by basing compensation on performance, corporations motivate managers to maximize profits, or share value. Most important are corporate takeovers; mangers who let profits dwindle invite a takeover by a corporate raider who will oust them.[20]

17. "Maximization of profits" does not adequately describe the firm's goals because it fails to distinguish between the short and long term, or to suggest how future profits are to be discounted to present value. "Maximization of share value" is sometimes used to overcome these problems.

18. Fama & Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 301 (1983). *See also* Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 416, 418-19 (1983) (the most efficient corporate law rules, including proxy rules, "survive").

19. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1260 (1982). *See also* N. WOLFSON, THE MODERN CORPORATION: FREE MARKETS VERSUS REGULATION (1984); Baysinger & Butler, *Revolution Versus Evolution in Corporation Law: The ALI Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 560-66 (1984); Demsetz, *The Monitoring of Management*, in BUSINESS ROUNDTABLE STATEMENT, *supra* note 16, at B-1, B-6 ("The board of directors can do very little to improve on the powerful incentives that presently guide management to serve the interests of shareholder."); Hessen, *The Modern Corporation and Private Property: A Reappraisal*, 26 J. L. & ECON. 273, 285-89 (1983). These commentators do not claim that corporate governance is now perfect. Rather, they believe that "marginal conditions prevail, and we therefore observe monitoring and bonding by officers, directors and shareholders until the marginal cost of an additional increment of monitoring just equals the expected marginal benefits." Letter from Professor Jonathan R. Macey to George W. Dent, Jr., Feb. 8, 1989 (on file with the *Wisconsin Law Review*) [hereinafter Macey Letter].

20. The seminal work is Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). *See also* Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

Defenders of the status quo are right that reformers often exaggerate corporate deficiencies; most American corporations have performed fairly well. Most corporate managers and outside directors are competent, attentive and honest. Nonetheless, the Panglossian complacency of "If it ain't broke" is unjustified. Among managers, as in any group, some are incompetent, lazy or venal, and even an adequate manager is not necessarily the best person available. More important, human nature dictates that most people, managers included, cannot be objective when their own interests are at stake; no one can be her own judge. Finally, outside directors do not effectively constrain management.[21]

Economic constraints do not close the gap created by the ineffective board. Product markets discipline managers only by threatening bankruptcy. Even in a competitive industry, however, a firm may survive indefinitely with a venal or incompetent management. If profits shrink, shareholders, the tax man, employees and creditors bear much of the loss.[22] Bankruptcy will not scare managers who can maintain control or retire. Even when bankruptcy does discipline managers, it does so only at great costs to investors, employees and others.

Compensation schedules discipline managers only if they are tied to the managers' performance. Even when well designed, compensation is an imperfect motivator because managers get only a tiny fraction of their labors' benefits.[23] Moreover, compensation schedules are difficult to design. It is hard to observe and measure a manager's individual performance; therefore, some measure of firm performance, such as earnings or stock appreciation, is generally substituted.[24] These, however, reflect many forces other than the efforts of one officer or all officers together. Because managers are risk averse,[25] incentive compensation may even backfire. Managers may shun risks attractive to shareholders and pursue steady, albeit modest, returns that will assure steady compensation. If their compensation were fixed, managers might be more willing to undertake greater risks.[26] Finally, compensa-

21. *See infra* text accompanying notes 89-110, 118-19.

22. Lower profits reduce income taxes at both the corporate and shareholder level. Because labor markets are not perfect and frictionless, employees may accept lower compensation from an unprofitable firm. Creditors may accept less than full payment in a voluntary reorganization, rather than force the company into a lengthy, costly bankruptcy.

23. *See infra* note 165.

24. For example, many firms give bonuses based on earnings, stock options and stock appreciation rights, which reward officers based on appreciation of the firm's stock. *See* R. CLARK, *supra* note 5, at 201-19.

25. *See infra* text accompanying notes 45-52.

26. Coffee, *supra* note 12, at 18, 24 (compensation tied to firm performance makes managers more risk averse); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 869, 875-76 (1983).

tion does not discipline effectively because managers can shape their compensation schedules to their own benefit.[27]

Capital markets discipline managers only when they need outside funds. Most companies can survive and even grow with internally generated capital; managers of public companies are almost obsessive about retaining earnings.[28] Even when necessary, outside financing does not fully constrain managers. For debt financing, lenders care only whether the firm can pay principal and interest when due; they care little whether the firm maximizes profits, and they even share the managers' distaste for risks that might appeal to shareholders.[29] New equity financing by public companies is extremely rare and does not constrain managers; if firm profits are low, the price of the new stock will also be low, but that has little effect on managers.[30] Neoclassical economist posit that if profits ebb because of managerial dishonesty or slack, the firm's share price will fall. A corporate raider can then offer a premium for the devalued stock, seize control, oust the incumbent managers, and profit by reviving the firm.[31] Ironically, the sharpest critics of this exalted view of hostile takeovers are corporate executives, the neoclassicists' fellow critics of the managerial discretion theory.[32] Executives decry hostile takeovers as a disaster for all the target's constituencies, including its shareholders. Although this view is flawed,[33] it is true that takeovers do not curb managerial discretion.

First, tender offers do not strike all mismanaged companies, and only mismanaged companies. Share prices do tend toward fundamental values over time; however, substantial variations may persist for long periods.[34] A well-managed company may be undervalued and attract a

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27. *See infra* notes 54, 108.

28. *See infra* notes 50-52.

29. For example, the radical leveraging of many companies in recent years increased their stock prices but devastated the value of their debt. *See* Coffee, *supra* note 12, at 51.

30. Companies that raise outside capital prefer debt because it is cheaper (share purchasers demand higher returns than lenders) and does not increase the firm's exposure to takeovers. Thus, one study of 12 large industrial companies found that of the capital funds they invested over a decade, 74% came from retained earnings, 26% from long-term debt and none from new stock issues. G. DONALDSON, MANAGING CORPORATE WEALTH: THE OPERATION OF A COMPREHENSIVE FINANCIAL GOALS SYSTEM 45-46 (1984). *See also* W. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY 69-70, 79 (1965).

31. Jensen & Ruback, *supra* note 20; Manne, *supra* note 20; Manne & Ribstein, *The SEC v. the American Shareholder*, NAT'L REV., Nov. 25, 1988, at 26, 27.

32. Fogg, *Takeovers: Last Chance for Self-Restraint*, HARV. BUS. REV., Nov.-Dec. 1985, at 30; Williams, *It's Time for a Takeover Moratorium*, FORTUNE, July 22, 1985, at 133.

33. Jensen & Ruback, *supra* note 20. Takeovers benefit shareholders by generating large premiums. The possibility of takeovers also helps to keep up stock prices.

34. A firm's "fundamental value" represents the present value of all anticipated future earnings. *See* L. LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 53-54, 130-31 (1988); Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 902-08,

raider, while a poorly managed company may not. If a low stock price reflects poor management, the damage done may be so irreparable that no raider will try to salvage the firm. Thus, raiders do not invariably or even generally pursue poorly run companies.[35] Acquirers frequently overbid a firm's fundamental value,[36] so that even efficient management and high stock prices do not insure against takeovers. Moreover, the randomness of tender offers blunts their effectiveness in deterring managerial slack. Managers may even become demoralized rather than motivated by the threat of a takeover.[37]

Similarly, a successful takeover does not guarantee optimal management. Acquiring firms are not noticeably more profitable than targets and do not generally increase the profits of acquired firms.[38] Although the evidence here is necessarily soft, the conclusions do cast doubt on the neoclassicists' view of takeovers as a panacea. Management techniques are not standardized. Rather, managers tend to be firm or industry specific; what worked for a raider in one business will not necessarily work with the target.[39] The bidder's management may not be especially competent at all. Significantly, in a bidding contest, the victor may be not the bidder who can best manage the target, but the bidder most willing to injure itself by bidding more than the value of the target.

Third, managers of targets can avoid much of the sting of takeovers by obtaining golden parachutes that grant them rich payments in case of an unsolicited takeover. Golden parachutes may be fair and even desirable for shareholders,[40] but they also diminish the disciplinary power of takeovers.

Fourth, tender offers are expensive and risky, and target managers can force up the costs and risks in several ways. Poison pills and other

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920-25 (1988); *cf.* Wang, *Some Arguments that the Stock Market is Not Efficient*, 19 U.C. DAVIS L. REV. 341 (1988) (questioning the accuracy of stock market prices).

35. L. LOWENSTEIN, *supra* note 34, at 134-35; Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1211-12 (1984) (citing surveys of bidders).

36. Dent, *Unprofitable Mergers: Toward a Market-Based Legal Response*, 80 NW. U.L. REV. 777, 778-79 (1986).

37. Coffee, *supra* note 35, at 1238-43.

38. L. LOWENSTEIN, *supra* note 34, at 131-38 (studies show that targets have return on equity and return on capital at least as high as those of bidders).

39. Hedlund, The Role of the Institutional Investor in the Governance of the Corporation: An International Overview 3-4 (May 23, 1988) (unpublished manuscript presented at a conference at Columbia University entitled "The American Corporation and the Institutional Investor: Are There Lessons from Abroad?") [hereinafter Columbia Conference] (on file with the *Wisconsin Law Review*).

40. Golden parachutes may prevent a raider from breaching the managers' implied contract for back-loaded compensation. *See* Coffee, *supra* note 12, at 75-81. They also induce managers to invest their human capital in a firm, rather than go elsewhere, and dissuade them from opposing attractive tender offers. Both benefit shareholders.

shark repellents can radically raise the costs of tender offers, thereby shrinking the disciplinary threat. Some defenses not only discourage a raider, but harm the target. A company that fears its cash reserves may attract raiders, for example, can drain the cash in unwise acquisitions.[41] Then, the disciplinary stick not only misses the miscreants, the target managers, but the diverted blow strikes the intended beneficiaries: the target's shareholders. State legislatures have welcomed these defenses, and have created new ones by statute.[42] But this does not mean that tender offers are on balance detrimental or useless as a disciplinary tool. They do oust some incompetent managements and, more important, spur others to pay attention to shareholders. The many corporate restructurings undertaken in recent years show the influence of takeovers.[43] But tender offers are not panacea. The huge premiums over market price in takeovers, which routinely exceed 50 percent, imply two important facts: first, such large premiums are hard to explain unless they reflect, in part, some slack in target management; second, a firm can endure significant slack before becoming a takeover target.[44]

The weakness of economic constraints on management discretion would prompt no concern if the interests of managers and shareholders coincided. However, their interests often diverge. Managers fear risk more than shareholders do because managers cannot diversify their investment of human capital as shareholders can diversify their investments of money. Stuck with their eggs in one basket, managers treat that basket cautiously.[45] Managers, therefore, pursue growth rather than maximum share value. Growth appeals to managers because it justifies larger compensation and executive perquisites, confers pres-

41. Black, *Bidder Overpayments in Takeovers*, 41 STAN. L. REV. 597, 612 *et passim* (1989) (discussing theory "that firms with 'free cash flow' (cash flow in excess of that required to fund the firm's positive net present value projects) tend to waste that cash flow on excessive growth—including growth through acquisitions—rather than return it to shareholders"); Panter v. Marshall Field & Co., 646 F.2d 271, 294 (7th Cir. 1981) (takeover target exhausted spare cash with acquisitions).

42. *See infra* note 160.

43. Fear of takeovers has forced many managements to forgo unprofitable growth and low debt by selling assets, making payouts to shareholders, and refinancing with debt. *See* Coffee, *supra* note 12, at 41-52.

44. Kraakman, *supra* note 34 (discussing discounts and discretion). *See generally* W. MCEACHERN, MANAGERIAL CONTROL AND PERFORMANCE (1975) (performance of management-controlled companies tends to lag somewhat behind that of management-owned and investor-controlled companies).

45. W. MCEACHERN, *supra* note 44, at 7-20; Coffee, *supra* note 12, at 15-23, 68; Marcus, *Risk-Sharing and the Theory of the Firm*, 13 BELL J. ECON. 369, 373-75 (1982); Oesterle & Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 230-31 (1988).

tige, promises more promotions, diminishes risk, and protects the firm from raiders by increasing the cost of a takeover.[46]

The fear of risk and preference for growth show up in corporate planning, financing and dividend policies. Shareholders prefer high leverage because it increases share values.[47] Managers dislike debt because it increases the risk of bankruptcy and wide swings in corporate earnings, which in turn affect performance-based compensation. Some managers also act to increase current earnings, despite injury to the firm, because their compensation is often tied to earning.[48] Investors, especially institutions, willingly assume the greater risks of leverage because the statistically predictable failure of a few investments in their diversified portfolios is outweighed by the equally predictable success of many others.

