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Beyond Managerialism: Investor Capitalism?

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BEYOND MANAGERIALISM: INVESTOR CAPITALISM?

Alfred F. Conard*

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INTRODUCTION

Capitalism, in most large public corporations, has been subtly transformed from a system of dominance by the suppliers of capital to a system of dominance by the managers, dubbed "managerialism." In many respects, managerialism is beneficial to investors and other enterprise constituencies, since managers' rewards typically grow with the profitability of the enterprise. But managerialism permits drastic wastes of resources when managers hang on to their jobs after they have become inefficient or spend lavishly to defend themselves against takeover bids. Derivative suits, shareholder proposals, independent direc-

tors, and other prescriptions have failed to stifle managerial abuses. This is the message of Part I.

Through most of the twentieth century, managerialism appeared to be an inescapable consequence of the dispersion of share ownership in tiny fractions among tens of thousands of holders. But the last quarter of the century witnessed a dramatic concentration of shareholdings in investment institutions—principally pension funds, mutual funds, endowments, and stock ownership plans. The holdings of these institutions are so large that a manageable number of funds could feasibly join hands to supervise managers in a new system of control that might be called “investor capitalism.” This is the thesis of Part II.

The remainder of the Article explores the reasons why funds have not exerted their potential power and speculates on the consequences of institutions’ exerting it. Part III examines the motivation of institutions and their components. One problem is the dilemma of “collective goods.” A portfolio manager gains nothing for himself by improving the profitability of General Motors (for instance), since the gains will be shared by all the other portfolio managers who are in competition with the one that spent his own time and money in producing the improvement. Another problem is the pressure that fund sponsors can exert on portfolio managers. The managers of General Motors, for example, might press trustees of General Motors’ pension fund to support the managers of takeover targets, even though the fund would benefit from the bid’s success.

If institutional managers were to surmount the dilemma of collective goods, the pressure of sponsors, and other motivational impediments, they would confront a regime of federal securities regulation that is indifferent in some respects, and hostile in others, toward investors’ exercise of power over managers. These impediments are reviewed in Part IV.

Part V offers speculations on the consequences that might flow from institutional investors’ exercise of their potential power over corporate managers. At best, this change might accelerate the removal of inefficient managers and block the waste of resources on takeover battles. At worst, it might lead to sacrificing long-term goals for short-term gains, or to enhancing the entrenchment of enterprise managers through alliances between them and institutional managers. A few revisions of legislation and case law would enhance the probability of beneficial consequences.

In conclusion, the Article proposes changes in public and private attitudes and amendments of laws and regulations to advance the cause of "investor capitalism."

I. THE RISE AND THE FLAW OF MANAGERIALISM

In the capitalism decried by Marx and extolled by Schumpeter, enterprises were managed by owners—that is, by people who were expected by law and custom to receive the greatest benefits and to bear the greatest risks of the undertaking.¹ These are the participants whom contemporary financial economists call "residual claimants."² This system, which may be appropriately identified as "owner capitalism," continues to flourish in millions of small enterprises, and a few large ones, organized as simple partnerships or close corporations.

A discriminating observation of the contemporary scene will reveal that this ancestral form of capitalism has given way to a deviant form, which has some merits and some demerits that distinguish it from its ancestor.

A. *The Rise of Managerialism*

In the great majority of the largest enterprises, owner capitalism has been superseded by another system in which enterprises are managed by executives who hold very small fractions of total equity and who are virtually autonomous because they use the

1. Marx did not use the word "capitalism," but dwelt on the behavior of the "capitalist," who appears to have been a single individual who united the functions of owner, executive, middle management, and foreman. See K. MARX, *CAPITAL* 197-221, 331-41, 822-34 (1st American ed. 1906) (1st ed. 1867). Marx made no reference to corporations, nor to a divergence between the interests of owners and managers, although Adam Smith had called attention to this divergence 91 years earlier. See 2 A. SMITH, *THE WEALTH OF NATIONS* 211-44 (1934) (1st ed. 1776). Schumpeter distinguished between "entrepreneurial" capitalism, in which the owner-managers are risk-taking innovators, and "bourgeois" capitalism, in which the owner-managers are risk-shunning conservators, but took no notice of the division between owners and managers. J. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* 73, 131-42 (3d ed. 1950). For a description of this "traditional" system and its contrast with modern managerialism, see A. CHANDLER, *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 15-78, 377-500 (1977).

2. See Fama & Jensen, *Agency Problems and Residual Claims*, 26 *J.L. & ECON.* 327 (1983); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305, 311 (1976).

proxy system to cast the votes of most of the other shareholders.³

Although the contemporary literature of management favors the election of some directors characterized as "outside" or "nonmanagement," it plainly assumes that these directors are chosen by incumbent officers or directors, rather than by shareholders.⁴

This system has become known as "managerial capitalism" or, more briefly, as "managerialism."⁵ One writer has called it "ownerless capitalism."⁶ Under this system, the executives' shares of ownership are very small in relation to the resources that they administer, so that they have more to gain from manipulation of their positions of power than from the benefits of shareholding.⁷ The 1968 edition of the *Encyclopaedia Britannica* offered the observation that "capitalist managers under big business parallel the position of managers of trusts and factories in the Soviet Union. Both hold power by virtue of office rather than of ownership."⁸

3. E. HERMAN, *CORPORATE CONTROL, CORPORATE POWER* 53-113 (1981). For the divergence of ownership and management a half-century earlier, see A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932). See also R. GORDON, *BUSINESS LEADERSHIP IN THE LARGE CORPORATION* 128-34, 143-46 (1961); R. LARNER, *MANAGEMENT CONTROL AND THE LARGE CORPORATION* 19-21 (1970). For a recent recapitulation of the literature of managerialism, see E. EPSTEIN, *WHO OWNS THE CORPORATION? MANAGEMENT VS. SHAREHOLDERS* 1-16 (1986). Cf. I. KRISTOL, *TWO CHEERS FOR CAPITALISM* 20 (1978): "And though management will talk piously, when it serves its purposes, about its obligations to the stockholders, the truth is that it prefers to have as little to do with them as possible, since their immediate demands are only too likely to conflict with management's long-term corporate plans."

Two recent authors, basing their observations on British as well as United States enterprises, have taken a slightly different view of the power structure in large corporations. See J. SCOTT, *CAPITALIST PROPERTY AND FINANCIAL POWER: A COMPARATIVE STUDY OF BRITAIN, THE UNITED STATES AND JAPAN* 1-6 (1986) (arguing that large corporations are controlled by constellations of institutional investors and lenders); M. USEEM, *THE INNER CIRCLE* 175-79 (1984) (contending that executives are effectively supervised by an interlocking directorate of executives from other companies, who impose standards of behavior that are prevalent in the community of large corporation executives).

4. See THE CONFERENCE BOARD, *CORPORATE DIRECTORSHIP PRACTICES: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD* 135 (1973) (report written by J. Bacon and J. Brown) [hereinafter *DIRECTORSHIP PRACTICES*]; Committee on Corporate Laws, Section of Corp., Banking & Business Law, Am. Bar Ass'n, *Corporate Director's Guidebook*, 33 *BUS. LAW.* 1595, 1619-28 (1978) [hereinafter *Guidebook*].

5. A. CHANDLER, *supra* note 1; E. HERMAN, *supra* note 3, at 9; R. MARRIS, *THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM* 1-45 (1964); Mason, *The Apologetics of "Managerialism,"* 31 *J. BUS.* 1 (1958).

6. E. EPSTEIN, *supra* note 3, at 41.

7. See Coffee, *Shareholders versus Managers: The Strain in the Corporate Web*, 85 *MICH. L. REV.* 1 (1986).

8. *Capitalism*, in 4 *ENCYCLOPAEDIA BRITANNICA* 839, 844 (1968).

The separation of management from beneficial ownership has progressed through phases that one commentator has aptly characterized as "four stages of capitalism."⁹ In the first stage, owners were managers. In the second stage, ownership became dispersed among myriads of passive shareholders who retained the legal authority to choose managers but neglected to exercise it because of the effort and expense that would be required to inform themselves and to mobilize their fellows. In the third stage, many of the beneficial owners entrusted their funds to investment companies and trust companies, thereby losing even the legal right to vote directly in the affairs of the enterprises in which their funds were invested. In the fourth stage, a large fraction of individuals' savings was shifted from funds chosen by the savers to pension funds chosen by the savers' employers or unions.¹⁰ At this stage, the beneficial owners were triply removed from decisionmaking in the enterprises that employed their savings.

Managerial capitalism demonstrated some advantages over owner capitalism.¹¹ It permitted enterprises to grow to enormous dimensions, which never could have been reached if the number of shareholders had been limited to numbers that could participate effectively in governance.¹² It opened executive positions to competition based more on merit than on family relationship to major shareholders.¹³

At the same time, managerialism revealed a vital defect, which might be obviated by another kind of capitalism if appropriate changes were made in the legal and political environment of institutional investors.

B. *The Flaw in Managerialism*

Managerial capitalism has revealed, alongside its manifest virtues, a kind of "immune deficiency." Like other manipulators of power, from kings to corporals and from popes to professors, managers are inclined to serve their own interests at the expense

9. Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561 (1981).

10. R. IPPOLITO, PENSIONS, ECONOMICS AND PUBLIC POLICY 163-64 (1986).

11. See A. CHANDLER, *supra* note 1; see also Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 402-05 (1977).

12. See A. CHANDLER, *supra* note 1, at 455-83.

13. *Id.* at 8-10, 464-68.

of their constituents, and managerial capitalism contains no adequate restraints on their inclination.

During the first half of the twentieth century, the self-serving antics of managers seemed relatively innocuous, consisting chiefly of compensating themselves at levels that exceeded the market value of their services but did not significantly diminish returns to shareholders.¹⁴ There were also occasional instances of executives' hanging on to positions of power after their competencies had diminished, like Sewell Avery in Montgomery Ward & Co.¹⁵

Apologists of managerialism could plausibly contend that the costs of overcompensation and inefficiency were minute in proportion to shareholders' total returns, and that the threat of takeovers would keep them within reasonable bounds. If the costs became significant, these apologists theorized, better managers would take over through stock purchases.¹⁶

In the 1970s and '80s, as takeover bids proliferated, managers found ways to frustrate them with defensive tactics that acquired colorful sobriquets like "greenmail," "shark repellents," and "poison pills." By these devices, managers not only deprived their shareholders of millions of dollars of potential gains,¹⁷ but also insulated themselves from the discipline of future tender offers. The directors of Marshall Field, for example, denied their shareholders the chance to realize a gain of approximately 100 percent, amounting in the aggregate to more than one hundred million dollars.¹⁸

14. See R. GORDON, *supra* note 3, at 280-81; R. LARNER, *supra* note 3, at 33-61.

15. *Avery Holds the Fort*, BUS. WEEK, June 26, 1948, at 24.

16. The classic exposition of these views was made by Henry Manne in *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); for a more recent recapitulation, see Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982).

17. See Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 J. FIN. ECON. 183 (1983); Sprinkel, *The Real Issue in Corporate Takeovers*, Wall St. J., July 17, 1987, at 18, col. 3.

18. Carter-Hawley-Hale (CHH) proposed in 1978 to pay cash and securities valued at \$42 a share for all of the company's nine-million-odd shares, which had fluctuated between \$17 and \$21 for many months until about three weeks before the CHH proposal. MOODY'S INDUSTRIAL MANUAL 2591 (1978). After the proposal was rejected, the shares quickly fell to earlier levels, MOODY'S INDUSTRIAL MANUAL 2606 (1979), reaching a low of \$12.75 in 1980, MOODY'S INDUSTRIAL MANUAL 3866 (1981). In 1982, they rose slowly but never passed \$30 until taken over by BATUS Inc. at \$45.90 in June 1982. MOODY'S INDUSTRIAL MANUAL 4014 (1982). The board's action was sustained against a shareholder's attack in *Panther v. Marshall Field & Co.*, 486 F. Supp. 1168 (N.D. Ill. 1980), *aff'd* 646 F.2d 271 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981). For a critical evaluation of the board's conduct, see the dissenting aspects of the opinion by Cudahy, Circuit Judge, *Panther*, 646 F.2d at 299.

The directors of Disney paid over 300 million dollars to get rid of one takeover bidder and more than seven million dollars for a defensive maneuver to defeat a second.¹⁹ A number of legal and economic commentators called for some brake on defensive tactics.²⁰ Even in the absence of a takeover threat, General Motors paid Ross Perot more than 700 million dollars—over twice the market value of his shares—for his shares plus his agreement to leave the board of directors and stop criticizing the management.²¹ According to one successful investment manager, “The disenfranchisement of all shareholders by rapacious managements with kept boards of directors—some paid consultants to the very same corporations—has cost shareholders billions upon billions.”²² These massive diversions of enterprise resources seem likely to affect not only shareholders, but also employees, consumers, and communities, which share in varying degrees the affluence and the penury of enterprises.

There are, of course, critics who contend that resources are wasted less in resistance to takeover offers than in the tender offers themselves, which lead to overindebtedness and improvident liquidations.²³ According to these observers, many takeovers are driven by the desire of the acquirers’ managers to enlarge their empires and their perks, with slight regard for the returns of their investors.²⁴

One need not determine whether takeovers are predominantly beneficial or predominantly detrimental; there are probably

19. The first payment was to buy the stock of the bidder at a price that gave him a \$59 million profit; the second was an indemnity paid to rescind a merger agreement that had been made to fend off a second takeover bid. See *The High Price Disney Paid To Save Itself*, BUS. WEEK, June 25, 1984, at 32, 32-33, Magnet, *No More Mickey Mouse at Disney*, FORTUNE, Dec. 10, 1984, at 56.

20. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Easterbrook & Fischel, *Takeover Bids, Defensive Tactics and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277 (1984); Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?*, 28 J.L. & ECON. 151 (1985).

21. *GM Boots Perot*, NEWSWEEK, Dec. 15, 1986, at 56.

22. M. SOSNOFF, *SILENT INVESTOR, SILENT LOSER* 6 (1986).

23. See E. HERMAN, *supra* note 3, at 100-01; Lipton, *Takeover Bids in the Target's Boardroom; An Update After One Year*, 36 BUS. LAW. 1017 (1981); Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983).

24. One investment manager has described “corporate managements who feather their nests and make mindless acquisitions only so that they can reward themselves with higher salaries and longer-range Gulfstream jets.” M. SOSNOFF, *supra* note 22, at 42.

some of each kind.²⁵ Under either hypothesis, some enterprise managers are consuming resources on a grand scale to protect or to aggrandize their own positions.

A few observers contend that the battles between bidders and targets increase "shareholder wealth," in spite of the enormous expenditures involved, because they result in higher aggregate market prices for securities.²⁶ This argument is not completely persuasive because it seems to confuse price inflation with increases in wealth and to ignore the fact that a good deal of the markup in prices goes into the pockets of arbitrageurs,²⁷ of whom Ivan Boesky provided the most spectacular example.²⁸ The investing public owns the same assets after the takeover battle as it owned before but has contributed additional savings for the privilege, with much of the difference going to arbitrageurs, lawyers, and investment bankers, who brought about the higher securities prices. Even if the increase in the price of the assets reflects some enhancement of their profitability under new management, policymakers should explore the possibility that the same enhancement could be produced less expensively and more reliably by other mechanisms.

The spectacle of enormous expenditures of executive effort on battles for control, and of the capricious distribution of the capital gains that result from them, has led to a widespread opinion that the takeover wars are intolerable. In this vein, the chairman of the American Bar Association's Committee on Corporate Laws declared:

The unfriendly tender mania has provoked unseemly behavior by both antagonists. The surprise raid and the front-end loaded offer tilt the rules unfairly. Greenmail, the piranha-like Pacman defense, the poison pill, the golden parachute have added spice to our vocabulary but brought us no honor. We should recognize that our cor-

25. For an exhaustive litany of complaints against takeover offenses and defenses, see *Impact of Corporate Takeovers: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 99th Cong., 1st Sess. (1985)* [hereinafter *Impact*].

26. See, e.g., Jensen, *Takeovers, folklore and science*, HARV. BUS. REV., Nov.-Dec. 1984, at 109.

27. See Williams, *What's Legal—and What's Not*, FORTUNE, Dec. 22, 1986, at 36; Worthy, *Wall Street's Spreading Scandal*, FORTUNE, Dec. 22, 1986, at 26, 28-29.

