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Reinventing the Outside Director: An Agenda for Institutional Investors

Ronald J. Gilson and Reinier Kraakman*

Managerialist rhetoric puts the institutional investor between a rock and a hard place. The institutional investor is depicted as a paper colossus, alternatively greedy and mindless, but in all events a less important corporate constituency than that other kind of investor, the "real" shareholder. The unspoken corollary is that, regardless of the institution's investment strategy, its interests may appropriately be ignored.

An institution that trades stock frequently is considered a short-term shareholder without a stake in the future of the corporation. According to the familiar argument, the short-term shareholder has no more legitimate claim on management's attention than does a holder of options on the company's securities. Neither investor really cares about the corporation. They are only concerned, as is commonly known, with the fickle walk of market prices during the brief interval in which they are investing.¹

Yet, an institution that buys and holds stock for the long term fares no better in the standard polemic. Some of the largest institutional investors today *are* long-term investors. For example, the annual turnover rate of the California Public Employees' Retirement System (CalPERS) equity portfolio is approximately 10 percent, and its average holding period for particular stocks is between six and ten years.² Indeed, CalPERS is soon likely to expe-

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1. In his recent account of the current state of boards of directors of large American public companies, Harvard Business School Professor Jay Lorsch illustrates the point aptly:

By shareholders, this director means the loyal investor who holds the company's shares for the long term and, from the perspective of the directors, institutions are the least loyal shareholders. In fact, they have difficulty taking the institutional owner seriously, believing its goals are at odds with the corporation's longer-term interests and are too concerned with short-term gain.

JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 46-47 (1989).

2. CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, WHY CORPORATE GOVERNANCE? 4 (1989).

rience even lower turnover because the proportion of its equity portfolio that is passively managed through indexing is expected to increase from 60 percent to 85 percent by 1991.³ Because CalPERS indexes to avoid trading, it is a long-term investor by definition. Nevertheless, many managers view it as the wrong kind of long-term investor. Consider the remarks of Andrew Sigler, the Chief Executive Officer of Champion International:

Instead of individual shareholders, Champion is 70 percent owned by institutions. They are owners of our stock in many ways through the index fund But think of that, they didn't buy Champion for any other reason than that the formula told them to, and they have to look at the list to see that they own us.⁴

In other words, because the indexed institution does not research the particular characteristics of a company, it is not a "real" shareholder. It just does not behave like a traditional owner.

In our view, these twin complaints about short-term trading and indexed investing point to an important problem that is seldom clearly articulated in the polemical literature. Put simply, we lack a normative model for how shareholders who invest "in the market" should behave toward the companies in which they invest. For Sigler, the "real" shareholder engages in fundamental analysis of particular companies and shares much the same concerns and time horizons that the traditional owners of a business might have. By contrast, the frequent trader and the indexed investor abstract from the company's real economic prospects to focus on its immediate performance or, even more narrowly, on its index weighting.⁵ Indeed, the indexed investor, who cares only about the covariances of stocks in its portfolio, undertakes the ultimate abstraction from the concerns of traditional owners.

Puzzlement over what constitutes appropriate behavior by the indexed investor—or by any other investor oriented toward the market rather than

3. Stephen Clark, *Why Dale Hanson Won't Go Away*, INSTITUTIONAL INVESTOR, Apr. 1990, at 79, 79-80. A stock index is a composite of a large number of selected stocks, such as the Dow Jones or the Wilshire 5000. Indexed investing is a means of maximizing investment return through buying and holding a weighted portfolio of all stocks in an index. A recent Financial Executives Institute (FEI) survey of plans totaling \$260 billion in assets reported that 34% of equity investments by the surveyed plans were passively managed by indexing. See David M. Walker, *The Increasing Role of Pension Plans in the Capital Markets and Corporate Governance Matters 3* (June 14-15, 1990) (paper presented at the Salomon Brothers Center and Rutgers Centers Conference on The Fiduciary Responsibilities of Institutional Investors) (on file with the *Stanford Law Review*) (reporting the FEI study).

4. THE GOVERNOR'S [NEW YORK] TASK FORCE ON PENSION FUND INVESTMENT, OUR MONEY'S WORTH 37 (1989) [hereinafter NEW YORK TASK FORCE REPORT].

5. Some commentators assert both the short-term and the indexed-investor criticisms. See, e.g., Clifford Whitehill, *A Sound Argument Why the American Law Institute Should Defer Adoption of Part VI of its Corporate Governance Project*, NATIONAL LEGAL CENTER WHITE PAPER, May 4, 1990, at 9-10 ("The managers of these [indexed] funds are looking at broad market movements and are not concerned with the performance of individual corporations. The long-term growth of a particular corporation is unimportant compared to the immediate issue of whether the price offered in a takeover is better than the current market price."). Clifford Whitehill is Senior Vice President and General Counsel and Secretary of General Mills, Inc., and Chairman of the Lawyers Steering Committee of the Corporate Governance Task Force of The Business Roundtable.

toward particular companies—is hardly limited to corporate managers. Recast only slightly, Sigler's complaint states the question that an investor like CalPERS, with almost \$50 billion of indexed investments, must inevitably ask itself: How *should* a passive investor relate to its portfolio companies?