Shareholders also want dividends.[49] Managers prefer to retain earnings to permit growth without outside financing.[50] This preference is so pronounced that some studies find that returns on retained earnings approach zero.[51] In general, managers have prevailed; dividends of American corporations have been very low. Managers seeking

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46. W. BAUMOL, ECONOMIC THEORY AND OPERATIONS ANALYSIS 383-85 (4th ed. 1977); G. DONALDSON, *supra* note 30, at 37; O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

47. Interest on debt is deductible for federal income tax purposes and returns on debt are lower. Therefore, refinancing with debt often increases earnings per share. Higher debt also increases the risk of loss, but the shareholders foist some of this risk onto employees, trade creditors and prior lenders.

48. For example, many public companies still use first-in, first-out accounting, even though it does not increase real earnings but only results in higher taxes than last-in, first-out accounting. *See* Lowenstein, *Pruning Deadwood in Hostile Tender Offers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 288-89 (1983). Management-controlled companies often magnify reported earnings despite resulting higher taxes. *See, e.g.*, Kamin v. American Express Co., 86 Misc. 2d 809, 383 N.Y.S.2d 807, *aff'd on opin. below*, 54 A.D.2d 654, 387 N.Y.S.2d 993 (1976) (suit alleging that board gave up tax benefits by spinning off rather than selling depreciated assets in order to maximize officers' earnings-based compensation).

49. This preference seems to be tied to managerial discretion. Dividends may be one way of forcing managers to submit plans for growth to the monitoring of outside investors who would finance growth only if it promised to be profitable. *See* Booth, *Junk Bonds, the Relevance of Dividends and the Limits of Managerial Discretion*, 1987 COLUM. BUS. L. REV. 553; Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 654 (1984).

50. G. DONALDSON, *supra* note 30, at 45-46; Coffee, *supra* note 12, at 20-22. *See also supra* note 30. Executives even opposed ending the double taxation of dividends because it would increase shareholder pressure for dividends. *See Why Washington May Not Lay a Glove on LBOs*, BUS. WK., Feb. 6, 1989, at 86.

51. Baumol, Heim, Malkiel & Quandt, *Efficiency of Corporate Investment: Reply*, 55 REV. ECON. & STATS. 128 (1973); Baumol, Heim, Malkiel & Quandt, *Earnings Retention, New Capital and the Growth of the Firm*, 52 REV. ECON. & STATS. 345 (1970) (during 1948-59, returns on retained earnings for U.S. companies averaged between 3% and 4.6%; for firms that issued little new equity, returns approached zero). *See also* M. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY 233-37 (1987) (reviewing the literature and discussing studies showing frequent damage to acquiring firms).

growth sometimes knowingly pursue unprofitable transactions. Corporate acquisitions are often disadvantageous and even devastating for the acquiring company; yet such deals are far too frequent to be written off as errors of judgment.[52]

Managerial and shareholder interests also diverge over executive compensation. Managers want high pay for little work; shareholders favor the opposite. Executive compensation in owner-controlled firms equals or exceeds that in management-controlled firms.[53] Public firms, however, provide more sumptuous executive perquisites, such as luxurious facilities and offices, staff, and corporate jets.[54] Counting perquisites, executive compensation in public companies is much higher.

The interests of executives and shareholders diverge most dramatically in takeovers and management buyouts. Despite accusations of many executives that tender offers are no boon to target shareholders,[55] even sophisticated shareholders approve of tender offers. Investors may also want reforms that encourage competitive bidding and ease the shareholders' collective action problems in order to obtain the maximum possible premium.[56] Managers, however, often construct defenses to thwart all bids, rather than to extract the highest premium. These measures so damage investor interests that even normally passive

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52. Black, *supra* note 41, at 616-23; Dent, *supra* note 36, at 780-81 (discussing studies showing frequent damage to acquiring firms).

53. W. McEachern, *supra* note 44, at 7-20, 65-66, 80, 86-87 (reviewing prior literature). In management-owned companies, the managers control through stock ownership. In management-controlled companies, managers lack sufficient stock to exercise direct control, but maintain control through the proxy mechanism. *See infra* notes 121-42 and accompanying text. In investor-controlled companies, one or a few large shareholders control the board but do not manage the company; officers are hired to manage but do not control. W. McEachern, *supra* note 44, at 60.

54. W. McEachern, *supra* note 44, at 65-66, 80, 86-87. Kohlberg, Kravis & Roberts, the acquirer in the RJR Nabisco buyout, estimated it could save $100 million per year just by retiring RJR's fleet of planes. Helyar & Burrough, *How Underdog KKR Won RJR Nabisco Without Highest Bid*, Wall St. J., Dec. 2, 1988, at A1, col. 6. Choice of location for corporate headquarters can also be expensive. Of 38 firms that left New York City in recent years, 31 moved to within eight miles of the CEO's home, even though those firms lagged in economic performance behind those that remained. *See* W. Whyte, City: Rediscovering the Center 287-97 (1989). This suggests that these CEO's put their personal convenience over firm profitability.

It is unclear why managers of public companies prefer indirect compensation. Perhaps threats of lawsuits and adverse publicity among shareholders, employees and public officials encourage managers to opt for indirect compensation because it is harder to detect and measure. *See* W. McEachern, *supra* note 44, at 13-14.

55. *See supra* note 32.

56. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 Harv. L. Rev. 1693 (1985); Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concepts*, 34 Stan. L. Rev. 775 (1982); Lowenstein, *supra* note 48, at 317-34. *But see* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1981) (competitive bidding injures investors by discouraging initiation of takeover bids).

shareholders oppose them.[57] The managers' success in adopting anti-takeover measures is the strongest evidence of managerial discretion.

Many managers responded to takeovers by offering to buy out public shareholders with borrowed money and take their companies private. Leveraged management buyouts do generate premiums, but do not always maximize shareholder returns.[58] Managers cannot be impartial in buyouts because they have such heavy interests at stake. Outside directors are poorly positioned to bargain with management; their access to information and knowledge of the firm and its industry are inferior to those of management. Further, they naturally defer to management. Thus, managers have significant discretion in timing and structuring these deals.[59]

In sum, the Berle-Dodd thesis is valid and significant: managers of public companies are not tightly controlled by shareholders, outside directors or economic forces, but enjoy considerable discretion. This discretion varies among public companies and commentators disagree about its breadth. However, most agree that it is significant.

The motto, "if it ain't broke, don't fix it," reflects a fatal smugness in American businesses. When a firm is broke, it may be beyond repair. Although most public corporations are not "broke," there is plenty of room for improvement. Corporate governance plays as great a role in the economy as product development, marketing and finance. Excessive managerial discretion not only cheats investors, it is inefficient and undermines our economy. Means to reduce it should be sought.

C. Support for Separation of Ownership and Control: Managerialism

Some commentators welcomed the news that corporate managers had freed themselves from shareholder domination.[60] In this "managerialist" view, large corporations are not private enterprises, but social institutions accountable not only to shareholders but to many constituencies, including creditors, consumers, employees, suppliers and the communities in which the firms operate. Shareholders, obsessed with profits, would slight other constituencies. Managers, however, take a broader perspective that balances the needs of the firms' many publics. Reflecting this view, many state legislatures have

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57. *See infra* text accompanying notes 139-42.

58. L. LOWENSTEIN, *supra* note 34, at 183-86.

59. Oesterle & Norberg, *supra* note 45, at 218-20, 235.

60. Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932). *See also* Donaldson, *Financial Goals: Management v. Stockholders*, 41 HARV. BUS. REV., May-June 1963, at 116; Manning, *Book Review*, 67 YALE L.J. 1477, 1477 (1958). Some commentators embrace managerialism only indirectly; they do not expressly praise it, but they criticize forces that limit managerial discretion. *See* Reich, *Leveraged Buyouts: America Pays the Price*, N.Y. Times, Jan. 29, 1989 (Magazine), at 32.

adopted statutes permitting directors to consider other constituencies when weighing a takeover bid.[61]

Most commentators have not been so sanguine about managerial discretion. In a classic debate with Dodd, Berle himself argued against vesting broad power in self-selected business managers with no more than a "pious wish" that something good come of it.[62]

Experience confirms that managers do not exercise discretion for the good of society. While managers probably contribute more to charities than shareholders would, they do not otherwise display notable beneficence. For example, management buyouts produce no more favorable treatment for employees or communities than takeovers by corporate raiders, who are so often maligned for their cold-heartedness.[63] For the most part, managers have used discretion to benefit themselves.[64]

Even if managers showed greater social sensitivity than investors, managerialism would still be objectionable. In a democracy, decisions about spending other people's money are made by elected officials. Vesting broad discretion over social policies in a self-selected corporate oligarchy violates this principle. Taxpayers as well as shareholders pay for this discretion because reduced profits from discretion generate lower tax revenues; taxpayers, however, have no say in how the discretion is exercised. Corporate managers tend to fund noncontroversial activities, such as public television and museum shows. Shareholders

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61. Johnson & Million, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846, 848-50 (1989).

62. Berle, *For Whom Corporate Managers* Are *Trustees: A Note*, 45 HARV. L. REV. 1365, 1368 (1932). Berle's later "concession" has been misconstrued. He conceded that "[t]he argument has been settled . . . squarely in favor of Professor Dodd's contention." A. BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954). He was only recognizing that the law permitted managers to consider social concerns as well as profit. He never conceded, however, that Dodd was right as a matter of policy. *See also* M. EISENBERG, *supra* note 4, at 19 ("it is only the shareholders' role that prevents . . . a de jure self-perpetuating oligarchy"); *id.* at 120-21 (there is no reason to believe that managers will use discretion "selflessly and wisely").

In *The Modern Corporation and Private Property*, Berle and Means were ambiguous about managerialism. They argued that

> [w]hen a convincing system of community obligations is worked out and is generally accepted, in that moment the passive property right [i.e., the rights of shareholders] must yield before the larger interests of society. Should the corporate leaders, for example, set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business, all of which would divert a portion of the profits from the owners of passive property, and should the community generally accept such a scheme . . . , the interests of passive property owners would have to give way.

A. BERLE & G. MEANS, *supra* note 1, at 356. Although this passage contemplates managers diverting profits to social objectives, it also contemplates public approval to enact such a program. Accordingly, it seems consistent with Berle's criticisms of true managerialism, and therefore is more of an alternative vision for corporate reform.

63. Oesterle & Norberg, *supra* note 45, at 237-39.

64. *See supra* text accompanying notes 45-51. Because of these problems, advocates of social responsibility have often pursued other reforms. *See infra* text accompanying notes 69-73.

and taxpayers might prefer different priorities, and entertain alternative notions of social responsibility. Managerial discretion would also sabotage the market mechanism, thereby injuring not only investors but also the intended beneficiaries, such as consumers and employees.[65]

Some commentators support managerial control because shareholders' view of corporate policies is too short term. Unlike other managerialist views, this position praises managerial control as beneficial for shareholders rather than, or as well as, for other interest groups. This argument will be discussed below because it bears on the proposal advanced in this Article.[66]

D. Deploring Separation: Corporate Reformers

Most commentators accept the Berle-Means thesis, but many, including Berle and Means,[67] have mixed or unclear goals. In the last category are proposals, made for over a century, for federal incorporation of public companies. These proposals spring from dissatisfaction with state regulation.[68] Federal incorporation is not an end in itself; rather, it is a means to the other goals of managerial responsiveness to shareholder and social needs.

Social responsibility proposals have foundered for three reasons. First, proponents often disagree about what, if anything, social responsibility means beyond a duty of the firm to obey the law. Proposals have urged greater responsibility to the environment, racial minorities, women, employees, consumers, suppliers and communities in which the firm operates inter alia. However, proponents have not agreed on how to serve these disparate and often conflicting interests.[69] Employees and consumers, for example, would clash over prices for the firm's products. In addition, proponents have not fashioned mechanisms to achieve their goals. For example, in the 1970s, Ralph Nader and others

65. *See infra* notes 71-73.

66. *See infra* text accompanying notes 211-30.

67. Much of their volume is devoted to decrying the erosion of fiduciary standards. A. BERLE & G. MEANS, *supra* note 1, at 220-76. They close, however, with an argument that social concerns may override shareholder interests. *Id.* at 356. *See supra* note 62.

68. The most recent wave of federal incorporation proposals took place in the 1970s and began with an article by former Securities and Exchange Commission Chairman William Cary: Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). He argued that the states, led by Delaware, were engaged in a "race for the bottom" to attract franchise fees. *Id.* at 666. In this race, the states competed to enlarge managerial power at the expense of shareholders. He proposed not federal incorporation, but federal minimum standards for state incorporation. *Id.* at 665-66. His proposal spawned others. *See, e.g.*, Nader, *The Case for Federal Chartering*, in CORPORATE POWER IN AMERICA 67, 84-90 (1973); Schwartz, *The Case for Federal Chartering*, 31 BUS. LAW. 1125 (1976).