28. See Pauly, *The SEC Bags Ivan Boesky*, NEWSWEEK, Nov. 24, 1986, at 68; Russell, *The Fall of a Wall Street Superstar*, TIME, Nov. 24, 1986, at 71; *Ivan Boesky's \$100 Million Mistake*, U.S. NEWS & WORLD REP., Nov. 24, 1986, at 9.

porate behavior is simply below the norm which over the long run the good sense of the Congress will tolerate.²⁹

In 1987, members of Congress voiced similar sentiments in a flurry of bills designed to restrain the efflorescence of takeover battles—creeping takeovers, junk bonds, unequal voting rights, greenmail, and poison pills.³⁰

Although there is no consensus on measures to be taken, there is a widespread consensus that ways must be found to achieve at lower cost whatever enhancements of profitability emerge from the takeover wars. The waste of enterprise resources is detrimental not only to people who think of themselves as shareholders, but also to countless other indirect beneficiaries—pensioners whose funds are invested in shares, students and scholars who depend on university endowments, innumerable citizens whose lives are enriched by the beneficence of foundations. Waste also affects employees, consumers, and ambient communities, whose opportunities to bargain for better treatment are narrowed when enterprises are less productive.

C. *Patches on the Flaw*

The twentieth century has witnessed a parade of efforts to patch managerialism's vital flaw. A review of the most notable of these efforts may cast some light on the endemic character of managerialism's immune deficiency.

1. *Shareholder derivative suits*— The most conspicuous of the extant deterrents of managerial abuses have been shareholders' derivative suits, but their deficiencies have been exposed in law review articles too numerous to cite. At best, derivative suits

29. Subak, *Chairman's Message*, 40 BUS. LAW. xiv-xv (1984).

30. See S. 78, 100th Cong., 1st Sess. (1987) (seeking to regulate greenmail and creeping takeovers) (sponsored by Senators Metzenbaum, Glenn, Mikulski, and Sarbanes); S. 227, 100th Cong., 1st Sess. (1987) (seeking to regulate creeping takeovers, duration of tender offers, golden parachutes, greenmail, and two-tier offers) (sponsored by Senator D'Amato); S. 336, 100th Cong., 1st Sess. (1987) (seeking to regulate creeping takeovers) (sponsored by Senators Kassebaum, Nickles, Glenn, Exon, Boren, and Danforth); S. 634, 100th Cong., 1st Sess. (1987) (seeking to regulate anticompetitive takeovers, greenmail, creeping takeovers, unequal voting rights, poison pills, golden parachutes, two-tier offers, junk bonds, and leveraged buy-outs) (sponsored by Senator Specter); H.R. 685, 100th Cong., 1st Sess. (1987) (seeking to regulate junk bonds) (sponsored by Representative Richardson); H.R. 2172, 100th Cong., 1st Sess. (1987) (seeking to regulate creeping acquisitions, junk bonds, delay in disclosure, unequal voting rights, golden parachutes, and poison pills) (sponsored by Representatives Dingell, Markey, Slattery, Bryant, Cooper, and Eckart).

are likely to succeed only when mismanagement is obvious; judges will not second-guess directors in close cases.³¹ At worst, derivative suits are abused by lawyers who prosecute them more for their settlement value than to penalize or deter mismanagement.³²

2. *Shareholder democracy*— In the 1950s, a flurry of publications and agency rulings focused on activating the rank and file of individual shareholders under the banner of “shareholder democracy.”³³ A similar concept surfaced in a pair of bills introduced in Congress in 1980, optimistically entitled “Protection of Shareholders Rights Act of 1980” and “Corporate Democracy Act of 1980.”³⁴

This idea was doomed from the start by the inability of individual shareholders to inform themselves about corporate affairs at a cost in time and money that would bear a reasonable relationship to what they might hope to gain. By 1980, the effective mobilization of individual shareholders had become mathematically impossible in many corporations because of the shift of shareholdings from individuals to institutions.³⁵

In an early recognition of the shift of ownership from individuals to institutions, Nader, Green, and Seligman proposed in the 1970s an ingenious variation of the shareholder democracy con-

31. See Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 278 (1981); Dent, *The Power of Directors To Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U.L. REV. 96 (1980). For a concise summary, see E. ERSTEIN, *supra* note 3, at 17-24.

32. Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 804 (1984); Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 13-33; cf. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U.L. REV. 542 (1980) (showing a high rate of settlement of shareholders' suits with modest benefits to corporations). The significance of Jones's study is limited by the lack of a separation of shareholders' derivative suits from shareholders' class action suits.

33. F. EMERSON & F. LATCHAM, *SHAREHOLDER DEMOCRACY: A BROADER OUTLOOK FOR CORPORATIONS* (1954); L. GILBERT, *DIVIDENDS AND DEMOCRACY* (1956); Caplin, *Proxies, Annual Meetings and Corporate Democracy: The Lawyer's Role*, 37 VA. L. REV. 653 (1951); Caplin, *Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage*, 39 VA. L. REV. 141 (1953); Garrett, *Attitudes on Corporate Democracy—A Critical Analysis*, 51 Nw. U.L. REV. 310 (1956). For a more recent discussion of the concept, see Schwartz, *Shareholder Democracy: A Reality or Chimera?*, CAL. MGMT. REV., Spring 1983, at 53.

34. These were, respectively, S. 2567, 96th Cong., 2d Sess. (1980), known as the Metzbaum bill, and H.R. 7010, 96th Cong. 2d Sess. (1980), known as the Rosenthal bill. An analysis of both appears in STAFF OF SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 96TH CONG., 2D SESS., *REPORT ON CORPORATE ACCOUNTABILITY 725-34* (Comm. Print 1980) [hereinafter *CORPORATE ACCOUNTABILITY*].

35. See R. IPPOLITO, *supra* note 10, at 11.

cept. They suggested that the "beneficial" owners of investment companies and pension funds should tell the investment managers how to vote the shares in their portfolios.³⁶ The same idea was put forward rather tentatively by some witnesses, and rejected very firmly by others, in the 1986 pension fund hearings conducted by Congressman Wirth.³⁷ The beneficiaries of these funds seem even less likely to have useful ideas about the conduct of portfolio enterprises than direct shareholders of enterprises.³⁸

The hope that individual share owners could effectively monitor the managers of large enterprises no longer seems to be entertained seriously by anyone. A revival of the shareholder democracy idea was suggested by the title of a 1987 proposal for a House Concurrent Resolution, "To express the sense of the Congress with respect to the need for shareholder democracy in the rules administered and supervised by the Securities and Exchange Commission," but its operative clauses were limited to urging the SEC to preserve equality of voting rights.³⁹ It contained no provisions for facilitating action by shareholders, either individual or institutional.

3. *Independent Directors*— In the late 1970s and the 1980s, most of the critics of managerialism abandoned hope for shareholder democracy and turned their attention to installing directors who would be free of the conflicts of interest that affect executives. The Conference Board presented arguments for the presence of "outside directors" on boards, and even for an

36. R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* 128 (1976).

37. *Pension Funds in the Capital Markets: Hearing before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 99th Cong., 2d Sess. (1986) [hereinafter *Pension Funds*]. Robert J. Scott, executive director of the Public Employees Retirement Association of Colorado, thought that fund beneficiaries should have votes, but that it would be difficult to arrange, *id.* at 31; Professor Tamar Frankel of Boston University thought that pass-through voting should be allowed, and that it might work in small funds, *id.* at 77; Roger C. Bransford, on behalf of the Association of Private Pension and Welfare Plans, declared that pass-through voting would be prohibitively expensive, *id.* at 60.

38. R. NADER, M. GREEN & J. SELIGMAN, *CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS* 203 (1976). Recognizing the improbability that beneficial owners would have useful knowledge about portfolio enterprises, the Nader group proposed in an earlier draft that the beneficial owners of funds should elect policy boards to direct the voting of fund shares. *Id.* at 203-04. This suggestion disappeared in the revision entitled *TAMING THE GIANT CORPORATION*. R. NADER, M. GREEN & J. SELIGMAN, *supra* note 36. Ronnie J. Straw, representing the Communication Workers of America, testified in the pension fund hearings that labor unions (presumably through their officers) should participate along with employers in management of pension funds, including the voting of portfolio shares. *Pension Funds*, *supra* note 37, at 43.

39. H.R. Con. Res. 42, 100th Cong., 1st Sess. (1987).

"overwhelmingly outside board."⁴⁰ The Corporate Director's Guidebook of the American Bar Association's Corporate Laws Committee advocated that key committees of the board should be composed exclusively of "nonmanagement" directors.⁴¹ A keystone of the American Law Institute's successive drafts of *Principles of Corporate Governance* was the requirement or recommendation that large public companies have specified proportions of directors who would be "free of any significant relationships with the corporation's senior executives."⁴²

The idea of requiring publicly held corporations to provide themselves with independent directors is excellent, but it will not alleviate the vices of managerial egoism until independence is measured by a more stringent criterion than the mere freedom from employment by the corporation, from a family relationship with executives, and from equity ownership in a supplier of goods or services to the corporation.⁴³ Executives can easily find directors who are neither subordinates, relatives, nor suppliers, who will support almost anything that the executives propose, and who will resign in extreme cases rather than oppose the executives who have invited them to the board.⁴⁴ They have been given a powerful incentive to select directors of this kind by a recent extension of the business judgment rule that gives a presumption of validity to conflict-of-interest transactions when independent directors have approved them. In particular, courts defer to the opinion of "independent directors" that a derivative suit should be dismissed because it is not in the best interest of the corporation.⁴⁵ In a few cases, the approval of directors who

40. DIRECTORSHIP PRACTICES, *supra* note 4, at 28-71, 62-63 (1973). The Conference Board is an association of executives of large corporations.

41. *Guidebook*, *supra* note 4, at 1625-27.

42. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03 (Tent. Draft No. 1, 1982) [hereinafter T.D. 1]. The first draft contained a provision requiring that large, publicly held corporations have boards with a majority of such directors. In 1984, the majority norm was demoted to a "recommendation of [good] corporate practice," but a requirement of independent directors on the auditing committee was retained. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 3.04, 3.03 (Tent. Draft No. 2, 1984).

43. These are the principal elements of independence as defined by T.D. 1, *supra* note 42, § 1.24.

44. See Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83; M. SOSNOFF, *supra* note 22, at 170-74, 182-83.

45. See Block, Prussin & Wachtel, *Dismissal of Derivative Actions Under the Business Judgment Rule: Zapata One Year Later*, 38 BUS. LAW. 401 (1983); Brown, *The Business Judgment Rule: Burks v. Lasker and Other Recent Developments*, 6 CORP. L.J. 453 (1981); Sparks, *Recent Developments in Substantive Business Judgment Rule*, 61 N.C.L. REV. 534 (1983); Veasey, *Seeking a Safe Harbor from Judicial Scrutiny of Directors'*

are "independent" in the same vague sense has been held to relieve executives of the burden of proving fairness in transactions between themselves and their corporations.⁴⁶ Under these conditions, "independent" directors resemble, in Victor Brudney's simile, the facade of a Potemkin Village.⁴⁷

In the 1970s, a few commentators proposed to mitigate the supremacy of managers by authorizing government agencies to appoint one or more directors.⁴⁸ Since this suggestion has not attracted any further adherents, its obvious complexities will not be explored here.

4. *Specific Prohibitions*— During the 1980s, protesters against the abuses of the tender-offer wars often proposed new rules and laws to penalize acquirers' tactics, such as creeping acquisitions and two-tier offers, or defensive devices, such as golden parachutes, greenmail, poison pills, and unequal voting rights.⁴⁹ One such measure was enacted in the form of a penalty tax on unusual termination benefits.⁵⁰

These proposals are unlikely to curb abuses, so long as the dynamics of management power remain fundamentally unchanged. If managers are forbidden to pay themselves cash benefits, they can sell themselves parts of the enterprise, or even the whole enterprise in a "leveraged buy out." If they are forbidden to issue preferred shares with discretionary features (a common form of "poison pill"), they can issue discretionary debt obligations. If they are forbidden to pay high cash prices ("greenmail") for shares, they can exchange the shares for a company asset—an oil field or a product line. The curbing of abuses can be achieved only by giving investors the effective power over managers that corporation laws were originally designed to provide.

Business Decisions—An Analytical Framework for Litigation Strategy and Counselling Directors, 37 BUS. LAW. 1247 (1982).

46. See *Cohen v. Ayers*, 596 F.2d 733 (7th Cir. 1979); *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976). This view was adopted by The American Law Institute. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02(b) (Tent. Draft No. 5, 1986).

47. Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982).

48. C. STONE, WHERE THE LAW ENDS 159 (1975); Moscow, *The Independent Director*, 28 BUS. LAW. 9, 11-12 (1972).

49. For a list of the congressional proposals of early 1987, see *supra* note 30.

50. 26 U.S.C. § 4999 (Supp. IV 1986) (subtitled "Golden parachute payments").

II. THE INVESTORIAL ALTERNATIVE

In the 1980s, a new approach to the control of managerialism became plausible as a result of the concentration of shareholdings in the hands of institutional investors and changing attitudes of institutions toward shareholder activism. These developments, and their relation to the dynamics of enterprise governance in some other countries, are discussed in the paragraphs that follow.

A. *The Institutional Eruption*

The immensity of aggregate institutional holdings of enterprise equities is well known. What makes these holdings significant, however, is not their aggregate immensity, but the proportions of ownership that they represent in particular corporations and the numbers of institutions that make up these proportions.

The reported proportion of equities held by institutions rose from about 16 percent in 1960 to about 34 percent in 1980, and was expected by some observers to rise to fifty percent by the year 2000.⁵¹ If nonreporting institutions were included, the percentage may have already passed 50 in the 1980s.⁵²

While the potential power of institutional shareholders was growing, the power of individual shareholders was shrinking, since individuals' fraction of corporate equities necessarily fell as the institutional fraction rose.⁵³ The possibility that individual shareholders would act to defend their interests became more and more remote.

51. R. IPPOLITO, *supra* note 10, at 157; *Pension Funds*, *supra* note 37, at 3 (statement by Congressman Donald E. Luken).

52. NYSE FACT BOOK 55 (1985). The New York Stock Exchange estimated that 35.4% of all NYSE-listed shares were held by "major institutional investors" in 1980, and that if all institutional categories were included, the institutional fraction of NYSE-listed shares would pass 50%.

53. According to Federal Reserve System figures, "household" ownership of equities declined from 86% in 1961 to 66% in 1984, while holdings of insurance companies, pension funds, and mutual funds rose from 11% to 29% over the same period. The only other significant class of holders was "foreign," amounting to three percent in 1962 and five percent in 1984. BOARD OF GOVERNORS, FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS; FINANCIAL ASSETS AND LIABILITIES YEAR-END, 1961-84, at 35-36 (1985) [hereinafter FLOW OF FUNDS]. The percentages of institutional holdings indicated by these figures are lower than in other reports; the figures are derived from different sources and reflect "all equities," rather than equities listed on particular exchanges or those selected for coverage in an investment manual.

Institutional holdings are not, of course, equally distributed among enterprises, and the power of institutional investors depends in large part on the level of holdings and the number of holders in particular companies. For institutions to exert influence in any particular enterprise, it is necessary not only that the institutions hold a large proportion of the shares, but also that the number of institutions involved be small enough to facilitate collaboration among them. In order to find out how often these conditions coexist, an analysis was made of the holdings reported by 100 randomly chosen issuers of actively traded equities.⁵⁴

Institutional holdings in the 100 companies ranged from over 90 percent at the high end to a little more than 6 percent at the low end.⁵⁵ Thirty of the 100 enterprises were owned by institutions to the extent of more than 60 percent. Sixty of the 100 were owned by institutions to the extent of 40 percent or more. The distributions are tabulated in Table 1.

TABLE 1

Proportions of shares held by institutional investors

Proportion of shares held by institutions	0-20%	20-40%	40-60%	60-80%	80-100%
Number of companies so held	7	33	30	29	1

The number of institutions holding these proportions of equities is also important, because the ease of collaboration among

54. The 100 companies were chosen from the 944 companies reported in MOODY'S HANDBOOK OF COMMON STOCKS (Winter 1986-87 ed.) [hereinafter MOODY'S]. These companies were characterized by the publisher as companies whose stocks have "high investor interest," MOODY'S, *supra*, at 2; they were all listed on the New York Stock Exchange. The fact that they had high investor interest suggests that they may have had higher institutional participation than a random sample of all publicly traded equities would have. The institutional investors, whose holdings in the 944 issuers were reported by the Handbook, included about 1412 domestic and foreign investment companies, 1100 insurance companies, 250 national banks, 442 investment advisers, pension funds and other managers of \$100 million or more, and 239 colleges. MOODY'S, *supra*, at 7a. In view of the small size of the sample, and its possible bias, it should be regarded as suggestive, rather than definitive, of the potential influence of institutional investors on publicly held enterprises.