In this article, we offer not only an answer but also something else that is in even shorter supply among academics: a realistic agenda for institutional investors. We propose a strategy for improving corporate governance that need not wait for controversial legal or regulatory reform and that is largely within the control of current institutional investors to implement. Part I briefly restates the familiar but nonetheless important case that corporate governance reform is a sensible strategy for improving the performance of institutional investment portfolios. Part II then critically evaluates three current efforts by institutional investors to implement such a strategy: protecting the market for corporate control, establishing shareholder advisory committees, and appointing additional outside directors. With criticism, however, comes the responsibility to be constructive. Part III considers alternative approaches to corporate governance—the LBO Association and Japanese and German corporate groups—which returns us to the central role of the outside director. Part IV identifies the limitations of existing proposals for reforming the board of directors. In Part V, we offer our own agenda for institutional investors by discussing how a core of professional directors might be organized and how it would likely function in practice. Finally, Part VI explores the political and legal feasibility of our agenda and concludes that the barriers to collective action by institutional investors are far less imposing than is commonly supposed.

Like many other proposals, our strategy for reform focuses on the structure of the board of directors as the traditional center of corporate governance. However, while most recent efforts addressing the governance role of the board have urged increasing the independence of outside directors from management, we advocate increasing the dependence of outside directors on shareholders. In our view, corporate boards need directors who are not merely independent, but who are *accountable* as well.

I. THE INEVITABILITY OF A CORPORATE GOVERNANCE STRATEGY

The movement of large institutional investors toward indexed investing reflects two different, but complementary, trends. The first is the increased influence of the efficient capital market hypothesis on institutional investors, and especially on pension funds. During the last twenty years, an important body of research has shown that on a risk-adjusted basis, over time and on average, active portfolio management of publicly traded equities does no better than the market. After netting out commission and management fees, active portfolio management often does worse than the market.⁶ By con-

6. See, e.g., WILLIAM F. SHARPE, INVESTMENTS 178-79 (2d ed. 1981); Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. FIN. 389 (1968); Norman E. Mains, *Risk, the Pricing of Capital Assets, and the Evaluation of Investment Portfolios: Comment*, 50 J. BUS.

trast, indexed investing allows investors to obtain the same performance as the market with dramatically lower transaction costs.

The second trend is the rapid growth—both in rate and absolute amount—of funds under management by institutional investors. Even if fundamental analysis of individual corporations before investing is conceptually sound, the sheer size of institutional holdings makes active portfolio management increasingly difficult.⁷ Especially after the shrinkage in publicly traded equities during the 1980s, altering a portfolio to track the prospects of individual companies is difficult and expensive in a market with too few investments and too many institutional assets. The very act of selling or buying influences the price of a security.⁸ By contrast, holding the market through indexing eliminates this problem by eliminating the need to trade.

The fact that institutions increasingly hold the market is the starting point for understanding how they should relate to their portfolio companies. It implies that institutions neither can nor should adopt the traditional owner's interest in improving individual companies.⁹ Institutions with well diversified portfolios cannot take such an interest because they hold too many companies. Monitoring every company would mean sacrificing most of the transaction cost savings that motivated adopting an indexing strategy in the first place. Moreover, institutions *should not* take such an interest because they stand to gain much less from it than traditional owners might gain. Many improvements affecting the value of one company in an indexed portfolio come only at the expense of other companies in the portfolio. For example, the institutional investor does not gain when one of its portfolio companies acquires market share at the expense of another. From the portfolio holder's point of view, this improvement merely transfers money from one pocket to another in the same pair of pants.

A corporate governance strategy for passive portfolio managers begins with the insight that efforts to increase investment values must be measured by their effect on the entire portfolio, not just on the individual companies. This can be explained most clearly by analogy to a different kind of indexed investor: the United States government. The government's proceeds from the corporate income tax resemble the returns on a fully indexed (at least

371 (1977). Walker, *supra* note 3, at 3, reports that “[f]rom 1950 to 1987, passively managed funds (defined as plans with less than 15% average equity turnover) out-performed the most actively managed funds (defined as plans with over 70% average turnover).”

7. The Columbia Institutional Investor Project estimates that institutional investor asset holdings had reached \$5.8 to \$6.0 trillion by 1990, up from \$107 billion in 1950. The 1990 figure represents approximately 18.7% of total U.S. financial assets and 45% of total U.S. equities. Over the period 1981 through 1988, assets under management by institutional investors grew at a compounded annual rate of 13.9%. Carolyn Kay Brancato, *The Pivotal Role of Institutional Investors in Capital Markets 19-20* (June 14-15, 1990) (paper presented at the Salomon Brothers Center and Rutgers Centers Conference on The Fiduciary Responsibilities of Institutional Investors).