69. R. CLARK, *supra* note 5, at 688-90 (social responsibility proposals are vague about goals and inconsistent about means).

proposed that various constituencies be represented on the boards of public companies.[70] However, they never explained how consumers, for example, could choose representatives for these seats.

Most important, saddling the corporation with heavy and probably ill-defined social responsibilities would undermine the market mechanism to the detriment of investors and society generally, including the intended beneficiary constituencies.[71] Staffing corporate boards with representatives of competing constituencies would provoke conflict inimical to corporate planning. Diminishing the profit orientation of public companies would hobble them relative to private companies. Moreover, only shareholders have what Dean Manning calls the "perspective of the aggregate," that is, the devotion to efficiency that comes from being paid last, after all other constituencies have been satisfied.[72] Investors would not accept lower returns on equity than on other investments. Therefore, new equity could be obtained only at returns at least as high as those previously offered. This raises the cost of equity capital for public corporations, which in turn means higher prices for the firm's products, lower compensation for its employees, and disinvestment from public corporations. The value of existing shares can be plundered for the benefit of other constituencies. This raises questions of the fairness of fundamentally changing rules in the middle of the game. Further, investors could recoup their losses by selling out in a takeover.[73] The interests of other constituencies are best served not by tinkering with corporate governance, but through labor and consumer protection laws that optimize the constituencies' dealings with corporations, or through taxes on profits for social purposes.

Many reform efforts have aimed to benefit shareholders through shareholder democracy. Berle and Means helped to spark adoption of the full disclosure policy of the federal securities laws.[74] Although this

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70. R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION 123-26 (1976). For these reasons, some social responsibility proponents have embraced managerialism. *See supra* text accompanying notes 60-65.

71. Engel, *An Approach to Corporate Social Responsibility,* 32 STAN. L. REV. 1 (1979); Manning, *Thinking Straight About Corporate Law Reform*, 41 LAW & CONTEMP. PROBS. 3, 20-23 (1977); Rostow, *To Whom and For What Ends is Corporate Management Responsible?*, in THE CORPORATION IN MODERN SOCIETY 46, 64 (E. Mason 7th ed. 1970); Ruml, *Corporate Management as a Locus of Power*, 29 CHI.-KENT L. REV. 228, 242-43 (1951). *See also* M. FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962).

72. Manning, *supra* note 71, at 21. *See also* Easterbrook & Fischel, *supra* note 18, at 403. Social reform schemes could make debt more attractive because creditors bargain for fixed returns and thus are less affected by discretionary reduction of profits. This exacerbates tensions between shareholders, who can profit by refinancing the firm with debt, and managers, who resist debt. *See supra* notes 47, 58-59. *See also* Oesterle & Norberg, *supra* note 45, at 208-09.

73. If social responsibility rules applied only to public corporations, these rules could be avoided by selling the equity to a purchaser who would take the company private.

74. Hessen, *supra* note 19, at 279.

policy was designed primarily to facilitate investment decisions, it was also meant to assist shareholders in controlling their companies. To this end, Congress authorized the Securities and Exchange Commission (SEC) to require full disclosure in, and otherwise to regulate, proxy solicitations.[75] Proxy disclosure has not led to shareholder control; management still runs the proxy machinery and shareholders still lack any plausible alternative to supporting management.[76] Further, some SEC shareholder democracy initiatives have been counterproductive. For example, Rule 14a-8, the shareholder proposal rule, has become the tool of a vocal, politicized minority rather than a vehicle for shareholder control.[77] Reform proposals have failed to advance shareholder control because they envision a town-meeting form of democracy. The shareholders of public companies are too numerous and scattered, and their interests are too small for them to attain this vision.[78]

Reformers have advocated, inter alia, mandatory cumulative voting,[79] mandatory stock ownership by directors and stricter devotion to fiduciary principles.[80] Even if these suggestions make sense, they fall far short of curbing management control. Current reform efforts focus on the American Law Institute's Corporate Governance Project. The Project's reporters champion the monitoring model of corporate governance pioneered by Melvin Eisenberg, the Project's chief reporter. The monitoring model concedes that outside directors cannot manage the corporation, as traditional statutes in theory required them to do. Outside directors can perform a valuable service, however, by overseeing or monitoring management.[81] In particular, the monitoring model advocates several board oversight committees to be staffed primarily by outside directors and to oversee the firm audit, executive compensation

75. Securities Exchange Act of 1934, § 14, 15 U.S.C. § 78m (1988). The SEC has promoted disclosure to overcome shareholder apathy. SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 96th Cong., 2d Sess., SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY 66-68 (Comm. Print 1980) [hereinafter SEC REPORT].

76. *See infra* notes 121-38. *See also* Easterbrook & Fischel, *supra* note 18, at 419-20 ("shareholders' involvement in the voting process has not increased with the adoption of the proxy rules").

77. Dent, *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1 (1985). The rule permits shareholders who satisfy certain conditions to have their proposals included in the corporation's proxy statement at no cost to the shareholder.

78. Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 807 (1979).

79. Cumulative voting "can have a positive effect on firm value." Bhagat & Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J. L. & ECON. 339, 342 (1984). *See also* Dodd & Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401 (1983).

80. Berle and Means stressed fiduciary duties. A. BERLE & G. MEANS, *supra* note 1, at 220-76.

81. M. EISENBERG, *supra* note 4, at 162-70. *See also* Dent, *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U.L. REV. 623, 629-34 (1981).

and director nominations.[82] Monitoring by outside directors under this model extends beyond the oversight committees; however, the further duties are never clearly spelled out.

Ironically, the ALI Project has, in part, succumbed to the success of the monitoring model. In the last fifteen years, outside directors have become a majority of most public firm boards.[83] Additionally, most large public companies have also established all or most of the three oversight committees envisioned by the model. Some critics of the Project argue that most of the model's objectives have been achieved and that further steps are unnecessary and possibly counterproductive.[84] The critics, including the Business Roundtable, charge that the Project would mandate monitoring by threatening directors with liability if a court concludes that they were careless and caused a corporate loss. This threat, they claim, would discourage innovation and risk taking. They also argue that vigorous monitoring would make the board and management adversaries, thereby hindering the board's effectiveness. The neoclassicists argue that the ALI's reforms are unnecessary because the market already perfects corporate governance.[85] Interestingly, the critics have not included institutional or other investors.

Defenders reply that the Project would impose liability only for gross imprudence, not for reasonable or even adventurous risks, and would in many respects diminish the directors' risk of liability.[86] They also deny that the Project would spawn conflict between management and the board. To mollify critics, the drafters diluted many fiduciary obligations and enforcement provisions of the Project's early drafts.[87] Professor Eisenberg admits that the monitoring model's goals are mod-

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82. The audit committee works with the firm's accountants to ensure that management cooperates with the audit and accurately reports the company's financial condition. The compensation committee structures executive compensation to encourage good performance. To help ensure the board's independence, the nominating committee selects nominees for what is generally automatic election to the board of directors by shareholders. ABA Committee on Corporate Laws, *The Overview Committees of the Board of Directors*, 34 BUS. LAW. 1837 (1979).

83. Commentators disagree about the breadth of this development, largely because of disagreement about the definition of outside directors. Many who ostensibly are outside directors have ties to the corporation that may compromise their independence. *See infra* note 93. Also, the number of outside directors may recently have declined slightly.

84. *See generally* BUSINESS ROUNDTABLE STATEMENT, *supra note* 16; THE ALI AND CORPORATE GOVERNANCE: AN ANALYSIS AND CRITIQUE (1987) (a collection of essays criticizing tentative drafts of the ALI Project).

85. *See supra* notes 17-20 and accompanying text.

86. For example, the Project recommends a cap on the liability of directors for breach of the duty of care. *See* ALI PROJECT, *supra* note 2, § 7.17, at 25-26 (Tent. Draft No. 7, Apr. 10, 1987). *See generally* Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 801-03 (1984); Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 596-98 (1984).

87. Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1410 n.19 (1985).

est and that it will make an important difference only "in the 100th or 200th or 300th case."[88]

The Project's defenders may be right that it would do little to change corporate governance. Nevertheless, their denial underscores the Project's most serious shortcoming: it does not resolve the ultimate problem of separation of ownership and control. Notwithstanding the widespread adoption of some elements of the monitoring model, managers still dominate directors. In a leading study,[89] Myles Mace showed that boards do not manage; rather, they render advice when asked for it and in dire emergencies replace the chief executive officer (CEO). The impotence of outside directors springs first from their composition and selection. Despite the proliferation of nominating committees, CEOs still influence the selection of directors. The CEO can veto a candidate she opposes, and over time she usually obtains the board she wants.[90] The CEO naturally picks people who share her background and general views and whom she expects will not rock the boat.[91] Outside directors know this, and therefore choose not to rock the boat; if they are unable to go along with management, they either resign or decline the position to begin with. If they rock the boat, they are removed.[92] Many directors are officers subordinate to the CEO. Many outside directors are only nominally independent; they include lawyers, bankers, suppliers, accountants and investment bankers who do business with the corporation and thus depend on the CEO's goodwill.[93]

Outsiders are also hampered by the limited time they devote to the firm, their limited knowledge about its workings and their lack of independent sources of information. Directors typically meet about once a month, which is far too little time for the outsider to master the firm's

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88. Eisenberg, *supra* note 86, at 597.

89. M. MACE, DIRECTORS: MYTH AND REALITY (1971). *See also* R. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 114, 128-31 (2d ed. 1961); Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982).

90. Patton & Baker, *Why Won't Directors Rock the Boat?*, HARV. BUS. REV., Nov.-Dec. 1987, at 10, 11; Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1233 (1977). Independent nominating committees have not made much difference. *See* R. CLARK, *supra* note 5, at 108-09; Brudney, *supra* note 89, at 621-22; Geneen, *Why Directors Can't Protect Shareholders*, FORTUNE, Sept. 17, 1984, at 28, 28-29; Mace, *Directors: Myth and Reality—Ten Years Later*, 32 RUTGERS L. REV. 293, 298 (1979).

91. E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 29 (1981).

92. CEOs often "fire" outside directors. *See* M. MACE, *supra* note 89, at 80. *See also* HEIDRICK & STRUGGLES, INC., THE CHANGING BOARD 12 (1977) (over 36% of industrial companies surveyed reported having "fired" directors). However, removal of CEOs by outside boards also seems to have increased. *See* Brudney, *supra* note 89, at 633 n.93; Coffee, *supra* note 35, at 1202-03.

93. M. EISENBERG, *supra* note 4, at 144-46; E. HERMAN, *supra* note 91, at 26-48; Brudney, *supra* note 89, at 602-03; SEC REPORT, *supra* note 75, at 432-33 (half of outside directors have ties that compromise independence).

affairs.[94] They receive most of their information from the managers, the very people directors are supposed to oversee.[95] Not surprisingly, then, management sets the board's agenda; "the board itself has little capacity to generate significant proposals."[96] The board routinely defers to the CEO on business questions.[97]

Finally, outside directors lack incentives to assert independence and maximize profits. Most outsiders are well-paid executives of other companies. Their compensation as outside directors is a small fraction of their income and usually less pay per hour than their full-time jobs.[98] Most own little stock in the companies they direct; their compensation is not tied to the corporation's or their own performance.[99] Thus, even if they could improve the firm's performance, outside directors would not benefit from their effort.[100] If the corporation commits a costly mistake, however, they may be held liable or at least subjected to an unpleasant lawsuit. "If anything, they have reason to be even more risk averse than managers."[101] Together, these factors foster a "groupthink" atmosphere to which directors conform.[102] Thus,

94. M. EISENBERG, *supra* note 4, at 141-43; Dent, *supra* note 81, at 627-28. One study reports that the average outside director devotes only 122 hours per year to his position. Brudney, *supra* note 89, at 609 n.38 (citing KORN/FERRY INT'L, BOARD OF DIRECTORS: EIGHTH ANNUAL STUDY 20 (1981)). The problem is exacerbated by the growing size and complexity of large corporations, E. HERMAN, *supra* note 91, at 32, and by the trend for outside directors to hold several directorships, Patton & Baker, *supra* note 90, at 11.

95. M. EISENBERG, *supra* note 4, at 143-44; Mace, *supra* note 90, at 303. Some outside directors, such as suppliers, customers and bankers, may have both the incentive and the means to obtain independent information. *See* Macey Letter, *supra* note 19. The interests of these directors in the firm, however, are likely to diverge from the typical shareholder's interest in maximizing share value.

96. Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1484 (1984), *But see* Haft, *Business Decisions by the New Board*, 80 MICH. L. REV. 1 (1981).