55. At the high end, Tektronix, Inc., reported 90% institutional holdings; at the low end, Bic and Unilever reported between six and seven percent institutional holdings. See MOODY'S, *supra* note 54.

institutions varies inversely with the number of institutions that must collaborate to attain a critical mass. For 66 of the 100 companies, the number of institutional investors was no more than 200. In eighty-four of the 100, the number of institutional investors was no more than 400.⁵⁶ The distributions are exhibited in Table 2.

TABLE 2

Number of institutional investors per company

Number of institutional investors per company	0-200	201-400	401-600	601-800	801-1000
Percent of companies with these numbers of institutional investors	66	18	10	4	2

The key to institutional power, however, is the concurrence of a high proportion of institutional ownership with a small number of institutional owners. When that happens, institutional investors can organize an influential block with relative ease. In one of the 100 companies in the sample, 80 percent of the shares were held by no more than 400 institutions. Of the 30 enterprises that were more than 60 percent owned by institutions, 12 had no more than 200 institutional holders, and 20 had no more than 400. These distributions are exhibited in Table 3.

56. Forty-three of the 100 enterprises had no more than 100 institutional investors, 89 had no more than 500, and none had more than 1000. The companies in the sample with more than 500 institutional holders were General Motors (920), Philip Morris (830), Citicorp (606), Ameritech (604), Union Pacific (581), Allied-Signal (547), Ford Motor (533), Aetna (528), Dun & Bradstreet (530), Raytheon (513), and Warner-Lambert (502). *Id.*

TABLE 3

Number of companies with various numbers of institutional
investors and proportions of institutional shareholdings

Proportion of institutional holdings

	0-20%	20-40%	40-60%	60-80%	80-100%	Totals
Numbers of 801-1000 institutional investors per company	0	0	1	1	0	2
601-800	1	2	0	1	0	4
401-600	0	0	3	8	0	11
201-400	0	4	5	7	1	17
0-200	6	27	21	12	0	66
Totals	7	33	30	29	1	100

While institutional investors were increasing their holdings, they were also increasing their separate and collective activism in opposing the adoption of shark repellent and poison pill defenses by the targets of takeover bids. In 1985, a number of public pension funds formed the Council of Institutional Investors in order to coordinate institutional resistance to defensive maneuvers like the Disney greenmail payment.⁵⁷ In 1987, several of the largest pension funds joined in sixty shareholder proposals to require that poison pills be submitted to the vote of shareholders,⁵⁸ and a proposal in one company to rescind a poison pill that had been adopted.⁵⁹ The proposals for submission of poison pills to shareholders received 40 percent or more of the votes cast in 4 companies.⁶⁰

57. *Pension Funds*, *supra* note 37, at 27.

58. Franklin, *Down, But Not Out: Pill Challenges Fail; But Get Significant Numbers*, N.Y.L.J., May 28, 1987, at 5, col. 3.

59. Anders, *International Paper, Major Holders Press their Fight over Validity of 'Poison Pill'*, Wall St. J., Apr. 2, 1987, at 6, col. 1; Anders, *Institutional Holders Irked by 'Poison Pill'*, Wall St. J., Mar. 10, 1987, at 6, col. 1.

60. Franklin, *supra* note 58.

In at least one instance, institutional shareholders of a prospective bidder joined in protest against the launching of a take-over bid.⁶¹

The growing power of institutional investors and the shrinking power of individual investors suggest the possibility, and perhaps even the inevitability, of a system of corporate governance in which institutional investors would take a leading role in determining the purposes for which major corporations will be managed. I call it "investor capitalism."

B. *The Concept of Investor Capitalism*

"Investor capitalism" would recapture the essential genius of capitalism by restoring primacy to the interests of the suppliers of capital. This primacy is not only the idea from which the name of capitalism is derived; it is also the characteristic that, according to the traditional justifications of capitalism, makes it work.⁶²

The word "investor" is added to signify that the interests of the suppliers of capital are defended not only by the shareholders who are beneficial owners, but also by the institutional investors—pension funds, mutual funds, trustees, and foundations—to whom individual savers have entrusted the management of their funds.

Under investor capitalism, the great majority of decisions that managers make would be the same as under managerialism. Their decisions would be different only when managers' and shareholders' interests diverge. The most conspicuous divergences during the 1980s arose in some instances of target managers' resistance to takeover proposals, and some instances of bidders' executives' decisions to launch takeover bids. Less conspicuous instances of divergent interests have involved managers who had become inefficient but hung tenaciously to their positions, and managers who procured compensation far beyond the amounts necessary to motivate their best efforts.⁶³

Investor power might be asserted with varying degrees of intensity. At a minimum, institutional investors would organize to

61. Kilman, *Some of Interco's Shareholders Oppose Its \$500 Million Accord To Buy Lane Co.*, Wall St. J., Apr. 1, 1987, at 16, col. 3.

62. For capsules of conventional wisdom on the subject, see *Capitalism*, *supra* note 8, at 839-45; Sombart, *Capitalism*, in 3 *ENCYCLOPEDIA OF THE SOCIAL SCIENCES* 195-208 (1935). For a classic rationale, see J. SCHUMPETER, *supra* note 1.

63. See *supra* text accompanying notes 19-22.

give managers their opinions on payments of greenmail and bonuses, as they did in the winter of 1986-87 with regard to General Motors.⁶⁴ At a further stage, they would organize to vote together on charter amendments that facilitate or impede takeovers, on officers' compensation plans, and on shareholder proposals.⁶⁵ Ultimately, they would organize to nominate and elect directors of their choice.

Shareholder democracy—whatever is left of it—would be reinforced by investor capitalism, because institutional investors would supply sufficient expertise to analyze and identify shareholder interests and would exercise leadership in organizing voting blocks that comprise individuals as well as institutions.

Managers would continue to operate enterprises without interference by directors or shareholders, so long as they manage efficiently and avoid conflicts of interest. They would not be directed from above, as they often are in a subsidiary. But they would be checked by investor-oriented directors and by the votes of shareholders when their actions were contrary to investors' interests. In the ultimate phase of investor capitalism, fundamental differences between the views of executives and investor-oriented directors would be resolved by removal of the managers, rather than by resignations of the directors, as they are under managerialism.

C. *The New and the Old in Investor Capitalism*

Investor capitalism is not a new invention, but a means of giving vitality to the system of governance that legislators have decreed from the birth of business corporations to the present day. What is new about it is the adaptation of that legislative paradigm to the structure of contemporary finance, in which savers entrust most of their investment funds to financial intermediaries. Within this structure, the interests of savers must be defended not by the individual savers, but by the financial institutions to which savers delegate the function of monitoring

64. Levin, *GM's Smith Gets Conditional Backing of Fund Managers in Wake of Buyout*, Wall St. J., Jan. 29, 1987, at 4, col. 5; *One Big G.M. Holder Is Not Publicity-Shy*, N.Y. Times, Dec. 22, 1986, at D2, col. 5. This meeting was followed by an agreement for a continuing dialogue between GM management and institutional investors. Heard, *Pension funds and GM agree to establish advisory group*, 4 IRRS CORP. GOVERNANCE BULL. 46 (1987).

65. See, e.g., Anders, *International Paper Co. Holders Reject Poison-Pill Challenge; Earnings Triple*, Wall St. J., Apr. 15, 1987, at 6, col. 1.

the performance of the enterprises in which their savings are invested.

Although there is no existing example of investor capitalism that precisely fits this model, some of its elements may be found in the system of corporate governance that prevails in one of the more successful economic systems outside the United States—that of West Germany. There, a majority of the shares in the largest publicly held corporations are normally voted by proxy-holders named by banks. These proxy-holders vote shares that the banks own outright, shares that affiliated investment companies hold for the benefit of other owners, and shares that the banks hold as custodians for owners.⁶⁶

Japanese enterprises also present alternatives to managerial supremacy that differ markedly from those reported from other countries.⁶⁷ The most celebrated system, as reported by observers in the 1970s and 1980s, is the one prevailing in the combines known as *kigyoshuban*, which took the place of the *zaibatsu* that were dissolved after World War II. The well-known names of Mitsui, Mitsubishi, Sumitomo, and Yasuda are associated with combines of this type. Each combine comprises several companies in diverse lines of business; the Mitsubishi combine included a bank, a casualty insurer, a “heavy industry” manufacturer, a glass company, an electric company, and others.⁶⁸ In these combines, most of the component companies own shares in

66. U. IMMENGA, BETEILIGUNGEN VON BANKEN IN ANDEREN WIRTSCHAFTSZWEIGEN 101-05 (1978) (“Shareholdings of banks in other lines of business”) [hereinafter IMMENGA 1978]; see also U. IMMENGA, AKTIENGESELLSCHAFT, AKTIONÄRSINTERESSEN UND INSTITUTIONELLE ANLEGER (1971) (“Corporations, Shareholders’ Interests and Institutional Investors”) [hereinafter IMMENGA 1971]. For briefer expositions in English, see Grossfeld, *Management and Control of Marketable Share Companies*, 13 INT’L ENCYCLOPEDIA COMP. L. §§ 4-236 to 4-240, at 98-99 (1973) [hereinafter Grossfeld 1973]; Vagts, *Reforming the “Modern” Corporation: Perspectives From The German*, 80 HARV. L. REV. 23, 55-58 (1966) [hereinafter Vagts 1966]. For an exposition of the behavior of directors and managers under the German system, see C. VOGEL, AKTIENRECHT UND AKTIENWIRKLICHKEIT ORGANISATION UND AUFGABENTEILUNG VON VORSTAND UND AUFSICHTSRAT (1980) (“Corporation Law and Corporation Reality: Organization and Division of Tasks between Managers and Supervisory Council”). For a recent confirmation of banks’ power over enterprises, see Roth, *German Banks Maintain Grip on Nation’s Corporations*, Wall St. J., Sept. 30, 1987, at 32, col. 1.

67. Analyses in the English language of Japanese corporate governance are scarce. The best that I have found is in J. SCOTT, *supra* note 3, at 159-97. Also useful are M. SKULLY, *JAPANESE CORPORATE STRUCTURE: SOME FACTORS IN ITS DEVELOPMENT* (offset typescript, Dryden Press, Sydney, Australia 1981) and Tatsuta, in *Paris Colloquium on Corporate Governance*, 6 J. COMP. BUS. & CAP MKT L. 199, 237 (1984). I have also drawn on private conversations with various Japanese economists and analysts in international colloquia, and correspondence with Professor Yoshimichi Hiraide of the University of Nagoya.

68. J. SCOTT, *supra* note 3, at 189.

other components so that the reciprocal holdings constitute controlling blocks of shares in each company. The managers of each company pursue policies that satisfy the managers of the other members of the combine, and especially the managers of the principal bank. Although an American observer can imagine that the policies of each component's managers would receive the acquiescence of the managers of the other components, the practice seems to be just the opposite; each component's officers defer to the consensus of the presidents of other components, or to the views of the officers of the combine's principal bank.

A different control system exists in newer enterprises that are not parts of a combine; these include the major automobile manufacturers—Toyota and Nissan. In 1982, nineteen of the twenty largest shareholders of Toyota, holding 48 percent of the shares, were banks or insurance companies.⁶⁹ Policies are dominated chiefly by banks, exercising their influence as lenders, rather than as shareholders.

In both systems of control, hegemonic influence was not exerted by proxy contests or takeover bids, and rarely by cutting off credit, but rather through a tradition of deference whereby the chief executive of each enterprise yields to the opinions that prevail among executives of affiliated companies or executives of the company's principal banking connection.⁷⁰

The existence of alternative systems of governance in West Germany and Japan is interesting not only because enterprises of those countries appear to operate no less efficiently than those of the United States, but also because they maintain their efficiency without the "discipline" of takeover wars.

The German experience also suggests some of the kinds of people that might be elected to governing boards under the leadership of financial institutions.⁷¹ More than half of the board members in a recent survey were characterized as "shareholders," either "large" or "small." The next largest category (21 percent) comprised representatives of government (*öffentliche Hand*). Employees and officers of the banks amounted to only 9 percent and appeared in only one third of the companies sur-

69. J. Scott, *supra* note 3, at 177.

70. This point was emphasized by correspondence of Professor Yoshimichi Hiraide of the University of Nagoya.

71. The "board" in German corporations whose members are elected by the banks (on behalf of shareholders) is a "supervisory council" (*Aufsichtsrat*), which hires and fires the members of the "managing board" (*Vorstand*). For a fuller explanation, see Grossfeld 1973 or Vagts 1966 (in English) or IMMENGA 1971 or C. VOGEL (in German), *supra* note 66.

veyed. "Experts," including accountants, lawyers, and scientists, filled about 5 percent of the seats. Representatives of suppliers and customers amounted to about one percent of all members.⁷²

If institutional investors in the United States were to nominate directors of their choice, they could find qualified candidates among individual shareholders, their own officers or employees,⁷³ lawyers, accountants, and perhaps even some politicians, as banks seem to do in Germany. Whomever they might choose, their nominees could reasonably be expected to respond primarily to the interests of investors, rather than to the interests of managers, when interests diverge.

Would investor capitalism actually advance the interests of savers, or merely subject savers to the depredations of another cast of managers? If indeed it would be beneficial to savers, would it be beneficial or detrimental to other constituents of enterprise? Is it feasible at all? These questions will be explored in the pages that follow.

III. THE MOTIVATION OF INSTITUTIONAL INVESTORS

Whether institutional investors will exert their latent power to enhance the profitability of enterprises will depend, in large part, on the motivation of institutional managers. They are presumably no more and no less faithful than enterprise managers to their fiduciary duties. Like enterprise managers, institutional managers can be expected to maximize the financial returns of their funds, so long as the effort to do so contributes to their own rewards and job security. When their rewards are threatened and, even more, when their job security is imperiled, some of them are likely, like enterprise managers, to put their personal rewards and job security ahead of the interests of their constituents.

The important question is whether the self-interest of institutional investors will counteract the deficiencies of managers or

72. C. VOGEL, *supra* note 66, at 120-31. There was no category that was likely to be filled with the executives of other corporations, who predominate on American boards.

73. The frequency with which institutional investors' officers and directors serve on the boards of portfolio companies in the United States was the subject of a report in 5 INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 64, 92d. Cong., 1st Sess. 2716-48 (1971) [hereinafter INST. INV. STUDY]. In 800 portfolio companies, there were 1125 instances of institutional directors and 92 instances of institutional officers serving as directors of portfolio companies. In many of these cases, the institutions were banks or insurance companies that were creditors as well as shareholders of the portfolio companies.

will reinforce them. If institutional managers collude with enterprise managers to maximize the rewards of both at the expense of constituents, savers will be worse served by investor capitalism than by pure managerialism. If, on the other hand, the self-interest of institutional managers is served by restraining the occasional egoism of enterprise managers, investor capitalism may enhance the profitability of enterprises for the benefit of savers and other enterprise constituencies. The following pages offer some reflections on the motives that are likely to animate the players under a regime of investor capitalism. Understanding these motives requires a preliminary glance at the identities and roles of the principal players.

A. *The Players in Investor Capitalism*

Under managerialism, the principal players in the game of enterprise governance are the enterprise managers and the enterprise directors whom the managers have selected. The shareholders are generally acquiescent. The managers report to the directors on what they have done, are doing, or plan to do, and ask the directors to approve. The directors ask a few questions, make a few suggestions, and eventually approve or, if they disagree deeply, resign.⁷⁴

As institutional investors become more active, various additional players and their roles become significant. Several categories of players call for separate recognition.

1. *Fund managers*—Funds, like other business organizations, possess officers who bear primary authority and responsibility for managing the assets of the fund. Specific provisions on this point are found in the Employee Retirement Income Security Act (ERISA), which requires, with limited exceptions, that assets be entrusted to designated trustees.⁷⁵ The Investment Company Act imposes fiduciary duties on investment advisers.⁷⁶ In other funds, authority and responsibility are generally borne under general principles of corporation law by directors and of-

74. On the advisory role of directors, see M. MACE, *DIRECTORS: MYTH AND REALITY* (1971). On resignation as the "ultimate protest" of a director, see *DIRECTORSHIP PRACTICES*, *supra* note 4, at 19-20. On the need for disclosure of resignations and reasons, see Weiss & Schwartz, *Using Disclosure to Activate the Board of Directors*, in *CORPORATIONS AT THE CROSSROADS: GOVERNANCE AND REFORM* 109, 166-174 (D. Demott ed. 1980). For an instance of quiet resignation of outside directors, see Rowan & Moore, *Behind the Lines in the Bendix War*, *FORTUNE*, Oct. 18, 1982, at 156, 163.

75. 29 U.S.C. § 1102 (1982).