97. Manning, *supra* note 96, at 1490-91.

98. Brudney, *supra* note 89, at 613.

99. Patton & Baker, *supra* note 90, at 10-11. The usual justification for denying outside directors incentive compensation is that they have a minimal effect on corporate performance. *See* M. MACE, *supra* note 89, at 102-03.

100. Brudney, *supra* note 89, at 634. Some commentators speculated that a market for outside directors would develop; directors would cultivate reputations as expert monitors. *See* Fama & Jensen, *supra* note 18, at 315. No such market has evolved. So long as managers dominate the selection and functioning of directors, they will choose and keep directors who do not rock the boat, rather than directors who are aggressive, independent monitors. It has been suggested that directors are motivated by the fear that performing poorly would damage their reputations. Macey Letter, *supra* note 19. If everyone expects outside directors to be passive, however, a director does not hurt his reputation by being passive.

101. Coffee, *supra* note 12, at 26.

102. Coffee, *supra* note 35, at 1233; Brudney, *supra* note 89, at 634 n.98; Haft, *supra* note 96, at 35-39. The outsiders' passivity reflects no moral defect; groupthink pressures everyone to conform. Werner, *Corporate Law in Search of Its Future*, 81 COLUM. L. REV. 1611, 1663 (1981) (citing M. SHAW, GROUP DYNAMICS (1976); J. TEDESCHI & S. LINDSKOLD, SOCIAL PSYCHOLOGY 561-73 (1976); Reed, *On the Dynamics of Group Decisionmaking in High Places*, DIRS. & BDS.,

outside directors might not be more independent and effective even if the methods of their selection were improved. All incentives push them to caution and minimal involvement, a far cry from the preferences of the investors who in theory look to directors to work hard and accept risks in pursuit of maximum profits.

Outside boards do not financially outperform[103] and are not more socially responsible[104] than inside boards. Indeed, while the law treats the board as central to corporate governance, business analysts ignore the board, dismissing it as "a vestigial appendix."[105] The impotence of outside directors shows in their failure to limit managerial discretion. Outside boards do remove CEOs for poor performance more often than insider-dominated boards.[106] Nevertheless, they have neither curbed the managers' preference for growth over profits nor discovered and stopped illegal activities.[107] They have had little effect on executive compensation.[108] Outsiders have also failed to control management buyouts; they often approve buyouts on management's terms and sometimes even impede competing bids by outsiders.[109]

Most dramatically, though, outside boards have not prevented, limited, or even criticized the adoption of anti-takeover measures, no matter what the cost to the firm or to shareholders. These measures cannot be categorically censured; some may foil unfair tactics by raiders and get shareholders the highest price for their stock. Even the most

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Winter 1978, at 40. *See also* Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894, 1897-1901 (1983).

103. M. FRIEDMAN, *supra* note 71, at 133; Brudney, *supra* note 89, at 635 nn.101-03; MacAvoy, *ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis*, in BUSINESS ROUNDTABLE STATEMENT, *supra* note 16, at C-28 to C-34. A few commentators find that outside boards have been financially superior. *See* Baysinger & Butler, *supra* note 19, at 572; Baysinger & Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J. L. & ECON. ORG. 101, 118-19, 121 (1985) (boards with a mix of inside and outside directors are most effective); Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 293-94 (1980). However, firms with a dominant shareholder tend to have a low number of outside directors. *See* W. MCEACHERN, *supra* note 44, at 57. This suggests that knowledgeable shareholders do not find outside directors very useful.

104. Brudney, *supra* note 89, at 646-58.

105. Coffee, *supra* note 90, at 1142.

106. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 432, 458 (1988). The data are subject to conflicting interpretations, however. *See id.* at 453-55.

107. E. HERMAN, *supra* note 91, at 32-33 (almost all firms that have been involved in corporate scandals have had a large majority of outside directors); Brudney, *supra* note 89, at 616 (finding no evidence that outside directors effectively curb management overreaching); Vance, *Director Diversity: New Dimensions in the Boardroom*, DIRS. & BDS., Spring, 1977, at 40, 41. Outsiders have rarely dissented on matters in which insiders were later held liable or settled for substantial sums. Brudney, *supra* note 89, at 617-18. Moreover, some doubt exists about whether outside audit committees can improve the accuracy of financial information. *See id.* at 637-39.

108. E. HERMAN, *supra* note 91, at 354 n.50; Brudney, *supra* note 89, at 608 n.32; Kraus, *Executive Pay: Ripe for Reform?*, HARV. BUS. REV., Sept.-Oct. 1980, at 36, 36-37.

109. Oesterle & Norberg, *supra* note 45, at 236-37.

vociferous critics of takeovers, however, concede that defensive tactics often maim target companies.[110]

To remedy the shortcomings of outside directors, the ALI Project advances a "command model" of corporate governance; it would stimulate directors by exhortation and the threat of legal sanctions. In this respect, the ALI agrees with those who would tackle the separation of ownership and control with greater devotion to fiduciary principles.[111] So long as the reasons for directors' passivity remain, however, exhortations to greater effort will fall on deaf ears. The threat of liability has long been problematic in corporate law. It is extremely difficult to determine whether a board's negligence caused a corporate loss and, if so, which directors were culpable. To impose liability for an entire loss would often be draconian. Recognizing these problems, corporate law has hesitated to hold directors liable except for self-dealing. As Professor Bishop has said, "The search for cases in which directors of industrial corporations have been held liable . . . for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack."[112] In the rare cases where directors are held liable, indemnification and insurance invariably save them from personal loss.[113] The ALI would improve the system of liability by capping damages, thereby avoiding draconian liability. The ALI would also bar indemnification and insurance, thereby ensuring that directors pay something for their imprudence.[114]

The ALI proposals would improve corporate governance, but only marginally. Fiduciary duties work well where they require the fiduciary to perform ministerial tasks or to refrain from well-defined activities; they work less well where the fiduciary must exercise discretion. Judges

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110. L. LOWENSTEIN, *supra* note 34, at 162-64; Lipton, *Corporate Governance in the Age of Finance Capitalism*, 136 U. PA. L. REV. 1, 28-35, 64-65 (1987). On the shareholder wealth effects of defensive tactics, see Jarrell, Brickley & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988); Ruback, *An Overview of Takeover Defenses*, in MERGERS AND ACQUISITIONS (A. Auerbach ed. 1987); SEC OFFICE OF THE CHIEF ECONOMIST, THE EFFECTS OF POISON PILLS ON THE WEALTH OF TARGET SHAREHOLDERS (Oct. 23, 1986).

111. Brudney, *supra* note 89, at 659. Although the reporters would prod directors with threats of liability, they retain corporate law's vagueness as to what directors are supposed to do. *See infra* note 185.

112. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968).

113. In Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), the most controversial duty of care case in history, the Delaware Supreme Court found the directors liable for gross negligence; the parties then settled damages at $235 million. This entire amount was paid, however, by the directors' insurance and by the acquiring company in the challenged transaction. *See* W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 541 (6th ed. 1988). Thus, the exceptional case proves the rule of no personal liability. However, even this minimal threat proved too much for the corporate bar. It persuaded most state legislatures to adopt statutes that limit director liability for lack of care. *See infra* note 117.

114. *See supra* note 86.

cannot watch over the directors' shoulders and dictate their every move. Increasing liability for carelessness will not motivate the director who is minimally adequate. More likely, it would scare off directors and magnify their concern about liability insurance[115] and aversion to risk, as the Project's critics charge.[116] The ALI Project has also been outflanked by the corporate bar. While the ALI reporters worked to toughen directors' duties, the bar persuaded many state courts and legislatures to reduce or eliminate directors' duties and liabilities.[117]

To make matters worse, outside directors may actually expand manager discretion by immunizing them from liability. Courts routinely hold that approval of corporate action by outside directors cures any conflict of interest on the part of managers, and shifts the burden to the complaining shareholder to prove that the action was unreasonable or unfair.[118] Committees of outside directors that review derivative suits almost invariably recommend dismissal of the suits, and courts typically defer to these recommendations.[119] Outside directors also help defeat challenges to takeover defenses.[120] Courts believe that outsider review protects shareholders. The findings of Mace and others about the passivity of outside directors and their failure to curb or even object to anti-takeover activities and other damaging practices belies this reasoning.

The problems of corporate governance will not be solved until ownership and control are united. The current debate over the ALI Project offers no solution because it has bogged down over trivia; even the Project's supporters do not expect it to improve corporate performance markedly. Students of corporate law should jettison this sterile debate and seek more fruitful approaches. If corporate boards serve

115. It has become more difficult to attract outside directors in recent years. Melloan, *A Good Director is Getting Harder to Find*, Wall St. J., Feb. 9, 1988, at 39, col. 3. The searchers still limit themselves, however, to the traditional pool of candidates. Director liability insurance has also become more difficult to obtain and more expensive. Veasey, Finkelstein & Bigler, *Responses to the D & O Insurance Crisis*, 19 REV. SEC. & COMMODITIES REG. 263 (1986). It is not clear whether the increasing risk of liability has caused these developments, but undoubtedly the perception of greater risk has helped cause them.

116. Andrews, *Corporate Governance Eludes the Legal Mind*, 37 U. MIAMI L. REV. 213, 219 (1983).

117. DeMott, *Limiting Directors' Liability*, 66 WASH. U.L.Q. 295 (1988); Hazen, *Corporate Directors' Accountability: The Race to the Bottom—The Second Lap*, 66 N.C.L. REV. 171 (1987).

118. Brudney, *supra* note 89, at 603 n.15 (outside director approval of interested transactions); Oesterle & Norberg, *supra* note 45, at 242-43 (outside director approval of management buyouts).

119. R. CLARK, *supra* note 5, at 645-49; Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959, 963 nn.13-14.

120. Panter v. Marshall Field & Co., 646 F.2d 271, 294 (7th Cir. 1981); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

little purpose and if reform proposals, including the ALI Project, promise scant improvement, perhaps the board of directors should be abolished. Any beneficial functions it performs could be handled in other ways at lower cost and without insulating managers from fiduciary obligations. Before taking this drastic step, however, we should consider whether some steps could resolve the corporate governance puzzle by joining ownership and control.

III. THE SOURCE OF SEPARATION: PROXY VOTING

The keystone to separation of ownership and control is the proxy system.[121] Shareholders elect directors, but few shareholders personally attend shareholder meetings; most vote by proxy. Corporate law permits the board of directors to use the corporate treasury to solicit proxies under the name of the corporation.[122] If management dominates the board, as it usually does in the large public corporation, then management controls proxy voting. Shareholders routinely give management their proxies, largely because they have no alternative. Any shareholder dissatisfied with management can wage a proxy contest for control of the firm, but the insurgent must pay her own costs and campaign under her own name rather than that of the corporation. Management also runs shareholder meetings and can re-solicit shareholders who back dissidents.

An insurgent must also overcome the Wall Street Rule: shareholders' tendency to either vote with management or sell their shares.[123] This is extraordinarily difficult. Shareholders, especially institutions, are often criticized for passivity;[124] but under current practices, voting for management without thinking makes perfect economic sense. Indeed, the shareholder attitude is often called "rational apathy."[125] Nearly every shareholder realizes that she cannot individually affect the outcome of a proxy vote. If her vote will not affect the outcome, her rational level of investment in voting, including deciding how to vote and trying to persuade other shareholders, is zero. Even if a shareholder's vote might affect the result, her rational investment will be

121. Berle and Means recognized this. A. BERLE & G. MEANS, *supra* note 1, at 81-82, 86-88.

122. Soliciting under the name of the corporation also gives incumbents an important psychological advantage. M. EISENBERG, *supra* note 4, at 112.

123. For example, shareholder resolutions (other than those opposing anti-takeover measures, see *infra* note 140) opposed by management typically get little support. Dent, *supra* note 77, at 4-5. When supported by management, however, the same measures are overwhelmingly approved.

124. SEC REPORT, *supra* note 75, at 379-429; Curzan & Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670, 686 (1980).

125. Clark, *supra* note 78, at 779-83; Easterbrook & Fischel, *supra* note 18, at 402.

small unless the holdings, the potential impact of the vote on the firm, and the odds of affecting the result are all very large. Thus, if an investor owns $50,000 worth of stock in a firm and a correct decision in a proxy vote will increase the value of the firm by one percent, the investor would not rationally spend over $500 on the matter even if she could certainly decide the outcome. If the odds of changing the outcome are less than 100%, her rational investment must be discounted accordingly. Other shareholders would benefit from her action, but the investor cannot force them to share her costs; they can "free ride" on her efforts.[126] Rarely is the investor warranted in making any effort at all.