76. 15 U.S.C. § 80a-35 (1982).

ficers, or under the general law of trusts by anyone to whom powers of management have been delegated. These persons, who do not enjoy any widely recognized generic name, are identified in this Article as "fund managers."

Although the law assigns comprehensive power and responsibility to fund managers, they do not in practice make most of the funds' decisions independently. They are subject to influence from fund sponsors and investor services, and they delegate some of their functions to portfolio managers. Understanding the dynamics of fund behavior calls for an examination of the diverse roles and motivations of these various actors.⁷⁷

2. *Fund sponsors*— The largest group of institutional investors, measured by value of shareholdings, consists of pension funds. These funds are rarely, if ever, the creatures of their present and prospective pensioners. They have been created and are maintained in existence by private and public employers, generally characterized as their "sponsors," and their behavior varies widely according to their sponsorship.

One important group of sponsors consists of business enterprises; corporations like General Motors and American Telephone have their own pension funds. Funds of this type, commonly identified as "private pension funds," possessed in 1984 more than half of the equities attributed to all insurance, pension, and mutual funds.⁷⁸ Contacts among them are facilitated by the Association of Private Pension and Welfare Funds and, among their sponsors, by the Financial Executives Institute.

Trustees of private pension funds usually owe their positions directly or indirectly to officers of the sponsoring corporations⁷⁹

77. Vectors that affect the voting of fund shares are described in J. HEARD, *CONFLICTS OF INTEREST IN PENSION FUND VOTING* (1987) (published by the Investor Responsibility Research Center). The present author derived additional information from conversations with Mr. Heard, Director of the Corporate Governance Service of the Investor Responsibility Research Center, and Robert A. G. Monks, President of Institutional Shareholder Services, Inc. An earlier exploration of voting of pension fund shares, directed chiefly to social rather than financial issues, was contained in *Pension Fund Investment Policies: Hearings Before the Subcomm. on Citizens and Shareholders Rights and Remedies of the Senate Comm. on the Judiciary*, 95th Cong., 2d Sess. (1978). See, e.g., *id.* at 164, 169 (prepared statement and testimony of Harrison V. Smith, Executive Vice President of Morgan Guaranty Trust Co.); *id.* at 230 (prepared statement of John W. Heilshorn, Executive Vice President of Citibank); J. ALLEN, *THE EXERCISE OF VOTING RIGHTS BY LARGE INSTITUTIONAL INVESTORS: A SURVEY* (1977) (Congressional Research Service report), reprinted in *id.* at 309-46.

78. See *FLOW OF FUNDS*, *supra* note 53, at 36. This document estimated total equities owned by insurance and pension funds and by mutual funds in 1984 at \$578 billion, of which \$294 billion were held by "private pension funds."

79. See Minow, *One Man's Pension Trustee Is Another's CEO*, *Wall St. J.*, Apr. 23, 1987, at 32, col. 3.

and are likely to vote shares in conformity with the views of the financial officers of the sponsors.

A second group of pension fund sponsors is sponsored by states and cities. Officers of the California, New Jersey, New York City, and Wisconsin funds were prominent in the formation of the Council of Institutional Investors. These funds have spoken out in opposition to antitakeover defenses and in protest against General Motors' policies in paying bonuses to its executives and a large premium to Ross Perot.⁸⁰

A third group of sponsors consists of organizations like universities, churches, and foundations, which can be grouped under the name of "public benefit corporations." Their funds are frequently characterized as "the nonprofits," although the epithet applies logically to the sponsors, rather than to the funds. The most prominent fund of this type is the College Retirement Equities Fund (CREF), officers of which have been active in opposing poison-pill defenses. Organizations of this type have not yet formed any association for concerted action.

Another immense category of funds comprises investment companies, of which the most conspicuous are "mutual funds." Many of these funds were originally sponsored by investment bankers like Merrill Lynch or Morgan Stanley but are now required to be legally independent of these sponsors. However, they often depend on their sponsors to steer customers in their direction and therefore may remain somewhat responsive to the officers of their original sponsors. Most mutual funds are members of groups, such as the Fidelity group and the Vanguard group, which share advisory services, and are likely to share views that are common to the groups, rather than diverging randomly. Most of these funds, or their managers, are members of the Investment Company Institute, which gathers and publishes data on investment company operations and presumably informs federal agencies and legislators about group interests. The Institute does not purport to advise or inform its members with respect to their voting of portfolio shares.

3. *Portfolio managers*— Decisions to buy or sell securities and to vote them one way or another are generally made not by the nominal fund managers, but by individuals or firms who are assigned responsibility for particular categories of securities, like "domestic equities" or "bank stocks." These firms and individuals are commonly known as "portfolio managers." Some portfo-

80. Levin, *GM Executives to Explain Perot Buyout to Institutional Investors and Analysts*, Wall St. J., Dec. 15, 1986, at 2, col. 3.

lio managers are direct employees of the fund, but others are employees of separate investment advisors.⁸¹ Under this procedure, portfolio managers are different people, with perspectives that differ from those of the fund managers.

Portfolio managers are often in a precarious position because the fund managers reserve the power to withdraw assets on short notice and transfer their custody to other portfolio managers.⁸² On one hand, portfolio managers run the risk of losing their jobs because they are realizing lower rates of return than other managers of similar portfolios. "Returns" include not only dividends received and capital gains realized, but also paper profits (or losses) on the market values of securities. In this situation, portfolio managers can seldom afford to wait for a long-deferred price appreciation; if the price falls in the meantime, the assets in their custody may be moved to another portfolio manager.

On the other hand, portfolio managers may be pressured by sponsors to oppose takeover bids, even though the bid would enhance returns if it succeeded.⁸³ Witnesses at a Congressional hearing on pension-fund management testified that portfolio managers are sometimes coerced by their sponsors into voting against the interests of investors. A portfolio manager may be warned that if it votes against a takeover defense in Enterprise A, it will lose the accounts of the pension funds of Enterprises B and C.⁸⁴

4. *Investor services*— Various investor services have undertaken to supply information to investors about how they may vote to protect their interests.

The Investor Responsibility Research Center (IRRC) was established in 1972, in response to the flood of shareholder proposals involving racial discrimination, pollution, South African in-

81. *Pension Funds*, *supra* note 37, at 6 (statement of W. Gordon Binns, Jr.); *id.* at 58 (statement of Roger C. Bransford); *id.* at 77, 120 (statement and testimony of Tamar Frankel); *id.* at 87 (statement of James E. Heard). For comment on the plusses and minuses of outside portfolio managers, see Jansson, *Second Thoughts About Outside Managers*, INSTITUTIONAL INVESTOR, July 1987, at 137.

82. For an account of one year's shifts of portfolios among managers and a case study of portfolio losses by one manager, see *The 1987 Pension Olympics*, INSTITUTIONAL INVESTOR, Feb. 1987, at 89.

83. Parker, *The Proxy Pressure's On*, PENSIONS & INVESTMENT AGE, Sept. 21, 1987, at 3, col. 1. For an analysis of sponsors' motivations, see text of Part IIID *infra*.

84. *Pension Funds*, *supra* note 37, at 125 (testimony of Tamar Frankel); *id.* at 88 (statement of James E. Heard); *id.* at 100 (statement of Robert A. G. Monks). W. Gordon Binns, Jr., acknowledged that pressure was sometimes applied, but said it was successfully resisted. *Id.* at 18-19.

vestments, and other social issues.⁸⁵ During the 1980s, the IRRC devoted increasing attention to takeovers and takeover defenses, publishing a number of statistical studies of the effects of takeovers and analyzing the votes of institutional investors on takeover defenses.⁸⁶ James M. Heard, director of the Corporate Governance Service of IRRC, became a prominent advocate in Congressional hearings and elsewhere for investor activism.⁸⁷

Institutional Shareholders Services, Inc. (ISS) was founded in the 1980s by Robert A. G. Monks, a former administrator of the Office of Pension and Welfare Benefits, an agency of the Department of Labor that monitors the activities of pension funds. It promotes joint action by institutional investors in defense of shareholder interests in shareholders' meetings and in proposals made to Congress, to federal administrative agencies, and to state legislatures.⁸⁸

United Shareholders Association (USA) was formed in 1986 by Boone Pickens with the stated purpose to "restore management accountability and increase corporate competitiveness." It appears to direct its appeal primarily to individual shareholders.⁸⁹ In mid-1987, the Association claimed about 12,000 members.⁹⁰

B. *The Wall Street Rule*

According to a broad current of conventional wisdom, investors of all kinds are wise to forgo active participation in corporate governance, because they can protect their interests at less expense by selling their shares in enterprises that are inefficiently managed and switching their resources to better-managed companies. This principle of investor behavior has been

85. H. TALNER, *THE ORIGINS OF SHAREHOLDER ACTIVISM* 44-46 (1983). This title was published by IRRC.

86. *See, e.g.*, J. HEARD & H. SHERMAN, *CONFLICTS OF INTEREST IN THE PROXY VOTING SYSTEM* (1987); S. MARCIL & P. O'HARA, *VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1987 PROXY SEASON* (1987). Both of these titles were published by IRRC.

87. *See Pension Funds, supra* note 37, at 87-89.

88. For more specific examples of ISS activities, see the ISS Newsletter (a monthly publication issued by Institutional Shareholder Services, Inc., 3050 K. St., N.W., Suite 300, Washington D.C. 20007).

89. See announcements and news releases distributed periodically in 1987 to members and prospective members from the Association's office, 1667 K St., N.W., Suite 770, Washington D.C. 20006.

90. Letter from H.T. Bogardus of the United Shareholders Association to the author (Aug. 11, 1987) (copy on file with U. MICH. J.L. REF.).

called the "Wall Street rule."⁹¹ Its validity is said to be corroborated by the infrequency of investor opposition to management proposals and the even greater infrequency of investor nominations of directorial candidates to oppose the managers' nominations.

Although the Wall Street rule fits a typical individual investor, there are reasons to doubt that it fits a typical institutional investor in the 1980s. Selling out is a good alternative only for the holder of a small block of shares who gets the news before it is public or before others have time to act on it. The holding of a large fund or a large family of funds may be too large to liquidate without pushing down the price.⁹² When the bad news is a crown jewel lockup, it may come too late for any investor to sell before the price drops.⁹³

Moreover, the costs that any one institution would incur in organizing joint action with other institutions are much less than the magnitude of the losses imposed upon funds, or of the gains denied them, by managers' antitakeover tactics. The size of institutions' holdings enables them to assemble an impressive block of votes by canvassing a few hundred alert and sophisticated institutional holders, rather than thousands of passive individuals.⁹⁴ In a sample of 42 publicly held companies that were more than 50 percent owned by institutional investors, none had more than 900 institutional shareholders, and half of them had less than 200.⁹⁵

The recent emergence of activism on the part of pension funds indicates that the Wall Street Rule is no longer a pervasive prin-

91. CORPORATE ACCOUNTABILITY, *supra* note 34, at 392.

92. CORPORATE ACCOUNTABILITY, *supra* note 34, at 394-95; E.V. Regan, *Pension Funds: New Power, New Responsibility*, Wall St. J., Nov. 2, 1987, at 28, col. 3; see also comments of Daniel J. Baum and responses of Fred E. Brown in *Mutual Funds as Investors of Large Pools of Money*, 115 U. PA. L. REV. 669, 673-78 (1967).

93. Although a number of studies have been made of the effects of defensive measures on security prices, they have not distinguished different kinds of defenses and have reached conflicting results. See, e.g., J. POUND THE IMPACT OF ANTITAKEOVER CHARTER AMENDMENTS ON CONTESTS FOR CORPORATE CONTROL (1985) (publication of the Investor Responsibility Research Center).

94. Richard Schlefer, Investment Officer of College Retirement Equities Fund (CREF), offered the following cost-benefit analysis in an interview with the author on October 19, 1987. About one fourth of CREF's equity holdings of \$30 billion, or \$7.5 billion, are vulnerable to takeover bids. Surveys have shown that poison pills reduce the market values of shares by an average of one percent, which would amount to \$75 million in CREF's holdings. CREF's anti-poison pill campaign in 1987 involved total costs in time and communications of less than \$10,000—about one tenth of one percent of CREF's stake in the outcome of the campaign.

95. For the characteristics of this sample, see Moody's, *supra* note 54.

principle of conduct among institutional investors.⁹⁶ As institutional holdings grow, the rule will become less and less tenable as a canon of investment behavior.

C. *The "Collective Good" Dilemma*

The structure of institutional investment presents a peculiar obstacle to the participation of institutional managers in corporate governance. Although the community of funds might increase total returns by causing enterprise managers to accept tender offers rather than repel them by nonproductive expenditures, the effort required would cost time and money to the portfolio managers that would undertake it, while the benefits would be shared by all the other portfolios that hold shares in the same enterprise. The other managers would take a "free ride" on the efforts of the activists. Since the activists' funds would gain no more than the passive ones, but would incur expenses that the passive funds would escape, the activist managers would be likely to record lower returns than the passive ones.

The costs of activism may include not only the time of employees that is diverted from trading to rallying votes, but also a loss of access to opinions of enterprise managers who would be antagonized by the fund's activism, so that the fund would be disadvantaged in its trading. Although these costs may be incapable of separate measurement, they may diminish the activists' rate of return enough to divert business from activist funds to passive ones.

For these reasons, the effective supervision of enterprise managers presents a classic example of a "collective" or "common" good, like clean air and safe streets, which benefits the whole population, including those who make no contribution to their costs.⁹⁷ If the good is attained, it confers aggregate benefits on

96. CORPORATE ACCOUNTABILITY, *supra* note 34, at 397.

97. M. OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 14 (1971) defines a common, collective, or public good as any good such that, if any member of a group consumes it, it cannot feasibly be withheld from other members of the group. The concept is best known in its applications to goods that are usually provided by governments, like police protection and paved streets. In this sense, it has been applied to mandatory financial disclosure by issuers of securities. See Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 723-37 (1984); Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 680-85 (1984). But it applies equally to better wages and working conditions, which may be sought by private collective action of employees, or to higher prices for products, which may be sought by private collective action of industrial

the entire group that exceed the aggregate costs of obtaining them. But the benefit that will be received by an activist member is usually less than the costs incurred by that member in obtaining the benefits.

This deterrent to active supervision is particularly acute for portfolio managers, because fund managers may shift portfolios from one portfolio manager to another on the basis of minute differences in rates of return. The portfolio manager has little to gain from enhancements of enterprise returns that are shared by all its competitors, but has something to lose by spending money on supervision and by antagonizing the managers of portfolio enterprises.

Under these circumstances, one cannot be surprised to find that institutional investors generally neglect their chances to enhance their returns by supervising enterprise managers. What is surprising is that some institutions have become active in opposing managerial tactics. In 1986 and 1987, very large funds with highly diversified portfolios made the effort to organize shareholder voting on questions like poison pills.⁹⁸ In the spring of 1987, shareholder proposals were made in more than 60 companies by large institutional shareholders, including the Public Employees and Teachers Funds of California, the Wisconsin Investment Board, and the College Retirement Equities Fund.⁹⁹

Various explanations for these funds' activism may be suggested. In the first place, managers of these funds may reasonably expect their constituencies of governmental employees and teachers to applaud their efforts to restrain managerial self-serving, without questioning the possible costs.¹⁰⁰ Besides, their holdings may be large enough so that a very minor enhancement of their rate of return offsets the costs of activism.¹⁰¹ Finally, the managers of these broadly based pension funds are much less

cartels, or to richer returns for corporation shareholders, which may be sought by supervision of management. See M. OLSON, *supra*, at 6-7.

98. Rosenberg, *The Revolt of the Institutional Investors*, INSTITUTIONAL INVESTOR, May 1987, at 131.

99. ISS ISSUE ALERT, May 1987, at 1, col. 1.

100. This hypothesis seems contrary to the analysis of M. OLSON, *supra* note 97, who assumes that group members will be moved only by economic calculations, which they will make with mathematical rationality. I assume, on the contrary, that individual savers will sometimes pursue ideological objectives like disinvestment in South Africa without regard to costs, and that even when they pursue purely economic objectives, like the acceptance of tender offers, they tend to overlook the transaction costs of attaining them.

101. For the possibility of voluntary collective action led by group members who have a disproportionately large interest in the outcome, see M. OLSON, *supra* note 97, at 141-48.

vulnerable than portfolio managers to the danger of losing accounts if their rates of return are a shade under those of competitors; the teachers and civil servants whom they serve usually have no opportunity to switch their savings from the pension fund designated by their employer to an independent fund that is recording higher returns.

The important question ahead is whether other funds—particularly private pension funds—will support the activism of the large public funds. The private funds would incur no measurable monetary expense by voting for propositions initiated by the public funds. Informed observers have expressed privately the belief that many portfolio managers are inclined to vote against target defenses, and do so unless constrained by fund sponsors.¹⁰² The effective supervision of managers seems therefore to depend on whether private pension fund managers will pursue the common interests of their constituents or respond instead to the promanager biases of fund sponsors.

D. The Influence of Fund Sponsors

Managers of sponsoring corporations may use their influence over fund officers and trustees to induce them to vote their shares in favor of managers of portfolio companies without regard to the maximization of returns on the funds. Some enterprise attorneys and officers have openly urged company executives to join forces in supporting defenses against contested takeover bids.¹⁰³ Frankel, Heard, and Monks testified in the Pension Funds hearings that portfolio managers are sometimes threatened with losing accounts unless they support the management of a takeover target.¹⁰⁴ The testimony did not reveal how frequently this phenomenon occurs, nor how widespread are the conditions that facilitate it. At least one takeover defense advocate circulated widely an appeal to fund sponsors to direct their fund managers to support takeover defenses.¹⁰⁵

102. Conversation with James M. Heard of the Investor Responsibility Research Center (May 20, 1987); conversation with Robert A. G. Monks of Institutional Shareholder Services (May 21, 1987).

103. J. HEARD & H. SHERMAN, *supra* note 86, at 50-53, 97-100; *The Battle for Corporate Control*, BUS. WEEK, May 18, 1987, at 102, 106; *Corporate Managements Fight Back*, INSTITUTIONAL INVESTOR, May 1987, at 139.

104. *Supra* note 81; see also Cohen, *Gambling with the Future*, N.Y. Times, Aug. 12, 1986, at A25, col. 1.

105. A letter from Martin Lipton "To Our Clients" (Feb. 13, 1987), contained the following statement:

A survey conducted by the Employee Beneficial Research Institute reported that 65 percent of "pension fund investment managers" had been pressed to vote in favor of management on takeover questions.¹⁰⁶

E. The Power of Portfolio Enterprise Managers

When institutional investors attempt to exercise their statutory powers as shareholders over portfolio enterprises, enterprise managers have several ways of fighting back.¹⁰⁷ Managers often have various captive blocks of shares that will vote for management against any combination of outsiders. The most frequent are the company pension plan and the company Employee Stock Ownership Plan (ESOP). Enterprise managers, exercising the powers of the enterprise as sponsor, can usually direct the votes cast by the trustees of these plans.¹⁰⁸ Their votes seldom amount to a majority but may supply a critical addition to other blocks.

Enterprise managers also have a subtle means of exerting influence over portfolio managers and fund managers who have no organizational links with the enterprise. They can pick and choose the analysts whom they invite to their seminars, and with whom they have business lunches. At these trysts, they are likely to impart something less than material inside information, but something more than their published releases. They can leak de-

Recently the chairmen of GTE and Rockwell wrote to the chairmen of other companies asking support in the form of instructions to pension fund managers to vote in favor of charter amendments designed to protect against abusive takeover tactics. . . . I believe that it is time that all companies make their views known to their pension fund managers, banks, insurance companies and other institutions. If the corporate community makes its views known in a strong and decisive manner, support for corporate raiders and abusive takeover tactics will be reduced dramatically and legislation to abolish abusive takeover tactics would be a reality.

Copies also were circulated to a large number of academic commentators on takeover law.

106. Parker, *supra* note 83. In this report, the term "pension fund investment managers" seems to have been used to designate the players characterized in this article as "portfolio managers." The same source reported that only 25% of "corporate pension executives" reported feeling pressure from sponsors.

107. J. HEARD & H. SHERMAN, *supra* note 86, at 50-53, 97-100; *The Battle for Corporate Control*, *supra* note 103; *Corporate Managements Fight Back*, *supra* note 103.

108. For illustrations of the use of pension funds and ESOPs to support management in takeover battles, see *Norlin v. Rooney, Pace Inc.*, 744 F.2d 255 (2d Cir. 1984); *Buckhorn, Inc. v. Ropak Corp.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,371 (S.D. Ohio, Feb. 11, 1987); see also Robertshaw, *Bill Boosts ESOP Role*, PENSIONS & INVESTMENT AGE, Oct. 19, 1987, at 1, col. 2; Kotlowitz & Bean, *Spate of Corporate Buy-Outs by ESOP's Raises Questions of Benefits to Workers*, Wall St. J., Sept. 30, 1987, at 16, col. 2.

tails about sales and expenses, and their own guesses about the effects of pending economic and political developments. They can deliberately exclude from these meetings analysts who have voted shares in ways that they regard as hostile.¹⁰⁹

The analysts who are most vulnerable to this kind of pressure are the portfolio managers whose investment returns are regularly compared with the returns of competitors; they cannot afford to miss a market movement that is known to their competitors.

Even public pension fund managers may be vulnerable to pressure or blandishment by officers of portfolio companies. After the Wisconsin Investment Board filed a shareholder proposal for referenda on a transaction like the buy-back of Perot's shares, GM officers visited the Wisconsin governor and Investment Board, and the proposal was withdrawn.¹¹⁰

F. *The Fiduciary Duty of Fund Managers*

Fund and portfolio managers are, of course, under extensive fiduciary duties. The Employee Retirement Income Security Act is particularly explicit about fiduciary duties, providing a general definition of the duty (the prudent man standard of care) and a litany of prohibited transactions.¹¹¹ The Investment Company Act (ICA) does not define or enumerate fiduciary duties, but it imposes explicit liability for breaches of fiduciary duty.¹¹² Even without these statutory pronouncements, investment managers are bound by general fiduciary duties under the law of trusts.¹¹³

The voting of shares, however, is not mentioned by either ERISA or the ICA among the acts to which the fiduciary duty applies, and the law of trusts has very little to say about it.¹¹⁴

109. For discussion of the practice of disclosing to invited analysts material that is not given to the press, see Guyon, *Company Meetings with Analysts Raise Questions About Disclosure*, Wall St. J., Dec. 17, 1986, at 25, col. 4. This article does not report discrimination among analysts, but the possibility is inherent in the practice of admitting by invitation.

110. Burr, *Investors Ease Stance Against GM*, PENSIONS & INVESTMENT AGE, Feb. 9, 1987, at 2, col. 2; *Some GM Investors Are Wimps*, PENSIONS & INVESTMENT AGE, Feb. 23, 1987, at 10, col. 1; Conversation with Patricia Lipton, Executive Assistant to Wisconsin Investment Board (May 27, 1987).

111. 29 U.S.C. §§ 1101-1114 (1982).

112. 15 U.S.C. § 80a-36 (1982).

113. See H. BINES, *THE LAW OF INVESTMENT MANAGEMENT* ¶ 1.01 (1978); 2 T. FRANKEL, *THE REGULATION OF MONEY MANAGERS* 371-75 (1978).

114. H. BINES, *supra* note 113, ¶ 1.03, at 1-39, raises the question of fiduciary duty in voting but offers no answer. The duty is not mentioned by T. FRANKEL, *supra* note 113,

But there is no reason to doubt that voting is covered. With respect to ERISA, Labor Department officials have affirmed the duty of fiduciaries to vote shares in the interests of fund beneficiaries,¹¹⁶ but there is no report of any administrative or judicial sanction against fiduciaries for voting errors.

When portfolio managers vote shares against the interests of their beneficiaries in order to please their sponsors or the managers of their portfolio enterprises, they are obviously violating their fiduciary duties.¹¹⁶ But their liability for breach of trust is unlikely to deter them when the pressure is on. Fund beneficiaries would have very little chance to detect the breach, and even less chance of proving any damage.¹¹⁷ Even if a judge found that defeating a particular tender offer deprived a fund of a measurable profit, the judge might be persuaded that siding with the target's managers conferred net benefits on the fund. The fund managers might persuade the judge that if they had taken an antimanagement stand, the fund sponsor would have exercised legal options to curtail contributions to the fund or to withdraw excess reserves from it. Alternatively, they might convince the judge that they had to maintain a promanagement stance in order to receive favored access to the perspectives of the managers on enterprise prospects. Judges who have absolved target company managers of liability for rejecting handsome takeover bids¹¹⁸ would probably be equally sympathetic to fund managers who have sided with the target company managers.

Even if a court found a violation of duty, the amount of harm suffered would be too uncertain to form a basis of liability. One decision has imposed liability on a trustee for benefits conferred on an affiliate by the trustee's trading, even without harm to

nor by B. LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE* (1986).

115. *PWBA Prohibits Proxy Voting by Trustees or Named Fiduciaries Where Investment Manager Has Such Authority*, 6 Pens. Plan Guide (CCH) ¶ 23,747W (Feb. 23, 1988) (Letter from Alan D. Lebowitz, Deputy Assistant Secretary of Labor, to Helmuth Fandl, Chairman of Retirement Board of Avon Products, Inc.); see also J. HEARD & H. SHERMAN, *supra* note 86, at 32 (statement of Robert A. G. Monks, Administrator of Office of Pension and Welfare Benefits of U.S. Department of Labor); *The Battle for Corporate Control*, *supra* note 103 at 106-07 (statement of David M. Walker, Deputy Assistant Secretary for Pension and Welfare Benefit Programs).

116. See comments of Frankel, Heard, and Monks, *supra* note 84.

117. *Pension Funds*, *supra* note 37, at 125-26 (testimony of Tamar Frankel). Frankel suggested that criminal penalties should be added to the civil liabilities of ERISA.

118. See *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

beneficiaries.¹¹⁹ But it is hard to imagine proof of any measurable benefits received in compensation for casting one of several hundred votes at a shareholders' meeting.

G. Summary on Motivation

The available evidence indicates that institutional investors who are relatively independent of pressures from enterprise managers are prepared to exercise their voting power to enhance investors' returns. They are not deterred by the prospect that enhanced returns will be shared, like other collective goods, by most of their competitors.

When institutions support defensive tactics of enterprise managers, or refrain from opposing them, they are probably responding to pressure, or the fear of pressure, from fund sponsors or from the managers of portfolio enterprises, or to a fear of various juridical risks that attend investor activism. The next section of this paper explores some of the juridical risks.

IV. LEGAL OBSTACLES TO INVESTOR ACTIVISM

When institutions surmount the motivational conflicts of activism, they confront a remarkable dearth of legislative support for investor participation in governance, and a surprising series of perils implicit in federal securities laws. The Commission and the federal courts, in zealous efforts to catch malefactors, have constructed doctrines that threaten investors with formidable liabilities and burdens if they exercise their statutory rights in corporate governance. The net effect of securities laws and regulations is not to support shareholders' rights, but to fortify the entrenchment of management.

A. The Legislative Silence

Although judges sometimes refer to the "will of Congress" to insure the rule of shareholders in corporate affairs,¹²⁰ and the

119. *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984).

120. *See, e.g., Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 232 (9th Cir. 1975) ("In enacting section 14(a) [of the Securities Exchange Act of 1934], Congress intended to guarantee the integrity of the processes of corporate democracy.").

SEC has promulgated a few symbols of "shareholder democracy," the securities laws and regulations are critically deficient in support of shareholders' power in corporate governance. They remain silent on the most important instruments of shareholder suffrage.

Aside from a few bills that never emerged from committee,¹²¹ members of Congress have shown little interest in the rights of shareholders to participate in corporate governance. The hundreds of pages of hearings and debates on the Securities Act of 1933 are devoted, like the Act itself, wholly to securities sales.¹²²

Although the Securities Exchange Act of 1934 contained a section on proxies, the hearings and debates that preceded it were focused on market abuses, with only rare and casual references to the roles of shareholders and directors in corporate governance.¹²³ No mention of problems of governance appeared in either President Roosevelt's letter to the Senate supporting the bill,¹²⁴ or in the bill's statement of purpose.¹²⁵

B. *The Vulnerability of Voting Rights*

A single section in the Securities Exchange Act of 1934,¹²⁶ and none in the Securities Act of 1933,¹²⁷ deals with security-holders' voting. Unlike most other substantive provisions of the Exchange Act, which contain specific Congressional commands, this one contains only a grant of power to the SEC to make rules "in the public interest or for the protection of investors" that

121. The most significant were S. 2567, 96th Cong., 2d Sess. (1980), entitled "Protection of Shareholders' Rights Act of 1980," which was introduced by Senator Howard Metzenbaum, and was the subject of committee hearings, and H.R. 7010, 96th Cong., 2d Sess. (1980), which was entitled "Corporate Democracy Act of 1980," and was introduced by Congressman Rosenthal.

122. See 1 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J. Ellenberger & E. Mahar eds. 1973) (hearings reprinted) [hereinafter LEGISLATIVE HISTORY]; 2 LEGISLATIVE HISTORY, *supra* (debates reprinted).

123. See LEGISLATIVE HISTORY, *supra* note 122 (vols. 4-9). Brief references to the separation of ownership from control and to the abuses of control by executives awarding themselves excessive compensation appear in 78 CONG. REC. 7861-62, 7922-23, 7926 (1934), reprinted in 4 LEGISLATIVE HISTORY, *supra* note 122.

124. 78 CONG. REC. 2264, reprinted in 4 LEGISLATIVE HISTORY, *supra* note 122; 78 CONG. REC. 8048 (1934), reprinted in 4 LEGISLATIVE HISTORY, *supra* note 122 (remarks by Senator Thomas upon submission of an amendment).

125. Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1982) [hereinafter Exchange Act].

126. Exchange Act § 14, 15 U.S.C. § 78n (1982).

127. See 15 U.S.C. §§ 77a-77aa (1982).

relate to the solicitation of proxies.¹²⁸ It says nothing about rules on the rights of a security-holder to cast votes, or the subjects on which their votes may be cast. By the time Congress enacted the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940, it had become cognizant of the problem, and required equal voting rights for common shareholders in both of these acts.¹²⁹ But Congress remained mute with regard to voting rights in corporations of other types.

The historic silence of Congress on shareholders' voting rights need not be read as a signal of indifference toward them. Before the eruption of the antitakeover panic, most industrial corporations that were publicly traded showed no inclination to limit voting rights. The largest ones were generally listed on the New York Stock Exchange, which had required since 1926 that listed common shares have equal voting rights.¹³⁰

Publicly owned corporations of that day which were not already listed on NYSE aspired to be so listed when their size and investor interest would justify it, and tailored their charters to be prepared for listing. The American Stock Exchange and the Automated Quotation system of the National Association of Securities Dealers (NASDAQ) never adopted a similar rule. By 1986, expansion of these markets had made a NYSE listing dispensable. Companies listed on NYSE threatened to delist unless NYSE would relax its rule, and NYSE petitioned the SEC for permission to list nonvoting common stock.¹³¹

After long deliberations and consultations,¹³² the SEC issued, in July 1988, a rule that purports to freeze voting rights, but

128. Exchange Act § 14(a), 15 U.S.C. § 78n(a) (1982).

129. Public Utility Holding Company Act of 1935 § 7(c)(1), 15 U.S.C. § 79g(c)(1) (1982); Investment Company Act of 1940, § 18, 15 U.S.C. § 80a-18(i) (1982). On voting rights under the Investment Company Act, see also 3 T. FRANKEL, *supra* note 113, at 178-95.

130. NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL ¶ 313.00(A) [hereinafter NYSE MANUAL].

131. *NYSE's Proposed Rule Changes on Disparate Voting Rights*, 18 SEC. REG. & L. REP. (BNA) 1389-92 (1986); Ingersoll, *SEC Seeks Views on Possible Compromise on 1-Share, 1-Vote Rule for Stock Markets*, Wall St. J., Dec. 18, 1986, at 5, col. 1. For evaluations of the proposed change, see Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119 (1987) (favoring the proposal); Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986) (opposing the proposal); Dent, *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725 (1986) (favoring the proposal).

132. See Voting Rights Listing Standards—Disenfranchisement Rule, Exchange Act Release No. 25,891, 25,891A [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,247 (July 7 and 13, 1988); Voting Rights Listing Standards—Proposed Disenfranchisement Rule, Exchange Act Release No. 24,623 [1987 Transfer Binder] Fed. Sec.

leaves untouched the unequal voting rights that had already arisen,¹³³ and permits the emasculation of existing voting rights by the issuance of new nonvoting or limited-voting shares.¹³⁴

C. *The Emptiness of Shareholder Proposal Rights*

In a genteel gesture of sympathy with advocates of shareholder democracy, the SEC has given shareholders low-cost access to the suffrage of their colleagues through the shareholder proposal rule.¹³⁵ The rule permits a shareholder to circulate a proposition to the entire body of voting shareholders at the company's expense, through the company's own proxy statement.