Shareholders also tend to vote for management because assertive shareholders encounter management hostility. Managers can deny rebellious shareholders valuable information.[127] Bank trust departments hesitate to oppose managements for fear of offending them as commercial clients.[128] Although the managers of issuer-sponsored pension funds are supposed to be independent, they can be fired by the issuer's management and are, therefore, loathe to oppose its will.[129] Executives sometimes badger officers of other companies to pressure their fund managers to approve anti-takeover measures.[130] Even absent specific pressures, fund managers know that executives dislike active shareholders, and, therefore, the fund managers keep a low profile to protect themselves.[131] Recently, however, the Department of Labor has insisted that pension fund managers vote proxies solely in the interests of the fund.[132]

More surprising than management hostility are the legal pitfalls that activist investors face. One who discusses voting with a shareholder may be deemed to be soliciting a proxy; soliciting proxies from

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126. Clark, *supra* note 78, at 783-84.

127. L. LOWENSTEIN, *supra* note 34, at 61. *See generally* J. HEARD & H. SHERMAN, CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM 41-57 (1987) (describing pressures on institutional investors to vote with management).

128. J. HEARD & H. SHERMAN, *supra* note 127, at 41, 54; L. LOWENSTEIN, *supra* note 34, at 61.

129. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117, 148-49 (1988).

130. J. HEARD & H. SHERMAN, *supra* note 127, at 50-55; L. LOWENSTEIN, *supra* note 34, at 61, 208-09; Dobrzynski, *Whose Company Is It Anyway?*, BUS. WK., Apr. 25, 1988, at 60, 61.

131. Interestingly, managers of public pension funds, who are less subject to such pressures, oppose shark repellents more often than private fund managers. S. MARCIL & P. O'HARA, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1987 PROXY SEASON 38 (1987).

132. Dept. of Labor, Release No. 88-241 (May 11, 1988) (describing letter sent by the Department of Labor in February, 1988). In testimony before Congress, Professor Tamar Frankel proposed criminal penalties for managers who pressure shareholders in proxy voting. *Pension Funds in the Capital Markets, Hearings before Subcomm. on Telecommunications, Consumer Protection, and Finance, of the House Comm. on Energy & Commerce*, 99th Cong., 2d Sess., 78, 84 (1985).

more than ten shareholders requires the filing of a detailed proxy statement.[133] Even an informal meeting of shareholders owning over five percent of an issuer's stock may require that all file as a group under section 13(d) of the Exchange Act of 1934[134] and disclose their plans to the issuer. If together they own over ten percent, the shareholders may be considered a single beneficial owner for purposes of section 16 of the Exchange Act,[135] requiring them to disclose publicly all their trading in the stock and subjecting them to liability for short-swing trading.[136] They could also collectively be deemed a controlling person subject to registration requirements and liability under the federal securities laws and common law.[137] These laws have never been applied to institutional investors who discuss the affairs of portfolio companies without actually soliciting proxies or participating in control. The statutes' vagueness and the lack of clear safe harbors, however, deter institutions from acting. For all these reasons, proxy insurgencies are rare; success is even rarer.[138]

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133. SEC Rule 14a-2(b)(1), 17 C.F.R. § 240.14a-(2)(b)(1) (1989). SEC Rule 14a-1(*l*), 17 C.F.R. § 240.14a-1(*l*) (1989), defines "solicitation" to include any communication "reasonably calculated to result in the procurement, withholding or revocation of a proxy." This vague standard is broadly construed to include communications that make no reference to proxy voting. Sargent v. Genesco, Inc., 492 F.2d 750, 768 (5th Cir. 1974); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 600 (5th Cir. 1974).

134. 15 U.S.C. § 78m(d) (1988). *See* GAF Corp. v. Milstein, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972) (shareholders gathered to act in concert are a "group" for purposes of section 13(d)); *accord* General Aircraft Corp. v. Lampert, 556 F.2d 90, 95 (1st Cir. 1977). The term "beneficial ownership" is liberally construed and requires no written agreement among parties acting together. SEC v. First City Fin. Corp. Ltd., 688 F. Supp. 705 (D.D.C. 1988).

135. 15 U.S.C. § 78p (1988). The term "beneficial owner" is not defined in the statute and its application to shareholder groups has not been addressed by the courts.

136. Section 16(b) requires the disgorgement of any profits realized by officers, directors and large shareholders by purchasing and selling the company's stock within six months.

137. Under section 2(11) of the Securities Act of 1933, 15 U.S.C. § 77b(11) (1988), "issuer" is defined to include any person who controls the issuer. The statute restricts sales of securities by such persons without registration. Conard, *supra* note 129, at 159-60. Section 15 of the Securities Act, 15 U.S.C. § 77*o* (1988), and section 20 of the Exchange Act, 15 U.S.C. § 78t (1988), impose liability on controlling persons. "Control" has been construed to include not only actual control, but also the ability to control, even if not actually exercised. Walston & Co., 7 S.E.C. 937 (1940); Sommer, *Who's "In Control"*, 21 BUS. LAW. 559, 564 (1966). In addition, many courts have imposed liability for securities fraud on controlling persons under such common law doctrines as respondeat superior, even where liability did not attach under the controlling person provisions of the securities laws. *See, e.g.*, Commerford v. Olson, 794 F.2d 1319 (8th Cir. 1986); *In re* Atlantic Fin. Management, Inc., 784 F.2d 29 (1st Cir. 1986); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); T. HAZEN, THE LAW OF SECURITIES REGULATION 207 (1985).

138. The proxy fight is "the most expensive, the most uncertain" takeover technique. Manne, *supra* note 20, at 114. *See* Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 HARV. BUS. REV., Mar.-Apr. 1967, at 135, 137 (between 1956 and 1960, only nine of 28 proxy control fights succeeded).

Despite these obstacles, major investors have recently rebelled against some management actions.[139] Many corporate boards have adopted "poison pills" that complicate or prevent any takeover without board approval. Institutional investors have introduced proxy proposals requiring or encouraging management to submit poison pills to shareholder vote. Institutional investors have also opposed managements over greenmail, confidential voting and shareholder access to proxy statements. Although few of these proposals have succeeded, they attract much more support than most other challenges to management.[140] To coordinate their activities, several institutions formed the Council of Institutional Investors.[141] This new activism reflects the inadequacy of the Wall Street Rule resulting from the institutions' growth: institutions now loom so large in the market that they cannot collectively abandon a company without suffering great losses because a simultaneous selloff would cause a precipitous decline in value.[142] Moreover, when most public companies behave alike, as in adopting poison pills, the funds have few investment alternatives. The new activism shows that the stakes are so large in some areas, especially takeovers, as to prod even the generally passive funds into action.

The current proxy system is not immutable. Indeed, it was never carefully thought out, but evolved largely by default. If no one could tap the corporate treasury to solicit proxies, a firm might not get a quorum for a shareholder meeting. The firm might also fall prey to an adventurer who could win a proxy vote and capture control with only a few votes. To avoid these horrors, the corporation had to pay someone to solicit proxies. Not surprisingly, the board itself claimed that role, and the courts went along.[143] The result is disturbing, though; if the shareholders are supposed to select directors, it is incongruous to vest proxy control in incumbents seeking re-election.[144] This is like letting legislators fund their re-election campaigns from the public treasury

139. Conard, *supra* note 129, at 145-46; Dobrzynski, *supra* note 130, at 60, 60-61.

140. *Institutions' Proxy Power Grows*, N.Y. Times, July 5, 1988, at D1, col. 3 ("resolutions sponsored by institutional stockholders on 'corporate governance' issues achieved record support in 1988"); Dobrzynski, *Evening the Odds in Proxy Fights*, BUS. WK., July 4, 1988, at 37. Some proposals have succeeded. *Santa Fe Shareholders Reject 'Poison Pill' Plan*, N.Y. Times, May 25, 1988, at D2, col. 5 (shareholders voted to recommend that board rescind poison pill).

141. Rosenberg, *The Revolt of the Institutional Shareholders*, INSTITUTIONAL INVESTOR, May 1987, at 131, 137. The institutions, "mainly public funds, can afford to take activist stands . . . because they have no loyalty to their own companies." *Id.* at 132.

142. *Institutions' Proxy Power Grows*, *supra* note 140.

143. Lawyers' Advertising Co. v. Consolidated Ry. Lighting and Refrig. Co., 187 N.Y. 395, 80 N.E. 199 (1907). *See also* Rascovor v. American Linseed Co., 135 F. 341 (2d Cir. 1905).

144. "Strict fiduciary standards would categorically preclude insiders from spending corporate funds to perpetuate their power, whether they are deemed fiduciaries for stockholders alone or for several constituencies." Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 283 (1966). *See also* M. EISENBERG, *supra* note 4, at 102-03.

while requiring challengers to pay their own way. This system makes the board a self-perpetuating oligarchy and, once management controls the board, the tool for managerial control of the firm. In short, the system generates the separation of ownership and control.

This analysis belies the Panglossian claim of the neoclassicists, that the current corporate governance system is the best of all possible worlds because it has prevailed in competition among all possible forms.[145] Managerial control rests on a proxy system dictated by government, not by the market. The recent trend of taking public companies private suggests that the market itself dislikes aspects of the public corporation. The separation of ownership and control stemming from the proxy system may be the culprit.

IV. Returning Proxy Control to the Shareholders

A. The Proposal

The proxy system is the key to management control; giving shareholders control of the proxy system, therefore, is both a necessary and a sufficient condition for uniting ownership and control. However, collective action problems prevent coordination among all the shareholders, so control must vest in some subset of shareholders. Hence the law should grant exclusive access to the corporate treasury for proxy solicitations to a committee of the ten or twenty largest shareholders of the firm.[146] The largest shareholders should comprise this committee because they are the most knowledgeable, have the greatest stake in the firm and therefore should be the most diligent in improving corporate performance.[147] As institutional share ownership has grown, large shareholders have also become more representative.[148] The largest institutions would probably sit on several shareholder committees, thus developing expertise in that capacity.

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145. *See supra* note 18; *infra* text accompanying notes 203-09.

146. While specific procedures for implementing this proposal are beyond the scope of this Article, some general guidelines are in order. The range of 10 to 20 seems large enough to be representative and to have sufficient input without being unwieldy. Further evidence may be needed here. The SEC could use its rule-making power under this proposal, *see infra* text preceding note 162, to promulgate rules identifying the largest shareholders. The SEC could deal with such questions as whether affiliated shareholders should be treated as one, whether a very large shareholder could gain extra seats by splitting its holdings among affiliates, and whether certain classes of shareholders should be excluded from the committee because of conflicts of interest.

147. A 1978 study of 122 Fortune 500 companies showed that the 20 largest shareholders owned on average slightly less than 20% of the shares. Demsetz, *supra* note 19, at B-5.

148. The proportion of equities held by institutions may already exceed 50%. *See* Conard, *supra* note 129, at 131.

Rational apathy, the typical shareholder's attitude toward corporate governance,[149] will not undermine shareholder committees. First, the committees need not participate in directing the company; they will only nominate directors to do the job. The mere fact that the directors will know that they have been chosen by investors should make them more responsive to shareholder concerns. Second, the committee should have access to corporate resources to obtain and generate information it needs; individual members need not spend much of their own money. Third, where individual expenses are incurred, they will be justified by investors' large holdings in the company and by the utility of the expenses in performing the usual portfolio management functions.[150] There are signs that institutions are willing to perform these tasks.[151]

This idea is not totally unprecedented. Many commentators recognize that proxy voting is a travesty and recommend reforms. Like the current proposal, these recommendations acknowledge that institutional investors must act for all if shareholder involvement is to be effective. Melvin Eisenberg would permit shareholders together holding more than five percent of a firm's stock to nominate directors in the firm's proxy statement.[152] Victor Brudney and Martin Lipton would grant large shareholders as well as the incumbent board corporate funds for proxy solicitations.[153] These reforms might be beneficial, but they would not reunite ownership and control. Large shareholders would have to openly oppose management, a step they shun for many reasons.[154] More important, it would not alter the Wall Street Rule: vote with management or sell. Perhaps if we were starting with a clean slate these proposals would suffice. Currently, however, the advantages of incumbency permit management-dominated boards to retain control indefinitely. If large shareholders did solicit proxies, corporations' cost of subsidizing all sides in the ensuing proxy fights would be substantial; the benefits would be much less certain.[155]

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149. *See supra* note 125.

150. The efforts of committee members may enhance a particular investment and also generate knowledge useful for other investments. If these benefits do not elicit sufficient involvement by committee members, however, provision might be made for corporate payment of certain of the members' expenses.

151. *See infra* notes 226-30.

152. M. EISENBERG, *supra* note 4, at 117-20.

153. Brudney, *supra* note 144, at 284-85; Lipton, *supra* note 110, at 67-69.

154. *See supra* text accompanying notes 122-38.

155. One danger is that large shareholders could extort greenmail from corporations by threatening to wage expensive proxy battles unless they were paid. Similar tactics have succeeded under Rule 14a-8; shareholders have extracted corporate concessions by threatening to submit shareholder proposals under the rule unless their demands are met. *See* Dent, *supra* note 77, at 21-22.