But the Commission has framed the rule so narrowly that it provides no means of challenging the essential quality and policies of management. A shareholder's proposal cannot nominate directors, nor even express opposition to the management's nominations.¹³⁶ Even a proposed bylaw on the qualifications of directors was held to be outside the scope of the proposal rule.¹³⁷

Likewise, the proposal right is made unavailable to oppose anything that the management submits to a shareholder vote.¹³⁸ This means that shareholders cannot use the company proxy statement to oppose the shark-repellent amendments that pose the greatest threat to their interests. Shareholder proposals have generally been limited to procedural subjects, like cumulative

L. Rep. (CCH) ¶ 84,143 (June 22, 1987). In addition to the obvious arguments about the sufficiency of the market as a protector of investor interests, there was debate about the extent of the power of the SEC to regulate voting rights. See Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1266-69 (1984); Seligman, *supra* note 131, at 714-19.

133. Exchange Act Rule 19c-4(a) & (b), 53 Fed. Reg. 26,394 (1988) (to be codified at 17 C.F.R. § 240.19c-4(a) & (b)).

134. Exchange Act Rule 19c-4(d), 53 Fed. Reg. 26,394 (1988) (to be codified at 17 C.F.R. § 240.19c-4(d)). Firms can issue new non-voting or limited-voting shares and use the proceeds to buy back voting shares on the open market. See Hart, *SEC May Kill Shareholders with Kindness*, Wall St. J., July 14, 1988, at 26, col. 3.

135. Rule 14a-8, 17 C.F.R. § 240.14a-8(1988). For a historical review of the rule, see H. BOOTH, *THE SHAREHOLDER PROPOSAL RULE; SEC INTERPRETATIONS AND LAWSUITS* (1987); CORPORATE ACCOUNTABILITY, *supra* note 34, at 133-226.

136. Rule 14a-8(c)(8), 17 C.F.R. § 240.14a-8(c)(8) (1988).

137. *Rauchman v. Mobil Corp.*, 739 F.2d 205 (6th Cir. 1984). The proposal would have excluded citizens of OPEC member countries from directorships. Since an OPEC citizen was a candidate for election at the next shareholders' meeting, the court ruled that the proposal was related to an election and therefore inadmissible.

138. Rule 14a-8(c)(9), 17 C.F.R. § 240.14a-8(c)(9) (1988), allows the company to omit a proposal if it "is counter to a proposal to be submitted by the registrant at the same meeting."

voting and classified boards, and to "public interest" concerns like environmental protection and withdrawal from South Africa, which have little to do with the productivity of the enterprise and seldom interest more than 5 percent of the shareholders.¹³⁹

Support for shareholder proposals attained new highs in 1987, when a proposal to require shareholder referenda on poison pills won average support of over 29 percent, and in one company passed 45 percent. Proposals to withdraw from South Africa obtained average support surpassing 12 percent.¹⁴⁰ But if managers seize the initiative, and solicit shareholder approval of a poison pill, the rule will bar shareholders from using the company's proxy statement to oppose it.

When the shadow of institutional activism loomed on the horizon in the early 1980s, the Commission further narrowed the shareholder proposal right in a way that crippled its use in the cases where it was most likely to be effective. The Commission ruled that a shareholder could not put a proposal in the company's proxy statement if the shareholder had sent proxy materials at its own expense to holders of more than 25 percent of the shares.¹⁴¹ Under this rule, a fund that had taken the precaution of canvassing the views of other funds before filing a proposal forfeited its right to use the company proxy statement to reach the tens of thousands of individual shareholders. This bizarre restriction was dropped in 1987 after a number of bills in support of shareholders' rights had surfaced in Congress.¹⁴²

139. Leavell, *Corporate Social-Reform, The Business Judgment Rule and Other Considerations*, 20 GA. L. REV. 565 (1986); Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984); Comment, *SEC Rule 14a-8: New Restrictions on Corporate Democracy?*, 33 BUFFALO L. REV. 225 (1984); Comment, *The 1983 Amendments to Shareholder Proposal Rule 14a-8: A Retreat from Corporate Democracy?*, 59 TUL. L. REV. 161 (1984); CORPORATE ACCOUNTABILITY, *supra* note 34, at 156-64. A major development in the rule, as analyzed by H. BOOTH, *supra* note 135, at 28-31, was an increase from three percent to five percent in the vote required to justify a resubmission of a defeated proposal.

140. IRRIC NEWS RELEASE, June 23, 1987, at 3, 6. Further details on poison pill proposals and a tabulation of votes on these proposals in 30-odd companies may be found in Franklin, *supra* note 58.

141. Rule 14a-8(a)(1)(ii), added by Exchange Act Release No. 20,091, Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,417, at 86,202 (August 16, 1983). The explanation offered was that a shareholder who could reach holders of 25% without the company's aid could reach the rest in the same way.

142. See Proxy Rules—Amendments to Eliminate Filing Requirements for Certain Preliminary Proxy Material; Amendments with Regard to Rule 14a-8, Shareholder Proposals, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,211 at 88,949 (Dec. 21, 1987) (Exchange Act Release No. 25,217). For the Congressional bills, see *supra* note 30.

In 1980, an SEC staff group considered the possibility of allowing shareholders to nominate directors in the company's proxy statement¹⁴³ but announced no conclusion. Aside from the obvious impracticability of presenting the nominations of every shareholder, the staff were apparently impressed with testimony that most shareholders would have no idea about the most suitable candidates. They seem to have ignored the possibility that institutional investors would be competent to make informed nominations, and to surmount a threshold (like five or ten percent of outstanding shares) that would restrict nominations to a workable number.

Shareholders' rights to nominate directors on the company's proxy statement were also contained in the proposed Protection of Shareholders Rights Act of 1980 and Corporate Democracy Act of 1980,¹⁴⁴ neither of which emerged from committee hearings.

D. *The Liability of Controlling Persons*

If a coalition of investors should succeed in selecting a board of directors of its choice, notwithstanding the unhelpfulness of the proxy rules, it would face formidable risks of civil and criminal liability. These would result from a broad definition of "control" that the Commission has promulgated and persuaded a federal court to accept.

Under the securities laws of 1933 and 1934, anyone who "controls" an enterprise is liable prima facie for every violation of federal securities laws committed by that enterprise.¹⁴⁵ The controlling person can escape this prima facie liability only by proving that it "had no knowledge of or reasonable ground to believe" the facts involved (if the liability is under the Securities Act), or that it "did not directly or indirectly induce" the acts involved (if the liability is under the Exchange Act).¹⁴⁶

143. CORPORATE ACCOUNTABILITY, *supra* note 34, at 35-37, 50-54, 65-68.

144. *Supra* note 34.

145. Securities Act of 1933 § 15, 15 U.S.C. § 77o (1982); Exchange Act § 20, 15 U.S.C. § 78t (1982).

146. More specifically, Securities Act § 15 excuses a controlling person who "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." 15 U.S.C. § 77o (1982). Exchange Act § 20(a) excuses a controlling person who "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78 (a) (1982).

The legislators who enacted this provision presumably contemplated the kind of control exercised by railroad and public utility holding companies and by investment bankers like J. P. Morgan & Co., who caused controlled companies to issue masses of unsound securities in the 1920s.¹⁴⁷ A few senators and congressmen may have contemplated other kinds of control, such as "management control" and "control through a voting trust," that were described by Berle and Means in *The Modern Corporation and Private Property*, published the year before the Exchange Act was adopted.¹⁴⁸ In any case, they were visualizing the domination of company policies by persons other than the elected directors, as contemplated by the corporation laws.¹⁴⁹

The securities acts did not define "control," nor specify the means of proving it. In a zealous effort to facilitate proof, the SEC defined "control" to consist not only of the dictation of policies, but of the mere "power to direct or cause the direction of

147. See *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 228-48 (1933) (testimony of Robert E. Healy, General Counsel of the Federal Trade Commission), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 122 [hereinafter *House Hearings '33*]; *Securities Act: Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 211-26 (1933) (testimony of Robert E. Healy, General Counsel of the Federal Trade Commission), reprinted in 2 LEGISLATIVE HISTORY, *supra* note 122 [hereinafter *Senate Hearings '33*]; *Stock Exchange Practices*, S. REP. NO. 1455, 73d Cong., 2d Sess., 333-391 (1934), reprinted in 5 LEGISLATIVE HISTORY, *supra* note 122; F. PECORA, *WALL STREET UNDER OATH* 1-19, 113-30 (1939); J. SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 22-23, 36-37 (1982).

148. A. BERLE & G. MEANS, *supra* note 3, at 69-118.

149. The original bills that evolved into the Securities Act of 1933 did not contain any control provisions. *House Hearings '33*, *supra* note 147, at 1-9; *Senate Hearings '33*, *supra* note 147, at 1-9. The ancestors of the control provision emerged in a revision of S. 875 that was reported to the Senate on May 8, 1933. 77 CONG. REC. 2979-82 (1933), reprinted in 1 LEGISLATIVE HISTORY, *supra* note 122. They consisted of a definition of "dummy" (§ 2(k)), *id.* at 2979, and the insertion of "dummy" along with "device, scheme or artifice" among the things whose use to defraud was forbidden (§ 13), *id.* at 2982. "Dummy" was defined as:

a person who holds legal or nominal title to any property but is under moral or legal obligation to recognize another as the owner thereof; or a person who has nominal power or authority to act in any capacity but is under moral or legal obligation to act therein in accordance with the direction of another.

Id. at 2979. The Conference Committee eliminated the dummy clauses and introduced the provision that became § 15, with this explanation:

The Senate amendment contained provisions referred to as "dummy provisions" which were calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by the one party over the other. The House bill did not contain these provisions. The various provisions of the Senate amendment on this subject have been welded into one and incorporated as a new section in the substitute.

Id. at 3902.

the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."¹⁵⁰ Under a literal interpretation of this definition, any organized majority of shareholders is *prima facie* liable for securities law violations committed by the issuer of their shares.¹⁵¹

If a shareholding institution should combine with others to elect a majority of directors, it might subject itself to *prima facie* liability for any slips that a portfolio company might make in conforming to the hundreds of rules issued by the Commission. By combining to elect directors of their choice, institutions would arguably demonstrate their "power . . . to cause the direction" of the enterprise. One need not wonder why institutions have neglected to join forces to exercise their voting rights.

If the SEC ever decides to give substance to the voting power of investors, it can take a giant stride in that direction by modifying its definition of "control" to signify *actual* direction of policies, rather than mere "power to cause the direction." For good measure, it could expressly exempt investors that are unaffiliated with each other, and that combine only to elect directors, without constricting the autonomy of the directors that they elect. The liability that Congress wanted to impose upon "controlling persons" would still apply to holding companies, trust companies, and financiers that dictate the decisions of their portfolio enterprises.¹⁵²

E. Freezing Stockholdings

Beside incurring liability for securities violations of portfolio companies, members of a coalition that elected (or had power to elect) a majority of the directors of a portfolio company might find themselves frozen in their holdings. This consequence could follow from another of the SEC's expansive applications of its concept of "control."

150. Rule 405 under the Securities Act of 1933, 17 C.F.R. § 230.405 (1988) (emphasis added).

151. This definition differs significantly from the one employed in section 2(a) (9) of the Investment Company Act of 1940, which states: "'Control' means the power to exercise a controlling influence over the management or policies of a company, *unless such power is solely the result of an official position with such company.*" 15 U.S.C. § 80a-2(a)(9)(1982) (emphasis supplied).

152. Cf. Hass, *Insights into Lender Liability: An Argument for Treating Controlling Creditors as Controlling Shareholders*, 135 U. PA. L. REV. 1321 (1987).

When shares are sold by a "controlling person," the broker who executes the sale is deemed to be an "underwriter."¹⁵³ Sales by underwriters have to be registered unless they qualify for an exemption.¹⁵⁴ Since registration takes time, a shareholder who has to register before selling is likely to lose the critical moment for selling.

This inconvenience does not normally trouble an institutional investor, since its holdings in any one enterprise are usually small enough to fall within the "leakage" exemption of Rule 144.¹⁵⁵ However, the sales of persons who "act in concert for the purpose of selling" are "aggregated" in determining the limits of the exemption.¹⁵⁶ If several members of a large family of funds, like the Fidelity or Vanguard groups,¹⁵⁷ were to sell at about the same time, they could be accused of selling in concert.

This trap, like that of liability for securities acts violations, could be eliminated by relaxing the Commission's definition of "control."

F. *The Forfeiture of Short-Term Gains*

If an institution's sales are not frozen by the control principle, they may be penalized by the deputization principle. When a shareholder secures the election of a director in a company, and the person elected has authority over investments in the shareholder's portfolio, the shareholder has been held to become a director by deputy.¹⁵⁸ As a director, the investor is obliged to surrender the excess of any sale price over the price of any purchase made within six months before or after the sale.¹⁵⁹

On this principle, an institution that participates in electing one of its own analysts to a directorship is likely to forfeit its ability to realize a gain or escape a loss by a quick turnaround,

153. *United States v. Wolfson*, 405 F.2d 779, 782 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969); Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1982).

154. Securities Act of 1933 § 5, 15 U.S.C. § 77(e) (1982).

155. Rule 144 under the Securities Act of 1933, codified at 17 C.F.R. § 230.144 (e) (1988), contains a variety of alternative limits on transaction size, of which the most important are one percent of the outstanding shares of the class, or, if greater, an average week's trading.

156. Rule 144(e)(3)(vi), 17 C.F.R. § 230.144(e)(3)(vi) (1988).

157. In mid-1986, 35 Fidelity group stock funds held aggregate assets of about \$10 billion, while 20 Vanguard stock funds held assets of about eight billion dollars. *1986 Fund Ratings*, FORBES, Sept. 8, 1986, at 112, 118-19, 144.

158. *Feder v. Martin-Marietta Corp.*, 406 F.2d 260, 263-64 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

159. *Id.* at 266-67 (applying Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1982)).

and thereby to sacrifice the interests of its clients, and lose in the competition among institutions for the best rates of return. Under these circumstances, no prudent investment manager will nominate a member of its own staff for a directorship in a portfolio enterprise.

One sensible solution of this problem would be to repudiate the deputization principle, which deters not only institutional investors, but also most other investors, from exercising influence on corporate management. But a less radical change would help. At the least, unaffiliated institutions that combine to choose directors could be exempted from the deputization principle. A director can conceivably help a single sponsor with inside information but can hardly give an advantage to a whole group without destroying the advantage.

G. *The Group Filing Requirements*

Under an SEC rule, persons who "agree to act together for the purpose of . . . voting . . . equity securities" form a group¹⁶⁰ that is obliged to file the same package of information that is required of a *purchaser* of shares that increases its holdings beyond the five-percent level.¹⁶¹ The rule is an extravagant extension of the statute, which requires filing by persons who "act as a . . . group for the purpose of *acquiring, holding, or disposing of securities.*"¹⁶² It is supported by a second circuit dictum that the mere agreement to vote together constitutes an "acquisition" for purposes of the filing requirement.¹⁶³

The Seventh Circuit took a narrower view of the statute, and ruled that a mere agreement to solicit votes did not trigger the reporting requirement,¹⁶⁴ but the broader interpretation remains in force in the Second Circuit, where the most cases are likely to be adjudicated.¹⁶⁵

160. Rule 13d-5(b)(1), 17 C.F.R. § 240.13d-5(b)(1) (1988).

161. Rule 13d-1, 17 C.F.R. § 240.13d-1 (1988).

162. Exchange Act § 13(d)(3), 15 U.S.C. § 78m(d)(3) (1982) (emphasis added).

163. *GAF Corp. v. Milstein*, 453 F.2d 709, 715-716 (2d Cir. 1971). The facts of the case showed purchases concurrent with the agreement, but the court did not rely on the purchases for its application of § 13(d).

164. *Bath Industries, Inc. v. Blot*, 427 F.2d 97, 109 (7th Cir. 1970); *Calumet Industries, Inc. v. MacClure*, 464 F. Supp. 19, 29-31 (N.D. Ill. 1978).

165. Moreover, one of the bills introduced in Congress in early 1987 proposed to amend Exchange Act § 13(d)(5) to make a combination for voting an express trigger of the filing requirement. S. 227, 100th Cong., 1st Sess. § 3 (1987) (introduced by Senator D'Amato).

The information that must be filed by virtue of this interpretation and rule comprises not only the identification of holders and their holdings, but also their sources of finance and future plans for acquisitions and control.¹⁶⁶ Additional reports must be filed promptly after any change amounting to one percent in the holdings of the group,¹⁶⁷ which would require every member of the group to know the acquisitions and dispositions of other group members. Any institution that files under this would expose itself to the blizzard of litigation over the adequacy of disclosure that has followed similar filings in tender-offer cases, even where courts eventually determined that the disclosure was adequate.¹⁶⁸

Institutional investors and groups of institutional investors are mercifully remitted to a lighter regime, which requires filings only once a year and omits the requirement of information on finance and on plans for control.¹⁶⁹ But the exemption applies only if the members of the group have no purpose "of changing or influencing control of the issuer," and only if every member of the group is an institutional investor or other exempt person.¹⁷⁰ The practical effect is to deter prudent investors from nominating and electing directors and to frustrate the legislative design of shareholder power over management.

If the Commission were inclined to foster the power of shareholders, it could readily advance this objective by eliminating "voting" from the group purposes that require filing under section 13(d). The detailed disclosures and periodic amendments required by that subsection may be appropriate for takeover bidders, but they are grossly excessive for voting coalitions.

The only appropriate authority for regulating *voting* coalitions is the proxy rules, which contain provisions designed for election contests.¹⁷¹ These rules require a full disclosure of the identity of participants, of any unusual financial arrangements under which shares are held, and of any understanding about future transactions.¹⁷² But they are significantly free of the requirement for

166. Schedule 13D, Items 3-4, 17 C.F.R. § 240.13d-101, Items 3-4 (1988).

167. Rule 13d-2(a), 17 C.F.R. § 240.13d-2(a) (1988).

168. For examples of litigation over adequacy of disclosures under Rule 13d, see *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974), *cert. denied*, 419 U.S. 873; *Copperweld Corp. v. Imetal*, 403 F. Supp. 579 (W.D. Pa. 1975); *Texasgulf, Inc. v. Canada Dev. Corp.*, 366 F. Supp. 374 (S.D. Tex. 1973). For comment on the economic effects of litigation of this kind, see Rosenzweig, *Target Litigation*, 85 MICH. L. REV. 110 (1986).

169. Rule 13d-1(b)(1), 17 C.F.R. § 240.13d-1(b)(1) (1988).

170. Rule 13d-5(b)(2), 17 C.F.R. § 240.13d-5(b)(2) (1988).

171. Rule 14a-11, 17 C.F.R. § 240.14a-11 (1988).

172. Schedule 14B, 17 C.F.R. § 240.14a-102 (1988).

amending the statement whenever the holdings of the entire group vary by one percent,¹⁷³ which would require a group of investors to report to each other on every purchase or sale. They are also free of the requirement for a detailed disclosure of plans to change the policies of a company,¹⁷⁴ which is inapposite to a plan to elect directors who will reach their own conclusions about the policies of the subject enterprise.

It may be that the rule on proxy contest disclosures will need to be amplified when institutional investors make active use of them. But the disclosures that will be appropriate for voting contests will be quite different from those that fit takeover bids.

V. THE PROSPECTIVE CONSEQUENCES OF INVESTOR ACTIVISM

As policymakers face the growing potential of institutional activism, they must address the question of whether this phenomenon is likely to enhance or to impair the benefits that enterprises bring to savers, employees, consumers, and communities. On the positive side, institutional activism might enhance the profitability of enterprises, reduce the wastes of takeover wars, rationalize management compensation, and preempt shareholder suits. On the negative side, it might sacrifice long-term gains to short term profits, entrench inefficient managers in their jobs, give institutions preferred access to inside information, and diminish the responsiveness of enterprises to social demands. These possibilities are the subject of discussion in the following pages.

A. *Enhancing Profitability*

The most immediate benefit that investor capitalism might bring is enhancement of the profitability of portfolio enterprises. According to the prevailing current of supposition in the legal and economic literature of takeovers, there is an enormous opportunity for such enhancement in enterprises. Increases in profitability are believed to follow takeovers for various reasons, which include synergies, financial gains (such as tax shields and increased leverage), market power, and efficient management.¹⁷⁵

173. Cf. Rule 13d-2(a), 17 C.F.R. § 240.13d-2(a) (1988).

174. Cf. Schedule 13D, Item 4, 17 C.F.R. § 240.13d-101, Item 4 (1988).

175. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, *supra* note 20, at 1165-74; Jensen & Ruback, *The Market*

This line of thinking assumes that outside observers of target enterprises can perceive opportunities of increasing profitability on a scale that justifies paying premiums that average 30 percent over prior market prices of target shares.¹⁷⁶ Since a large proportion of enterprises have proved to be takeover targets, there must also be a very large fraction of enterprises that are falling far short of their profit potentials.

If takeover bidders can see opportunities to enhance profitability through better management, directors of potential target companies should be even better situated to perceive the opportunity and take advantage of it. Since the directors of most target enterprises have not done so, one must infer that these directors are poorly qualified, or (more likely) are unduly protective of the incumbent managers.

On these suppositions, institutional investors should be able to choose directors who would perceive opportunities to enhance profitability and would move to exploit them more promptly and less expensively than through takeover battles.

B. Cooling the Takeover Wars

Investor activism offers intriguing possibilities of reducing the waste of resources on takeover campaigns and takeover defenses.

First, let us consider those target enterprises that inspire takeovers because they present an opportunity to enhance profitability by a change of management. If directors were oriented toward the interests of investors, rather than the interests of managers, they should be just as able as outsiders to see the opportunity and change management without the stress and strain of a takeover. If they failed to act before a takeover bid materialized, they would not fight the bid, but offer just enough resistance to bargain for better terms. Since a consensual takeover is vastly less expensive to the bidder than a contested one, target directors should be able to negotiate favorable terms quite readily.

Second, let us consider those takeover bids that are not inspired by target companies' potential for increased profitabil-

for *Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 23-27 (1983); Sprinkel, *supra* note 17.

176. See Jensen & Ruback, *supra* note 175, at 7.

ity,¹⁷⁷ but by illusions of managerial superiority on the part of the managers of bidding companies or by these managers' ambitions to enhance their own prestige and rewards by presiding over more gigantic enterprises. Investor-oriented directors in the bidding companies would restrain their managers from ventures that merely expand gross sales or assets without enhancing earnings.¹⁷⁸ By this means, they would not only save money for acquisitive enterprises, but would also spare target enterprises from the costs of fighting meretricious takeover attacks.

C. Rationalizing Managerial Compensation

For more than half a century, observers of the corporate scene have denounced excessive compensation of executives.¹⁷⁹ A recent example of a proposal of excessive compensation, blocked only by the protests of institutional investors and Ross Perot, was General Motors' proposal to pay executive cash bonuses early in 1987, when the company was making massive layoffs of middle managers and operatives.¹⁸⁰ One can hardly believe that executives in this stumbling enterprise were being eagerly seduced by offers from competitors.

Overcompensation in this sense is easily dismissed on the ground that its direct effect on profitability is usually rather insignificant. In multimillion dollar enterprises, the overcompensation of executives—however it is measured—makes a barely detectable effect on the funds available for reinvestment or distribution. Its principal vice is its destructive effect on morale.¹⁸¹ From the perspective of lower level employees, unearned bonuses of executives set the example for kickbacks to purchasing agents and supervisors and for wage demands unrelated to productivity.

Overcompensation is peculiarly immune to correction by existing mechanisms of corporate governance. The "independent

177. See J. POUND, ARE TAKEOVER TARGETS UNDERVALUED? AN EMPIRICAL EXAMINATION OF THE FINANCIAL CHARACTERISTICS OF TARGET COMPANIES (1986); E. HERMAN, *supra* note 3, at 100-01.

178. See Kilman, *supra* note 61.

179. See *Rogers v. Hill*, 289 U.S. 582, 591-92 (1933); P. DRUCKER, THE NEW SOCIETY 92-5, 251-52 (1950); Geneen, *Why Directors Can't Protect the Shareholders*, FORTUNE, Sept. 17, 1984, at 28; Loomis, *The Madness of Executive Compensation*, FORTUNE, July 12, 1982, at 42; Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252-57 (1981).

180. See *GM Boots Perot*, *supra* note 21.

181. See P. DRUCKER, *supra* note 179, at 92-5, 251-52.

directors" who predominate on corporate boards are doubly biased; most of them owe their jobs to the executives whose compensation they must determine and are themselves executives of other corporations,¹⁸² where they hope for reciprocal favor.¹⁸³ Management consultants, who prepare compensation plans, are selected by directors who often share a common interest in raising the general level of executive compensation. When levels of compensation are reviewed in derivative suits, judges can only compare compensation in the case before them with compensation in other enterprises that are subject to the same biases.

Directors chosen by fund managers would be uniquely qualified to determine objectively how much compensation is optimal because they would be free of personal ties to the executives involved. Their access to the accounts of other companies would provide them with observations on the consequences of awarding higher and lower levels of compensation. They could conduct experiments with lower compensation that would never be suggested by managerially appointed directors and could experiment with higher compensation without being suspected of boardroom bias. The arrangements that they would approve would be more likely to be perceived as fair by lower level employees, and by judges when the arrangements are challenged in derivative suits. The predominance of institutional nominees on boards would eliminate much of the suspicion and resentment that is currently associated with the compensation of executives.

D. Preempting Shareholder Suits

Investor capitalism might reduce, in two ways, the waste and annoyance of shareholders' suits—both direct and derivative. First, the presence of directors who are responsive to investors might restrain managers from many of the actions that provide grounds for shareholders' suits. Second, the existence of a board that is demonstrably responsive to investors' interests, rather

182. See Useem, *Shared Directorships among Large Corporations and the Formation of a Nationwide Business Leadership*, in CORPORATE GOVERNANCE AND INSTITUTIONALIZING ETHICS 31 (W. Hoffman, J. Moore & D. Fedo eds. 1983) [hereinafter ETHICS]; *Corporate Governance: A Look at the Future*, in INVESTOR RESPONSIBILITY RESEARCH CENTER, CORPORATE GOVERNANCE: ISSUES FOR THE 1980s, at 84, 88-89 (1983) (remarks by Roger F. Murray) [hereinafter ISSUES].

183. This inference is contrary to the view of Vagts, *supra* note 179, at 275-76, who argued that executive compensation could be controlled by staffing compensation committees with outside directors, providing shareholders with better data on prevailing standards of compensation, and more rigorous scrutiny by judges in derivative suits.

than to the interests of managers, would reinforce the disposition of judges to rely on the judgment of directors.

E. The Quick Buck Bias

The most widely advanced apprehension of detrimental consequences flowing from institutional investors' influence is the fear that institutional investors will sacrifice long-term objectives by grasping immediate gains.

The most prominent of the ideas involved in this accusation is the belief that institutional investors grasp tender offers at prices above the pre-tender market price without regard to the probability of realizing more by waiting for the target enterprise to reap the benefits of the farsighted policies of managers. Harold Williams, former chairman of the Securities and Exchange Commission, observed that, "[W]e've heard a lot today . . . about the short-term outlook of the institutional investors, and, indeed, their outlook is very short-term."¹⁸⁴ A CEO of a major corporation was heard to ask, in the course of a tirade against "raiders," "Can you apply the word 'owner' to a 26-year-old pension-fund trader sitting at his CRT screen and trying to outperform the woman down the hall?" In a like vein, a representative of the Association of Private Pension and Welfare Plans remarked in colloquy that "the investment manager seems to live or die on the relatively short-term merits of his or her own performance."¹⁸⁵ The charge has evidently been heard by fund managers, several of whom took pains in a House pension fund hearing to deny that they act on a short-range horizon.¹⁸⁶ One corporate executive has proposed that the tax-exempt status of pension funds be eliminated in order to reduce the funds' short-term pressure on capital markets.¹⁸⁷

184. Williams, *Luncheon Speech*, in ISSUES, *supra* note 182, at 111, 115 (1983); see also *The Corporate Board: Institution at the Crossroads*, in ISSUES, *supra* note 182, at 9, 42, 40, 107 (remarks of A.A. Sommer, Jr. and Ira M. Millstein); *Corporate Governance: A Look at the Future*, in ISSUES, *supra* note 182, at 84, 107 (remarks of Roger F. Murray).

185. *Pension Funds*, *supra* note 37, at 133 (testimony of Roger C. Bransford).

186. *Pension Funds*, *supra* note 37, at 7, 32, 59 (testimony of W. Gordon Binns, Robert J. Scott, and Roger C. Bransford). The force of Bransford's disclaimer was somewhat muted by his observation, *supra* note 185, about what "the investment manager seems to live or die on."

187. *Idea Sounds Funds' Death Knell*, PENSIONS & INVESTMENT AGE, Feb. 9, 1987, at 10, col. 1.; cf. Mayer, *Tax-Free Funds' Unfair Advantage Damages Markets*, Wall St. J., June 27, 1988, at 12, col. 3; Rohatyn, *Institutional 'Investor' or 'Speculator'?*, Wall St. J., June 24, 1988, at 18, col. 3 (proposing a 50% tax on all trading gains under one year).

The charge that fund managers systematically seize takeover bids even when target managers foresee greater gains from holding on is plausible, even though no empirical proof of it has been presented. If one fund realizes a takeover premium while a second fund passes it up in reliance on long-term expectations of target managers, the first fund will show a better return in the next quarterly comparison, and the second firm may have no chance to vindicate its faith in long-term expectations because it may be squeezed out of the captured enterprise at a price related to the pre-tender market.

But this charge, even if true, does not show that fund managers are not acting in the best interest of savers. No one has produced any evidence that target enterprise investors have lost money as a result of takeovers or of the partial liquidations that sometimes follow them. The market's low evaluation of the target managers' expectations seems more likely to be based on an objective valuation of available information than is the self-serving opinion of target managers. Even if fund managers accepted the target managers' expectation of future profits for the enterprise, they could reasonably doubt that those profits would be translated into gains for shareholders, rather than into perks and job safety for the managers.

Even less does the charge imply that investor-oriented directors would favor short-term goals in enterprise management. An SEC study indicated that institutions tend to favor enterprises that have high rates of expenditure for research and development.¹⁸⁸

Proponents of the assertion that takeovers lead to the sacrifice of long-term gains often adduce the charge that takeovers lead to "bust-up mergers," in which components of an enterprise are sold off to liquidate the costs of acquisition.¹⁸⁹ But components are not sold unless someone is willing to buy them for more than they contribute to the market value of the selling enterprise. The laments about bust-up mergers have yet to be supported by evidence that targets which defeat tender offers achieve market values comparable to the tender offer.

Takeover critics also complain that enterprises become over-indebted as a consequence of borrowings by takeover bidders to finance acquisition or by borrowings by the targets to finance

188. OFFICE OF THE CHIEF ECONOMIST, SEC, INSTITUTIONAL OWNERSHIP, TENDER OFFERS AND LONG-TERM INVESTMENTS 12-18 (1985).

189. See *Impact*, *supra* note 25, at 13 (testimony of Martin Lipton).

defenses, including leveraged buy-outs.¹⁹⁰ It is certainly true that contested takeovers and takeover defenses have resulted in a massive rise in the debt ratios of corporations. But this consequence appears to flow not so much from the funds' receptivity to takeover bids as from managers' resistance. If target managers would willingly accept takeovers, many of them would be accomplished by share-for-share exchanges, without any increase in debt. The increase in debt is most often a feature of borrowing to finance a cash tender offer to overcome a resistant target management, or of the target managers' own leveraged buy-out. The culprits in the mounting debt scandal seem to be chiefly resistant target managers, plus a corporate income tax system that allows deductions for interest on high risk bonds, but none for dividends on equity shares.

Moreover, the fact that institutions are prone to accept takeover bids does not prove that increased investor activism would accelerate takeovers. Although portfolio managers can seldom afford to pass up a premium tender offer, they may simultaneously support takeover defenses that enable target managers to bargain with bidders for better terms or even defeat the takeover. A great many institutional investors' shares have been voted in favor of defenses.¹⁹¹ Critics of these votes reproach the voters for neglecting their fiduciary duties or violating them in response to pressure from clients.¹⁹² But investors may favor defensive tactics as a device for producing an auction for control of the target; some contemporary authors contend that this is the optimal course for directors to pursue in the interests of shareholders.¹⁹³ The chances that investors would support defensive measures, either in reliance on the target's future prospects, or in support of an auction market, would be enhanced if investors

190. See *Impact*, *supra* note 25, at 577 (testimony of Preston Martin, Vice Chairman of the Board of Governors of the Federal Reserve System).

191. *Pension Funds*, *supra* note 37, at 87-88 (statement of James E. Heard); Heard, *Pension Funds and Contests for Corporate Control*, CAL. MGMT. REV., Winter 1987, at 89, 92-95.

192. *Pension Funds*, *supra* note 37, at 87-88 (statement of James E. Heard); *id.* at 27-28 (statement of Roland M. Machold); Heard, *supra* note 191, at 92-95.