Louis Lowenstein would have a few directorships, perhaps a quarter, elected by shareholders without management interference. To ensure shareholders a real choice, twice as many nominees as directorships would be listed on the corporation's proxy form. Candidates nominated by holders of the most shares would appear on the ballot.[156] Lowenstein's proposal would improve corporate governance, but would not fully resolve the problem of separation of ownership and control. First, management neutrality would be hard to enforce. Even if management could not overtly support candidates, it would be presumed to back shareholders' candidates with which it has close ties, such as employee stock option plans with trustees appointed by management. Management could punish shareholders who opposed these candidates as it does now.[157] Second, requiring ballots with twice as many nominees as board seats would compel shareholders to fight among themselves. This seems perverse, given that the shareholders' impotence springs from an inability to cooperate. Shareholders would still shrink from voting against management-favored candidates and, even more so, from nominating vigorous, competent outside directors.

Even if the Eisenberg, Brudney, Lipton or Lowenstein proposals made outside directors more numerous, they would not make them more effective. Past efforts to influence corporate governance by appointing a minority of directors have failed. Where government or labor unions choose some directors, managements co-opt them. Co-optation is eased by the minority's tendency to mimic the majority; minority directors usually wind up indistinguishable from the majority.[158] Cooptation is especially likely because shareholders could not easily replace ineffective directors. If the minority did stubbornly persist in independence, the majority would treat them as spies and exclude them from serious discussions.[159] The majority's collaboration with management facilitates this. Management controls the flow of information to the board, and can selectively withhold information from an obstreperous minority. Management directors and their allies can meet informally to work out any problems and then present a united front at board meetings. This is not far different from what happens now. Thus, shareholder-elected directors would not be very effective.

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156. L. LOWENSTEIN, *supra* note 34, at 209-18. Although Lowenstein criticizes institutional investors for myopia, he recognizes that if they had a greater voice in corporations they might show more interest in them. *Id.* at 213.

157. *See supra* text accompanying notes 127-31.

158. W. CARY & M. EISENBERG, *supra* note 4, at 223-25. The tendency may spring from the majority's superior knowledge of and information about the firm and the pressures of groupthink.

159. *Id.* This can be done by vesting most of the board's authority in an executive committee from which uncooperative directors are excluded.

Lowenstein's proposal is also troubling on a theoretical level. If shareholders own the firm, why should they select only a quarter of the board? And if a quarter of the directors are selected to represent shareholders, whom do the other three-quarters represent? Granted, Lowenstein's proposal would improve upon the status quo. However, the improvement would be marginal because it does not eliminate the separation of ownership and control. The proposal resigns itself to separation, and merely seeks to smooth some of its rougher edges.

The states are unlikely to adopt the reform proposed here. State corporation laws have generally been enlightened; however, they sometimes go astray, especially in the realm of takeover defenses. Corporate managers have used their power to choose the state of incorporation to bludgeon state legislatures into enacting laws that entrench managers to the detriment of shareholders.[160] At the federal level, this will not work. Managers are better positioned to lobby state legislatures than are investors, who have little local political influence and whose lobbying efforts face the same collective action problems, legal obstacles, and management hostility that hamper their proxy voting.[161]

Investors have a better chance at making themselves heard at the federal level. The federal government has long regulated proxies, so establishing shareholder proxy committees would not swerve far from traditional federal domain. Indeed, by resolving the conflict between investors and managers arising from the separation of ownership and control, the proposal would facilitate a true market for incorporation, or race to the top, among the states. Each state would try to devise the corporate law that best reduces transaction costs and enhances firm values. Unlike federal incorporation, this proposal leaves corporate law, including takeover defenses, to the states. The proposal does not contradict the deregulation movement. Although it would establish a federal rule, that rule would require very little bureaucratic enforcement.

Ideally, Congress would enact reform by amending the securities laws, with the SEC having rule-making powers to supply details. However, the SEC may already be able to give shareholders some control of the proxy machinery. Despite some criticism,[162] the SEC has long re-

160. Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987). *See supra* note 117. The Supreme Court has vacillated on whether these laws are unconstitutional burdens on interstate commerce or are preempted by federal securities laws. *Compare* CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987) (upholding Indiana law) *with* Edgar v. MITE Corp., 457 U.S. 624 (1982) (striking down an Illinois statute).

161. The one state where investors might have a sufficient stake to warrant a struggle is Delaware because so many public companies are incorporated there. Interestingly, Delaware has not been a leader in anti-takeover legislation, but a follower, usually with milder legislation than other states.

162. Dent, *supra* note 77, at 6-28 (arguing that the SEC lacks authority to adopt the shareholder proposal rule).

quired public firms to include shareholder proposals in proxy statements.[163] If the SEC has the power to do this, it can also require corporations to pay for proxy solicitations by a committee of the largest shareholders.[164] Although the SEC probably cannot forbid corporations from paying for incumbent boards' proxy solicitations, it can require disclosures that stress an incumbent board's domination by management. This would help offset the board's advantage of incumbency.

B. Benefits of Shareholder Control

In most respects, shareholder control will probably not change corporate behavior much; most corporations are reasonably well managed and would continue to be so. Shareholder control would generate many small changes in public companies and in some cases would produce major changes.

Shareholder control would result in executive compensation tied more tightly to corporate performance than to growth.[165] Shareholder control will not diminish direct executive compensation and may even increase it, but it will reduce executive perquisites, including large staffs.[166]

Shareholder control would also influence executive hiring and retention. Cronyism, nepotism and incompetence in public firms may not be widespread, but they exist in some cases. Shareholder directors would have strong incentives to end these practices which diminish the value of the firm and its stock. Takeovers can oust incompetent managers, but boards could perform this task better because they can remove officers more easily. Boards do not face takeover defenses and enjoy better access to information than raiders, so they can monitor better and act more quickly.[167] At the same time, shareholders have incentives to retain good managers.

Managers would continue to lead in fashioning corporate strategy because they devote full time to the firm and are more expert than outside directors; there is generally no reason to hire an executive for a

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163. 17 C.F.R. § 240.14a-8 (1989).

164. One justification for Rule 14a-8 is that shareholders want to know about motions to be submitted at shareholder meetings. Dent, *supra* note 77, at 6-8. The meager support given to shareholder proposals belies this argument. Director nominations by a committee of large shareholders will command tremendous interest, however, as indicated by the wide support for shareholder initiatives against management's anti-takeover efforts. *See supra* notes 139-42.

165. One study found that in public corporations, CEOs earned an extra $.02 for every $1,000 gained in firm market value and returns. In post-leveraged buyout companies, the comparable figure was $64. Passell, *Executive Pay: Is It Too High?*, N.Y. Times, Apr. 27, 1988, at D2, col. 1. *See also* Easterbrook & Fischel, *supra* note 56, at 1172 n.31 (stock options do not reduce managerial discretion).

166. *See supra* note 54 and accompanying text.

167. O. WILLIAMSON, *supra* note 46, at 145-48.

job unless he can do it better than the board. However, directors would have an incentive to review corporate plans. In particular, they would curb management's preference for growth over firm value and its aversion to risk; shareholders are generally risk-neutral. New projects would be undertaken only if they promised a market rate of return or better.

Shareholder control would transform corporate finance by reducing retention of earnings and increasing payouts.[168] Payouts could even exceed earnings, with the shortfall made up by debt because shareholders do not share the managers' abhorrence of debt. However, dividends would not be needed to assure that shareholders will not be cheated since the shareholders will control.[169] Shareholder control would end such wasteful practices as using accounting methods that increase taxes and reported earnings without affecting real earnings.[170] Investor control would curtail unprofitable acquisitions and spur deconglomeration, which has greatly profited shareholders.[171] In general, shareholder control should improve profitability.[172]

At the same time, shareholder control could help revive public equity financing. Stock markets often price equity far below fundamental value because of uninformed trading and fears that management-controlled public companies will waste earnings.[173] The discounting of publicly traded shares inflates the cost of public equity financing. By eliminating discounts, shareholder control could make public stock a more attractive investment and financing vehicle. This could spur greater use of public stock offerings and stem the tide of going-private transactions, which are often attractive only because separation of ownership and control makes equity financing undesirable.[174]

The greatest immediate effect of shareholder control would be in the realm of takeovers. Although commentators disagree about many aspects of takeovers, nearly all agree on two points. First, takeover de-

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168. Some commentators have urged policies to increase payouts in order to curb managerial discretion. M. Fox, FINANCIAL AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY 335-39 (1987). *See supra* note 49.

169. *See supra* note 49.

170. Investor-controlled companies rarely engage in these practices. *See supra* note 48.

171. Coffee, *supra* note 12, at 55. Managers in control make unprofitable acquisitions, often of a conglomerate kind, in pursuit of growth rather than profits. *See supra* note 52.

172. Profitability is highest at moderate levels of share ownership by the board. Morck, Shleifer & Vishny, *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 293 (1988).

173. *See supra* notes 49-52; *infra* notes 221-22.

174. Institutional investors are increasingly avoiding investments in publicly traded stock. *See infra* note 208. It is not inconsistent to predict an increase in both debt and equity financing. Management-controlled companies now finance primarily with retained earnings. *See supra* notes 30 & 50. By diminishing earnings retention, shareholder control might increase both debt and equity financing.

fenses often severely damage targets and potential targets.[175] Second, shareholders can be victimized by some raiding tactics; the same collective action problems that hinder them in voting prevent them from coordinating their responses to the raider. Shareholder control would eliminate both problems. Shareholders would support takeover defenses that would fetch a higher price for the firm. This would counter both the entrenchment of managers and plundering by raiders. Further, the proxy committee would help shareholders to coordinate their responses to takeover bids. This would prevent raiders from stampeding shareholders into selling at a suboptimal price.

Consider, for example, the most common takeover defense, the poison pill. Most institutional investors dislike poison pills because they reduce the value of a firm's common stock.[176] Managers defend poison pills on the ground that they enable management to negotiate with the raider and others to make sure that shareholders receive a fair price.[177] Given the shareholders' collective action problem, this defense is not a priori implausible. However, the negative effect of adopting poison pills on share prices shows that investors do not trust managers to negotiate for the best interests of the shareholders. With the largest shareholders in control, poison pills might be unnecessary; the members of the proxy committee could coordinate their responses to a bid, and because they own so much stock,[178] a raider might find it difficult to gain control if they did not tender their shares. If poison pills were still desired to permit the target to negotiate for better offers, poison pills would enhance share values; investors would trust directors selected by a proxy committee to yield the pill for the shareholders' benefit because the members of the committee are themselves shareholders and have the same interests as other shareholders.

At the same time, a shareholder-controlled board could negotiate contracts to protect managers from the personal dangers that often cause them to resist takeovers.[179] More important, shareholder control could obviate most takeovers. Takeovers serve to close the gap between a firm's stock market price and fundamental value that arises from fears

175. OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, UPDATE—THE EFFECTS OF DUAL-CLASS RECAPITALIZATIONS ON SHAREHOLDER WEALTH: INCLUDING EVIDENCE FROM 1986 AND 1987 at 8 (July 16, 1987) ("we find significant and negative abnormal stock returns at the announcement of the dual-class recapitalization"); OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, THE EFFECTS OF POISON PILLS ON THE WEALTH OF TARGET SHAREHOLDERS 5 (Oct. 23, 1986) ("poison pill adoptions reduce stock prices").

176. *See supra* note 175.

177. Lipton, *supra* note 110, at 30-31.

178. *See supra* note 148.

179. Coffee, *supra* note 12, at 9, 24, 73 (takeovers violate implicit employment contracts providing managers with security and deferred compensation).

of misinvestment by management or from uninformed trading.[180] Shareholder control would calm fears of misinvestment and discourage uninformed trading,[181] and thereby help limit tender offers to situations where they can produce synergy.

The most important long-range effect of shareholder control, however, would be to rationalize corporate governance, beginning with the role and structure of the board. Theorists speculate, for example, whether boards should include members of management or directors who are knowledgeable about one aspect of a firm's business but not about the industry generally.[182] Similarly, they disagree about the optimal size of the board,[183] the role of board committees, and the size and form of compensation for outside directors.[184]

A principal problem for the monitoring model, the ALI Project and all other reform efforts focusing on outside directors, is to define the role of outside directors. As Bayless Manning has said, "We do not know what the directors are supposed to do; we know only that they are supposed to do it 'with care.' "[185] Those who can best decide what directors should do are those who will be most affected by their actions; that is, the shareholders. They now have little reason to ponder the question because they play no role in the selection of directors. Only when shareholders control the board will they start to figure out how

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180. *See infra* notes 221-24.