193. See Bebchuk, *Comment: The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981). This is a tacit assumption in the flurry of debate on particular tactics, like target tender offers. See Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377 (1986); Bradley & Rosenzweig, *Defensive Stock Repurchases and the Appraisal Remedy*, 96 YALE L.J. 322 (1986); Gordon & Kornhauser, *Takeover Defense Tactics: A Comment on Two Models*, 96 YALE L.J. 295, 296 (1986).

had greater influence over target managers' use of their defensive weapons.

F. *Entrenchment of Management*

There is an opposite peril of institutional investor activism that has been little noticed, although it may well be greater than that of the quick buck bias. This is the danger that enterprise managers will use their power over institutional investors to entrench themselves against any attack and to paralyze the efforts of institutional investors to protect the interests of savers.

Enterprise managers have means of exerting pressure on institutions that they could not exert on individual shareholders. In particular, enterprise executives can put pressure on the executives of private pension funds, whom they often have power to appoint and reappoint.¹⁹⁴ They can cultivate friendly relations with portfolio managers by preferring them in invitations to company seminars.¹⁹⁵ They can intimidate public pension fund officers by suggestions of opening or closing plants in the affected states.¹⁹⁶ Managers of one company can use these powers to support the managements of other companies, in an alliance of reciprocity. The fiduciary duty of fund and portfolio managers is a weak shield against these influences.¹⁹⁷

For these reasons, the enhanced influence of institutional investors may menace the interests of the beneficial owners and other constituents of enterprises unless the voting of shares held by pension funds is insulated from the influence of corporate pension fund sponsors. In funds governed by ERISA, voting in the interest of beneficiaries might be promoted by listing votes along with other acts that are prohibited when they involve a conflict of interest.¹⁹⁸ For other funds, the general law of trusts needs to be made more articulate with regard to trustees' duty to vote, as well as to buy and sell, in the exclusive interest of beneficiaries.¹⁹⁹ Insulation might be accomplished by amending

194. See Minow, *supra* note 79.

195. See *supra* text in Part III E.

196. See *supra* text in Part III F.

197. See Parker, *supra* note 83.

198. Section 406 of ERISA, 29 U.S.C. § 1106 (1982), lists various transactions with parties in interest that are prohibited. Under § 409, 29 U.S.C. § 1109 (1982), fiduciaries who violate the prohibitions of § 406 are not only liable for damages, but also subject to other equitable or remedial relief, including removal.

199. See *Pension Funds*, *supra* note 37, at 116-17 (testimony of Robert A. G. Monks).

ERISA to require that fund managers delegate voting authority along with investment authority to independent financial institutions, unless the managers are themselves independent financial institutions.

G. *Preferential Access to Inside Information*

A spontaneous response of many lawyers to the prospect of increasing institutional investor influence over portfolio enterprises is the apprehension that institutional portfolio managers will exploit their power by obtaining inside information.

This would be a valid objection to a system in which one particular institution, such as the Morgan Guaranty bank,²⁰⁰ would exercise a dominant influence because of its role as a lender, a trustee of funds, and the affiliate of an underwriter. But the exploitation of inside information by a consortium of institutions that hold a large fraction of the company's outstanding shares would be virtually impossible. If any considerable fraction of the group tried to use the information, the market would respond to negative any advantage. Exploitation by particular group members would be unlikely because each member of the group would be alert to prevent any other member from gaining an advantage. Institutions would probably refrain from naming their own staff members to boards of directors; they would name individual shareholders or officers of other companies. If they sometimes named their own employees, they would be extravagantly careful to build walls between their delegates and their portfolio managers, in order to fend off inside information penalties.

A more likely danger is that institutional influence would intensify the already prevalent practice of executives conveying their perspectives on enterprise prospects in "seminars" that are attended chiefly by institutional analysts, and rarely by individual shareholders.²⁰¹ As a consequence, institutions as a group might increase their advantage over individual shareholders in access to information. The SEC's institutional investor study of 1971 reported that "institutions or their managers, by reason of their ability to influence the outcome of efforts to transfer cor-

200. The pervasive influence of The Morgan Guaranty Trust Company was decried in 1 STAFF OF SUBCOMM. ON DOMESTIC FIN. OF HOUSE COMM. ON BANKING AND CURRENCY, 90TH CONG., 2D SESS., COMMERCIAL BANKS AND THEIR TRUST ACTIVITIES: EMERGING INFLUENCE ON THE AMERICAN ECONOMY 2, 4-5 (Subcomm. Print 1968).

201. See Guyon, *supra* note 109.

porate control, appear in a number of cases to receive preferential treatment as compared with individual investors."²⁰²

The priority of institutions in access to insider perspectives on company prospects would not necessarily be detrimental to less-informed individual investors, and might even be helpful to them. Trading by well-informed institutions, like trading by executives, tends to enhance the efficiency of markets by accelerating market response to changing conditions.²⁰³ The contribution of insider trading to market efficiency is not only celebrated by critics of laws against insider trading, but conceded by defenders of these rules, who claim that the harm done outweighs the efficiency benefits.²⁰⁴

Unlike trading by executives, trading by institutions would not give executives an incentive to manipulate information, nor divert capital gains from ordinary investors.²⁰⁵ The gains made would be dispersed widely among the individual savers, the pensioners, and the endowments whose funds the institutions manage, augmenting returns on their investments and enhancing the inducement for them to direct their savings toward capital markets.

The jump ahead of the market that institutions gain by superior perspectives on enterprise prospects is not usually obtained at the expense of individual investors, who inevitably trail behind the market, but at the expense of arbitrageurs. The gains of institutions are more likely than are the gains of arbitrageurs to increase the rewards of savers and thereby enhance the incentive to invest.

H. Loss of Social Responsibility

A last ditch argument against institutional activism is that institutional influence diminishes the responsiveness of enterprise managers to the interest of employees, consumers, and commu-

202. 1 INST. INV. STUDY, *supra* note 73, at xxix. The preferential treatment was reported to be partly in "premium prices" and "guaranteed profits" and partly in "non-public advance information concerning takeover efforts."

203. With respect to trading by executives, see H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 93-110 & *passim* (1966); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 866-72 (1983).

204. See Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 645-48; Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1225-48 (1981).

205. On these consequences of executive trading, see Cox, *supra* note 204, at 642-53.

nities. Although managers insist that they have no *duties* to these constituencies, they claim that they have discretion to shape enterprise policies in ways that benefit these constituencies without material adverse consequences for investors.²⁰⁶

Critics of institutional power contend that institutional investors, unlike enterprise managers, are bound by their fiduciary duties, and impelled by competition, to vote with unmixed devotion to pecuniary profit. Institutions have no contacts with enterprise customers, employees, or communities that might inspire beneficence toward these constituents, and they win no praise for the social responsivity of their portfolio enterprises.

To this argument against enhancing institutional investor influence there are answers for observers at two poles of opinion. At one pole, observers will applaud institutional indifference or hostility to nonprofit impulses. This is the probable response of observers who share the faith expressed in Milton Friedman's famous dictum, "The social responsibility of business is to increase its profits."²⁰⁷

At the other pole, observers who favor social responsivity should notice the total lack of evidence that institutional investors are less responsive than enterprise managers to social concerns. In the House Pension Fund Hearings, a labor union representative urged that pension funds should be invested "in companies that emphasize employment security, retraining, good labor-management relations, and acceptance of unions." He thought that investments "in antiunion companies with a frequent record of plant closings, layoffs, and shifting work offshore" should be avoided even if they provided "hefty pensions" to the pensioners of other companies.²⁰⁸ But neither this witness nor any others reported the actual pursuit of prolabor policies in existing funds.²⁰⁹ The SEC's Staff Report on Corporate Accountability in 1980 investigated impacts of institutional investors on

206. For statements of associations of corporate executives on social responsibilities of corporations, see BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE RESPONSIBILITY (1981); cf. DIRECTORSHIP PRACTICES, *supra* note 4, at 9-10 (1973). For a sociologist's observations on corporate social behavior, see Coleman, *Responsibility in Corporate Action: A Sociologists's View*, in CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES 69 (K. Hopt & G. Teubner eds. 1984).

207. This is the title of an article by Milton Friedman that appeared in the New York Times Magazine, Sept. 13, 1970, § 6 (Magazine), at 32.

208. *Pension Funds*, *supra* note 37, at 41-42 (statement of Ronnie J. Straw, director of the Development and Research Department of the Communication Workers of America).

209. The testimony of Roger C. Bransford on behalf of the Association of Private Pension and Welfare Plans, with 475 members, made no mention of supporting the employees' interest in governance. *Pension Funds*, *supra* note 37, at 57-76.

the conduct of portfolio companies but reported no impact on portfolio companies' responses to social issues.²¹⁰ In 1976, Peter Drucker concluded that "pension fund socialism" had made no significant change in the relationship of business enterprises to employees.²¹¹ The five-volume study of institutional investors published by the SEC in 1971 gave no attention to effects, if any, of institutional investors on the social responsivity of portfolio enterprises.²¹²

The sparse evidence that exists on institutional investors' social responsivity indicates that some of them are very much concerned with it. Institutional investors are the principal supporters of the Investor Responsibility Research Center (IRRC), which analyzes corporate actions with regard to their social implications and informs its subscribers about its findings.²¹³ According to the SEC Staff Study, "[F]oundations and educational institutions are more likely to adopt guidelines which incorporate social as well as financial or investment considerations."²¹⁴ These charitable investors are likely to be joined by pension funds like the College Retirement Equities Fund to which institutions of this kind commit funds.²¹⁵ On the whole, the influence of institutional investors on the responses of enterprises to social demands seems unlikely to change substantially the responses currently made by autonomous managers. Different institutions have such divergent priorities among their social concerns that they will rarely form a solid phalanx for or against any one policy.²¹⁶ Enterprise managers will probably continue to exercise their personal conceptions of social responsibility with regard to environmental pollution, labor relations, and routine contributions to charities.

210. CORPORATE ACCOUNTABILITY, *supra* note 34, at 383-89.

211. P. DRUCKER, *THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA* 109-39 (1976).

212. INST. INV. STUDY, *supra* note 73. "[T]he Study found relatively little evidence of concerted action to influence corporate management except in its case studies on transfers of control." 1 INST. INV. STUDY, *supra* note 73, at xxviii.

213. The subscribers of IRRC in 1986 included 31 large trust companies, 65 investment managers and advisers, 34 public pension funds, 14 foundations, 110 educational institutions, and a number of insurance companies, church funds, and other entities. IRRC 1986 ANNUAL REPORT (1987).

214. CORPORATE ACCOUNTABILITY, *supra* note 34, at 403 (citing J. HEARD, *PROXY VOTING BY INSTITUTIONAL INVESTORS: SIX CASE STUDIES* (1979)); see also Vogel, *Shareholder Activism Today: An Update and Review*, in ETHICS, *supra* note 182, at 77 (1983).

215. See Lee, *Wharton, Chief of \$54 Billion Fund, Is Advocate of Social Responsibility*, Wall St. J., Feb. 13, 1987, at 14, col. 1.

216. See Lee, *It's All Relative: Mutual Funds Discover 'Socially Responsible' Is in Eye of Beholder*, Wall. St. J., May 20, 1987, at 37, col. 4.

If institutional activism has any net effect on social responsiveness, it will probably be a restraining influence on unusually large gifts to pet projects of chief executives, like Ford Motor Company's investment in Detroit's Renaissance Center.²¹⁷

The bottom line may be that the growing influence of institutional investors will bring about a modest diminution in the total contributions of business enterprises to public-interest projects.

I. The Choice

In the remaining years of the twentieth century, public and private policymakers will choose by action or inaction whether to tolerate a regime of managerialism, unchecked by the interests of investors, or a regime in which the interests of savers are effectively represented by institutional investors.

If business managers are allowed to defeat takeovers without regard to investors' interests, they will hold their positions of power regardless of their inefficiencies and will reward themselves without regard to their productivity. These indulgences will eventually produce demands for increased government regulation, and perhaps government operation of basic industries, as in France and Great Britain.

If institutional investors are enabled to combine in defense of the interests of savers, enterprises may be driven to maximize their profitability with a substantial reduction in the takeover wars, and in the occasions for government intervention.

Investor capitalism would not give unchecked power to fund managers. Investors can act only through executives, who will normally be strong individuals, able to affect enterprise behavior by the ways in which they inform investors and by the degree to which they expedite or retard the implementation of investors' wishes. The actual conduct of business in enterprises that are actively supervised by directors whom investors have chosen will reflect a series of compromises between the views of investors and those of executives. The activation of institutional investors appears, at this juncture, to offer the best hope of restoring to private enterprise the vigor that is inherent in the design of capitalism.

217. According to Lee Iacocca, Henry Ford II caused Ford Motor Company to contribute over \$100 million to the Detroit Renaissance Center ("RenCen"). L. IACOCCA, *AN AUTOBIOGRAPHY* 106-07 (1984).

Even enterprise managers are likely to benefit from investor capitalism, although it would in the first instance diminish their freedom of action. They would find institutional investors more sympathetic to their expectations of deferred gains, if the institutional managers had more confidence that the enterprise managers would respond to investor interests. Investor capitalism would also improve enterprise managers' chances of defeating shareholders' suits because judges would have more reason to trust the opinions of directors chosen by investors than those of directors chosen by enterprise managers.

Managers of potential targets would benefit from the installation of investor capitalism in potential bidders. Takeover bids that are inspired by imperial ambitions rather than by realistic probabilities of increased profitability would be more often suppressed at their inception by the investor-oriented directors of potential bidders.

Although one cannot expect most enterprise managers to welcome a shift from the autonomy that they now enjoy to a need for continuous interaction with shareholder representatives, a thoughtful analysis should lead them to the conclusion that if they are themselves competent and faithful to their trust, they would benefit from the prevalence of investor capitalism.

VI. PROPOSALS

The emergence of institutional investors' dominance in shareholding offers a new opportunity and a new need for institutional investors to restrain the occasional aberrations of managerialism. This objective can be achieved without increasing governmental and judicial intervention if institutional investors are liberated from the hobbles that inhibit their exercise of the rights that the corporation laws purport to give them. I sketch here for the attention of enterprise managers, institutional investors, the SEC, and Congress some measures that seem likely to advance the interests of the beneficial owners of private enterprise.

A. Activation of Institutional Investors

Institutional investors of all types should join in the movement of public pension funds to participate actively in supervising the management of portfolio enterprises. When institutional

investors held a small minority of shares, they could plausibly hope that individual investors would exercise the powers entrusted by law to shareholders. That is no longer possible. Managers of all types of funds—pension funds, ESOPs, mutual funds, and foundations—can not discharge their fiduciary obligations without mobilizing their statutory powers of corporate governance.

B. Liberation From Sponsors

Pension funds, ESOPs, and foundations that have been sponsored by business enterprises need to be liberated from dictation of their voting practices by their sponsors. The statutes that govern these organizations should affirm the duty to vote, just as emphatically as they affirm the duty to trade, in the sole interest of beneficiaries. The tenure of fund managers and the choice of their successors should be determined by fund beneficiaries or other persons who are independent of the sponsor, except under fixed benefit plans in which the sponsor bears the investment risk. Sponsors that retain direct or indirect control over fund managers should lose tax deductions for contributions to these funds, and funds controlled by sponsors should lose tax exemption.

C. Liberation From Control Liabilities

Shareholders, including institutional investors, should be freed from the threat of liabilities of “controlling persons” or of “directors-by-deputy” when they join forces to elect directors who supervise the management of enterprises as provided by corporation laws. The SEC could point the courts in this direction by amending its definition of control. But Congress should eliminate all doubt by inserting in the Securities Act and Securities Exchange Act a restrictive definition of control somewhat like the one in the Investment Company Act.

D. Access to Company Proxy Statement

Significant groups of shareholders should have the same access as management to the company proxy statement. Congress should authorize access to the company proxy statement for

nominations and for opposition to management proposals by any group representing five percent of the shares, with authority for the SEC to raise or lower the fraction so as to avoid a confusing multiplicity of proposals while admitting significant alternatives to management proposals.

E. Declaration of Policy

The control of business enterprises by their shareholders, including their institutional shareholders, should be declared as a purpose of each of the laws that govern securities, employee pension and benefit funds, mutual funds, foundations, and other institutional investors that are the subjects of federal legislation. The purpose clauses of these laws should be expanded to articulate this objective.

F. Attitudes of Enterprise Managers

Executives of business organizations should take a more favorable view of investor activism. In the short run, it threatens their autonomy, which they enjoy as much as do other custodians of power. In a longer view, it opens the way for creating an atmosphere of greater confidence between shareholders and enterprise managers, for reducing occasions for intervention by courts and commissions, and for quieting the demand for proliferating rules on takeovers and takeover defenses. The revival of capitalism through the activism of institutional investors offers long-term benefits for all of the constituents of private enterprise.