181. By increasing payouts and by working against discounts of stock prices from fundamental value, controlling shareholders would reward intelligent investing. Uninformed trading, or speculation, is encouraged by erratic share price changes arising from uncertainty about future payouts. By reducing that uncertainty, shareholder control would discourage speculation.

182. Former SEC Chairman Harold Williams argued that a board should include only one manager, the CEO, who should not be the board chairman. Address by Harold M. Williams, Fairless Lecture, Carnegie-Mellon University (Oct. 24, 1979). Even investor-controlled companies, however, usually include several officers on the board. Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1220 (1984) (giving reasons for management representation on boards). Many companies now have directors with specialized skills, but some commentators criticize this development. *E.g.*, Manning, *supra* note 96, at 1482-83 (specialized directors with non-business backgrounds "are often not knowledgeable about many matters that come up on the board's agenda").

183. Patton & Baker, *supra* note 90, at 12 (arguing that current boards are too large to be effective).

184. For example, incentive compensation was traditionally denied to outside directors on the theory that they do not affect corporate performance. *See supra* note 99. However, a growing number of firms now grant outside directors incentive compensation. Schleifer & Vishny, *Value Maximization and the Acquisition Process*, 2 J. ECON. PERSP. 7 (1988). Shareholders in control would have strong incentives to solve these puzzles.

185. Manning, *The Business Judgment Rule in Overview*, 45 OHIO ST. L.J. 615, 620-21 (1984). *See also* C. BROWN, PUTTING THE CORPORATE BOARD TO WORK 5 (1976) ("A well-known corporate officer recently observed in public discussion, 'Most boards of directors I have been on don't know exactly what they are supposed to do.' "); C. STONE, WHERE THE LAW ENDS 141 (1975) ("there is almost no authoritative guide as to what, exactly, the directors are supposed to be doing"); Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1803 (1976) ("The confusion as to the role and responsibility of the corporate director has precipitated serious debate.").

much time outside directors should devote to their positions, how actively they should participate in corporate planning, how to handle executive compensation, takeover defenses, and all the other problems that have long plagued corporate governance.

Improving corporate governance would improve corporate law, including fiduciary duties.[186] With shareholders in control, it might be possible to restrict or eliminate derivative suits. Such suits have always been problematic to corporate law, and, like tender offers, are a response to the collective action problem.[187] Removing the collective action problem might obviate the need for derivative suits.

C. Possible Objections

A number of objections to the proposal may be raised. First, organization is oligarchy.[188] Would a shareholder proxy committee serve its own interests rather than those of all shareholders? Fiduciary obligations would easily extend to the functions of committee members. More important, opportunities for committee members to line their pockets would be extremely limited. The law generally forbids discrimination among shareholders.[189] Large shareholders could not, for example, cause a dividend to be paid only on their shares. Thus, by law, shareholders' interests largely coincide.[190] Empirical evidence confirms this identity of interests.[191]

186. It is not clear whether shareholder control should affect the directors' and officers' duty of care. Because shareholders would have better control over directors, it might make sense to relax legal intrusion by lowering the standard of care. Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 835 (1983) (the law should regulate less where beneficiaries have greater control of fiduciaries). But perhaps a higher duty of care would be justified on the theory that more could and should be expected of outside directors who are really selected by shareholders.

187. Clark, *supra* note 78, at 780-85. Nearly all derivative suits are brought against managers. Derivative suits are permitted on the theory that many boards are not independent of management and cannot be trusted to enforce the managers' fiduciary duties. Derivative suits face many restrictions, however, on the theory that the board generally controls the corporation and that individual shareholder plaintiffs cannot be trusted to litigate in the best interest of the company.

188. R. MICHELS, POLITICAL PARTIES 15 (1962).

189. 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5352 (rev. ed. 1958) (rule of equal treatment); H. HENN & J. ALEXANDER, *supra* note 5, at 651-52 (directors and officers may not "favor one intracorporate group to the detriment of another").

190. Easterbrook & Fischel, *supra* note 18, at 405-06; 11 W. FLETCHER, *supra* note 189, at § 5352. Although differing investor interests and preferences can create coordination problems among shareholders, these problems tend to be small in public corporations with no dominant shareholder. Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 WASH. U.L.Q. 1, 21 (1987).

191. Easterbrook and Fischel, *supra* note 18, at 407, cite studies showing that when a shareholder accumulates a large bloc of stock, the firm's share price rises. They argue persuasively that this shows that large shareholders do not threaten to exploit the small; rather, the existence of large shareholders reduces the collective action problem, the principal obstacle to shareholder influence. *See also infra* note 226.

The law also circumscribes dealings of fiduciaries with the firm. Occasions for self-dealing by proxy committee members would be rarer and more easily policed than the current opportunities of executives for self-dealing; most institutional investors simply do not have the kinds of businesses that would lend themselves to self-dealing.[192] Some shareholders may be less diversified than the largest shareholders. It does not necessarily follow, however, that the undiversified shareholders will be more risk-averse; if they are undiversified, they probably want some additional risk.

Committee members might also enjoy opportunities for insider trading. Although insider trading is not an overriding evil, it is a cause for concern.[193] Selection of directors by institutional investors, however, would not materially increase insider trading. Inside information is confided to directors only a few days each year; they and their affiliates can refrain, or be prohibited, from trading at those times. Institutional investors can also be screened from the directors' inside information by a Chinese Wall or by the selection of directors with no institutional affiliations.[194] Additional steps may be needed to police insider trading and insiders may still realize some benefits, but these constitute a small price for better corporate governance.

A related concern is that the institutions' diverse investments could lead to conflicts of interest when they participate in corporate governance. An institution with interests in a supplier and a customer, for example, might try to influence the one in which it has a smaller stake to grant sweetheart deals to the one in which it has a larger interest. Corporate law already forbids controlling shareholders from abusing control this way.[195] More important, temptations and opportunities to ex-

192. Some institutional investors, such as commercial banks and investment banks, deal with industrial firms in ways (such as lending and securities underwriting) that might invite abuse. However, these investors would probably be too few on most shareholder committees to exert much influence. Whatever influence they enjoyed, moreover, would be remote from the firm's operational decisions and subject to existing law on related party transactions. Nonetheless, further regulation of these special situations might be desirable.

193. R. CLARK, *supra* note 5, at 265-77. *But see* H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); Carlton & Fischel, *supra* note 26. However, most advanced countries permit insider trading. *E.g.*, Kallfass, *The German Experience*, 1988 COLUM. BUS. L. REV. 775, 781 (within limits, insider trading is legal in West Germany). Insider trading is sometimes lauded as appropriate compensation for insiders and the same argument could be made for shareholder committee members. If some compensation is needed to elicit their diligence, however, it would be better to make the compensation overt. Carlton & Fischel, *supra*.

194. M. EISENBERG, *supra* note 4, at 62; L. LOWENSTEIN, *supra* note 34, at 215-16. "Chinese Wall" is a term used for the technique of isolating confidential information held by one part of a firm from the other parts. Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459, 461-62 (1975).

195. H. HENN & J. ALEXANDER, *supra* note 5, 637-44.

ert such influences would be rare.[196] Antitrust concerns could be handled by existing laws against interlocking directorates.[197]

Fear of conflicts of interest should not paralyze efforts to improve corporate governance. The American fixation with conflicts of interest is understandable but can be counterproductive. Japanese and continental systems tolerate and even encourage influence for such institutions as lending banks and other firms with which a company does business.[198] Any damage from the conflicts of interest in these relationships is deemed outweighed by the benefits. Indeed, Japanese and some European languages have no term for conflict of interest.[199] We should not ignore conflicts of interest, but neither should we be obsessed with them. Moreover, we should consider the problem of conflicts of interest not in the abstract, but in comparison to other possible approaches: institutional investors may have some conflicts of interest, but they pale in comparison with those of the executives who now dominate public firms.[200]

A second possible objection is that shareholder control could expose management to mistreatment. For example, shareholders might risk bankruptcy (and in turn the managers' jobs) by excessive borrowing or might cheat managers of expected compensation by suddenly selling the firm. The experience of investor-controlled firms, however, shows that managers can protect themselves and may even fare better than they do under management control. Direct management compensation tends to be higher in investor-controlled than in management-controlled firms.[201] Managers of investor-controlled firms usually hold more firm stock, which further balances the greater risks shareholders might impose. Where investors control, it is easier to negotiate a contract to cushion the blow of bankruptcy or sale of the firm or to provide expressly for deferred compensation; in management-controlled companies, these bargains are often left to "golden parachutes" because of

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196. *See supra* text accompanying note 192.

197. Clayton Act, § 8, 15 U.S.C. § 19 (1988) ("No person at the same time shall be a director in any two or more corporations, any one of which has capital, surplus, and undivided profits aggregating more than $1,000,000 . . . if such corporations are or shall have been theretofore, by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the provisions of any of the antitrust laws.").

198. L. LOWENSTEIN, *supra* note 34, at 192, 212-14; Kallfass, *supra* note 193, at 783-84. *See also infra* note 212 (interlock among Japanese companies).

199. Mikuni, Our Financial System and the Role of Shareholders (address), Columbia Conference, *supra* note 39.

200. *See supra* text accompanying notes 45-59 (divergent interests of managers and shareholders).

201. W. MCEACHERN, *supra* note 44, at 65-66, 80, 87.

problems of self-dealing and publicity.[202] Incompetent managers may not fare well, but this is no cause for concern.

A third objection flows from the neoclassical economists' view of corporate governance: if the proposal were beneficial, it would already have been adopted by public companies.[203] This view recalls the joke about a finance professor walking with a student who sees a twenty-dollar bill; the student asks the professor if he should pick it up. "Of course not," the professor replies, "if it really were there, someone would already have picked it up."[204] Someone must be the first. Only gradually has the nature of the corporate governance problem come into focus.[205] Moreover, changing conditions now demonstrate that larger investors have fewer conflicts of interest and fewer opportunities for self-dealing than the individuals and families who once figured more prominently among major shareholders.[206] Among large institutional shareholders, fewer are now commercial or investment banks that might also have conflicts of interest. Institutional investors have also become more interested in working to keep portfolio firms on, or return them to, the right track, rather than following the Wall Street Rule of voting with management or selling.[207]

Shareholder control has also failed to evolve for want of mechanisms to effect change. Institutional investors could pursue shareholder control through charter amendments, but this would require a lengthy, expensive firm-by-firm campaign. More important, it would require resort to the proxy mechanism, which is the root of the problem; if the proxy system already worked for shareholders, it would not need reform. Moreover, shareholder control has increased, albeit only in special cases where evolution was possible. In the growing field of venture

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202. Coffee, *supra* note 12, at 9, 24, 73-81 (discussing implicit contracts for deferred management compensation). Deferred compensation contracts may have been left implicit in the past because the threat of shareholders' reneging by selling the firm was so remote. Because of the growth of takeovers, more firms have now adopted explicit contracts which provide payments for managers ousted in takeovers. However, these have attracted unfavorable publicity and lawsuits. *Id.* at 77.

203. *See supra* note 18.

204. This joke appears in Tobin, *On the Efficiency of the Financial System*, 153 LLOYDS BANK REV. 1, 2 (1984).

205. For example, commentators long misunderstood the collective action problem and thought shareholders were inactive only because they lacked information. F. EMERSON & F. LATCHAM, SHAREHOLDER DEMOCRACY: A BROADER OUTLOOK FOR CORPORATIONS 3-16 (1954). Some commentators still deny that any corporate governance problem exists. *See supra* notes 17-20.

206. *See supra* note 192 and accompanying text (institutional investors have few opportunities for self-dealing).

207. *See infra* notes 225-30.

capital financing, investors typically demand a hand in control.[208] Tender offers seek to replace management control with owner control. Management buyouts also unite ownership and control, not by giving control to the shareholders, but by selling ownership to the controlling managers. Even where corporations remain public, institutional investors are asserting themselves more in corporate governance.[209] The popularity of these means for uniting ownership and control suggests that, despite the neoclassicists' claims, all is not well in corporate governance.

Although the proposal would add another layer to already complex corporate bureaucracies, the costs to the corporation would be small. The costs to the proxy committee members would not be great.[210] Newly fashioned boards would be more expensive only if investors decided to get better qualified directors and demand more work from them. These costs would be far outweighed not only by enhanced profits, but also by the reduced costs to all investors of monitoring the firm's managers.

The most serious objection to the shareholder proxy committee proposal is that shareholders, especially the institutions who would dominate shareholder committees, are obsessed with short-term profits. In this view, investors care only about the firm's market value; the stock market, in turn, is fixated with short-term considerations, such as quarterly earnings, and not with the fundamental value of the firm.[211] The officers, however, take an appropriately long-range view. Proponents of this view often compare American corporations unfavorably with Japanese firms which, they believe, take a commendably longer-range view of investment because they are free from shareholder influences.[212] Although shareholders could not easily transmit myopia to the board and

208. *See infra* note 227; Longstreth, *Corporate Governance*, N.Y.L.J., Oct. 19, 1989, at 5, col. 1 ("Institutional investors are increasingly turning to non-public investments" which "more completely align the interests of management with the interests of ownership.").

209. For example, Texaco recently agreed to add to its board a director suggested by the California Public Employees Retirement System. Triumph at Texaco: Shareholders' candidate placed on the board, Issue Alert, Feb. 1989, at 1 (newsletter published by Institutional Shareholder Services, Inc.).

210. *See supra* text accompanying note 150.

211. L. LOWENSTEIN, *supra* note 34, at 56-87; Lipton, *supra* note 110, at 7-8; Reich, *supra* note 60, at 36.

212. Japan's system of "interlock," in which most stock in industrial companies is held by banks and other firms with which the company does business, has produced stable shareholders and "has helped achieve a virtual independence between the management and the shareholders." Kurokawa (address), Columbia Conference, *supra* note 39, at 5. This independence facilitates long-term planning. *Id.* at 8. *See also* Kallfass, *supra* note 193, at 786 (interlocking corporate share ownership in West Germany).

management under this proposal,[213] the fear of short-sightedness warrants attention.

Managers sometimes take a longer-term view of corporate activities than do shareholders, but their perspective is not necessarily superior. Managers prefer to retain and reinvest earnings even if the return on investment is lower than the prevailing market rate; shareholders prefer that earnings be paid out unless they can be reinvested at a rate of return exceeding those on other investment opportunities.[214] If we accept the premises of a market economy, the shareholders are right. Japanese companies take a longer perspective than American, but only because Japanese market conditions are different. The cost of capital in America far exceeds that of Japan; projects that are sufficiently profitable for them are not for us.[215]

Even apart from the different costs of capital, comparisons between American and Japanese corporations are hazardous because of the tremendous cultural differences between the two countries.[216] To ascribe Japanese success to managerial independence seems far fetched. Given the substantial freedom of American managers from investors and the investor pressures on Japanese managers,[217] it is not even clear that Japanese managers enjoy greater freedom than American managers. Moreover, the Japanese situation may be changing, with investors obtaining more influence and demanding higher returns, as evidenced by the flight of Japanese capital to the United States. In short, Japanese capital markets may be becoming more like ours.[218] The higher returns commanded by American investors may be economically undesirable;

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213. Under the proposal, the committee is limited to meeting once a year to nominate candidates for the board. Shareholders who sell out quickly cannot influence even their own nominees.

214. *See supra* text accompanying notes 49-52.

215. "The cost of capital in Japan in real terms is about one-third of that in the United States." *Corporate Debt: Is It Riskier in U.S.?*, N.Y. Times, Nov. 10, 1988, at D1, col. 3 (quoting George Hatsopoulos, senior lecturer at Massachusetts Institute of Technology). *Accord* Farrell, *Why Junk in the First Place? Skimpy Savings*, BUS. WK., Sept. 11, 1989, at 92 (citing a study by the Federal Reserve Bank of New York).

216. This is not an appropriate forum to discuss their differences, but a few of them can be noted. "Theory Z" ascribes Japanese success to teamwork. W. OUCHI, THEORY Z (1981). If true, is this a product of Japanese corporate law or cultural attitudes? Theory Z may not even be true. Some claim that Japanese managerial success springs from fear instilled by intolerance for failure. Kotkin & Mishimoto, *Theory F*, INC., April 1986, at 53. Japanese business success also owes much to the famed appetite of managers and employees for work, but this, too, is induced by culture, not by corporate law.

217. Because of the system of "interlock," *see supra* note 212, Japanese managers need not worry about takeovers and daily stock prices. Interlocking shareholders insist on managerial competence and integrity, however, and may work to remove ineffective managers. Mikuni, *supra* note 199, at 7 (if a company is mismanaged, banks can demand change in management). *See also* L. LOWENSTEIN, *supra* note 34, at 212 (in West Germany, merchant bank shareholders step in if management is weak).

218. Mikuni, *supra* note 199, at 9; Kurokawa, *supra* note 212, at 8-10.

they discourage projects that could create employment and help American companies compete internationally. If America's higher cost of capital is a problem, however, it should be attacked by encouraging Americans to save and invest rather than by conceding managers' broad discretion with but a "pious wish" that they use it wisely.[219]

It could be argued that the proxy committee proposal will give control to myopic shareholders who want more than competitive rates of return. If, for example, shareholders only care about quarterly earnings, their already weak influence should not be enhanced, but eliminated. However, even investors who trade rapidly are probably not so irrational. Investors are not fooled by changes in earnings that reflect only quirks or changes in accounting, and stock prices tend to respond favorably to capital expenditures.[220] True, shares often trade at prices far lower than experts consider to be a firm's fundamental value. Struggling to explain this phenomenon, commentators advance two theories. One is the misinvestment theory. To investors, shares are worth only the income they will produce in future payouts, discounted to present value. If the firm pays low dividends and is insulated from hostile takeover by poison pills and other defenses, the value of the shares depends primarily on the hope that the entrenched managers will voluntarily raise dividends or permit the company to be taken over. This is true even though the firm has and promises to maintain strong, steadily growing earnings.[221] Given manager opposition to payouts and takeovers, stock prices simply reflect the realistic expectation of investors that they may never receive the fundamental value of their shares.[222]

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219. *See supra* note 62. The relative reluctance of Americans to save stems in part from tax policies that encourage spending (for example, tax deductions for interest on debt) and from the absence of tax policies, used by Japan and other countries, to encourage saving (for example, tax exemptions for interest on savings). The reluctance also stems in part from social attitudes about thrift and consumption. Thus, Japanese policies would not necessarily produce the same results here.

220. Hall, *The Effect of Takeover Activity on Corporate Research and Development*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 69 (A. Auerbach ed. 1988); McConnell & Muscarella, *Corporate Capital Expenditure Decisions and the Market Value of the Firm*, 14 J. FIN. ECON. 399, 416 (1985) (announced increases (decreases) in capital expenditures correlate with significant positive (negative) stock price changes). *Accord* Pound, Lehn & Jarrell, *Are tender Offers Hostile to Economic Performance?*, REGULATION, Sept.-Oct. 1988, at 25, 55.

221. Berle and Means recognized that the value of shares depends on the expectation of payouts, but that the shareholders' right to payouts is ephemeral. A. BERLE & G. MEANS, *supra* note 1, at 287.

222. Black, *supra* note 41, at 612-13 (investors discount the shares of certain firms because they expect the firms' retained earnings to be wasted); Kraakman, *supra* note 34, at 897-99. The shareholders' problem is underscored by the difficulty of even defining "fundamental value." One possible meaning is the price that the firm would fetch in an auction. This measure may be inappropriate because that price may be inflated by the tax benefits available to a purchaser (but not to incumbent management). Lipton, *supra* note 110, at 9-10. The price may also be increased by the synergy from merging the firm into the acquirer and by the willingness of many buyers to overpay. Dent, *supra* note 36, at 778-80. Another possible meaning is the present value of the firm's expected

A second theory argues that speculative, uninformed trading drives stock prices below fundamental value.[223] This theory has been questioned,[224] but even if it is valid, it does not follow that vesting control of the proxy mechanism in a committee of large shareholders would damage corporate performance. Institutions in many foreign countries, including Sweden, West Germany and Japan, play a large role on corporate boards and their influence is generally considered benign.[225] American experience also confirms the desirability of shareholder influence: corporations in which a few shareholders own enough stock to exert influence generally outperform firms that are management controlled.[226] Similarly, many institutions make venture capital investments in which they assume a prominent role—typically half of the seats—on the portfolio firm's board. These institutions willingly take a long-term view of the firm; indeed, that is one reason why managers often turn to venture capitalists and other institutions for equity financing.[227] In general, those who have an effective voice in an organization are less likely to exit from it.[228] Thus, shareholders who have an effective voice are less likely to follow the Wall Street Rule and sell when unhappy, but rather to exercise their voice in an effort to improve the firm.

Through leveraged buyouts, many institutions become controlling shareholders or part of the control group of industrial companies. Far from damaging these companies, investor control "eliminates managers' obsession with quarterly earnings and the bad habits that it creates."[229] The institutions are not an oddball few; several prestigious

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future earnings. That figure may depend greatly on whether one expects management to reinvest earnings at below-market rates of return. *See supra* note 51.

223. Kraakman, *supra* note 34, at 899-901. *Cf.* Wang, *supra* note 34.

224. Kraakman, *supra* note 34, at 939-41.

225. L. LOWENSTEIN, *supra* note 34, at 192, 212-14; Kallfass, *supra* note 193, at 790 (in West Germany, active institutional investors do not think short-term).

226. Schleifer & Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 465-71 (1986) (presence of large nonmanagement shareholders benefits small shareholders); Wruck, *Equity Ownership Concentration and Firm Value*, 23 J. FIN. ECON. 3, 3 (1989) ("announcement of a private sale [of equity] is associated with a 4.5% increase in non-participating shareholder wealth"). *Cf.* E. HERMAN, *supra* note 91, at 107-13 (superior performance of owner-dominated firms may be due to factors other than failure to maximize profits in management-dominated firms). *But see* Stigler & Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J.L. & ECON. 237, 259 (1983) (practices in management-dominated firms don't differ from those in owner-dominated companies).

227. Jereski, *Enter the 'Core' Investor—To Cheers and Boos*, BUS. WK., Sept. 18, 1989, at 104 (more U.S. firms are raising capital from a single large equity investor).

228. A. HIRSCHMAN, EXIT, VOICE AND LOYALTY 37 (1970).

229. *Power Investors Call the Shots*, BUS. WK., June 20, 1988, at 126, 127. The "bad habits" include accounting methods that inflate taxes and reported earnings without improving actual financial performance. *See supra* note 48. As evidence of their long-term commitment, institutional investors sometimes increase the capital budgets of the controlled firms. *White Shoes and Blue Collars and Morgan Stanley*, BUS. WK., June 20, 1988, at 122; *Progress Isn't Drowning in*

investment banks have created buyout funds and have persuaded many domestic and foreign pension funds and commercial banks to invest.[230]

These developments show that institutional investors are not inherently irrational and short-sighted. Their short-term focus, if it exists at all, results from their impotence in management-controlled firms and vanishes in leveraged buyouts and venture capital situations where they have some influence. Thus, the problems of investor myopia and of stock prices that bear no resemblance to fundamental value cannot be solved by keeping shareholders powerless. The solution is to give shareholders the control that, in theory, they should already possess as owners of the firm. The value of their shares can then be brought into line with the fundamental value of the firm.

In sum, the possible criticisms of the proposal, although enlightening, carry little force. Still, if the criticisms carry any weight at all, why change? In this regard, we should beware the nirvana fallacy, under which any actual or proposed state of affairs must be rejected if it is not perfect. Shareholder control of corporate boards cannot be perfect any more than any other human institution can be. The proper comparison is not with perfection, but with the current system of management control. The current corporate governance system has major shortcomings. The proxy committee proposal promises major improvements.[231] Its defects are, by comparison, slight.

V. Conclusion

More than fifty years ago, Berle and Means established the separation of ownership and control in the large public firm as the central problem of corporate law. It remains so today. By controlling the proxy system, managers have broken free of accountability to the owners of the business: the shareholders. The corporate governance debate has lost sight of this problem, however, and has become bogged down in an intellectual trench war over the monitoring model and the ALI Corporate Governance Project. The monitoring model and the ALI Project have some merits; nonetheless, even their supporters admit that they would not improve corporate governance greatly. Their key shortcoming is that they fail to resolve the separation of ownership and control.

Corporate governance scholarship needs to abandon the current sterile debate and grapple with the problem posed by Berle and Means. Some aspects of a new approach seem clear; shareholders must acquire control, but collective action problems and rational shareholder apathy

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Debt-Yet, Bus. Wk.: Innovation in America 110 (1989) (data do not show that firms involved in mergers, buyouts, or restructurings tend to reduce research and development).

230. *Power Investors*, *supra* note 229, at 116-17; *White Shoes*, *supra* note 229, at 122-23.

231. *See supra* text accompanying notes 165-87.

mean that shareholders cannot act as a town meeting, but must rely on institutional investors to take a leading role. This Article proposes that this be accomplished by granting corporate funds for proxy solicitations exclusively to a committee of the largest shareholders. This approach promises to unify ownership and control and, in so doing, resolve many problems that have long plagued corporate law. Apart from the significance of the particular proposal, it is hoped that this Article will help to lift the corporate governance debate out of the rut in which it is now stuck and elevate that debate to a new and more fruitful plane.