8. See NEW YORK TASK FORCE REPORT, *supra* note 4, at 37.

9. Paradoxically, institutions that trade frequently for short-term gains also “hold the market” in a somewhat different sense. Although these investors benefit primarily from near-term price movements in particular securities, they also stand to gain from any market-wide improvement in the quality of equity investments. Like indexed investors, moreover, they have little incentive to devote resources to the long-term improvement of particular companies.

nationally) portfolio of preferred stock with a stated dividend of the marginal tax rates. A strategy to increase the value of this portfolio—to increase the corporate tax yield—must promise to improve the performance of the *entire* economy since the government gains nothing if one company pays more taxes at the cost of decreasing the tax receipts from another company.¹⁰ An institutional investor is in precisely the same position. The surest way to increase the value of an indexed stock portfolio is to increase the value of all of the companies in the portfolio.

How then does a passive institutional investor improve the performance of the entire corporate sector? The only plausible answer is by improving the corporate governance *system* rather than by attempting to improve the management of particular companies. To reduce a familiar story to a syllogism, the dominant characteristic of the large American public corporation is the separation of ownership and management. Although this separation is beneficial because it permits the specialization of management and riskbearing, it is also costly. Management must have discretion to exercise its specialized skills, and with discretion comes opportunities for abuse. A corporate governance system should seek to allow management the discretion to act on the shareholders' behalf while at the same time establishing safeguards against the abuse of discretion. It follows that the indexed institutional investor should seek a corporate governance system that, by improving the monitoring of management in general, can improve the performance of all companies.¹¹

II. EVALUATING CURRENT CORPORATE GOVERNANCE STRATEGIES

Given their economic interest in corporate governance, it is hardly surprising that institutional investors, and particularly public pension funds,¹²

10. This point assumes that the rate structure of the corporate income tax is not significantly progressive.

11. Of course, any successful effort by institutional investors to improve shareholder monitoring of managers in general might be expected to benefit not only shareholders, but other stakeholders in public corporations as well. For example, if improved monitoring increased the operating efficiency of domestic corporations, competition in the product market might induce corporations to pass some of the resulting efficiencies on to consumers in the form of lower prices. Many institutional investors, including public pension funds, might consider such third-party effects as a welcome by-product of corporate governance reform—as long as third parties were not the chief beneficiaries of reform. In our view, however, the presence of benefits for consumers, employees, and other economic factors would hardly exclude gains to shareholders. Improved operating efficiency would benefit shareholders in the first instance because lower prices in the product and input markets would only partly dissipate shareholder gains from lower production costs, and because domestic companies with lower costs would capture market share worldwide at the expense of foreign competitors. In addition, shareholders would capture the bulk of the monitoring gains from the reduction of agency costs that are unrelated to operating costs and revenues, such as the gains that might arise from dissuading managers from investing free cash flows in unprofitable projects. Cf. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986) (arguing that shareholder losses might result from management misinvestment of free cash flows). We wish to thank Professor William Klein for calling our attention to the complexity of the "incidence problem" associated with social gains from improving corporate governance.

12. Corporate governance activism is not limited to public pension funds. Fidelity Investments, the nation's largest mutual fund organization, has removed investment limitations on 63 of its

have become increasingly active in the governance of their portfolio companies. To date, their efforts have taken three general directions, all of which were seen in the 1990 proxy fight for control of the Lockheed Corporation. The first has been to protect the market for corporate control by seeking to block or dismantle takeover defenses erected by portfolio companies without shareholder approval. For example, precatory shareholder proposals urged Lockheed's board of directors to redeem the company's shareholder rights plan and to opt the company out of the Delaware anti-takeover statute. The second direction, pioneered by CalPERS, urges the creation of shareholder advisory committees. Lockheed's management offered to create such a committee as a measure to placate its institutional investors. Finally, the most aggressive action taken by institutional investors has been to seek direct input into the selection of outside directors. In the Lockheed case, institutional investors reportedly secured management's commitment to allow institutional investors to influence the selection of three outside directors.¹³

Although the initiative behind each of these strategies is laudatory, they are insufficient, both individually and collectively, to yield real improvements in corporate governance. In this Part, we examine the shortfalls of each strategy. In the next, we begin to construct a more effective approach.

A. *Protecting the Market for Corporate Control*

Institutional investors first entered the world of corporate governance in response to efforts by portfolio companies to insulate themselves from the market for corporate control. Some four years ago, institutional investors began to offer precatory resolutions urging directors to redeem poison pill plans, submit them for shareholders' approval, or subject them to sunset provisions.¹⁴ In the 1990 proxy season, such resolutions were placed on the ballot at thirty-two companies.¹⁵ In addition, institutions now offer a much wider range of proposals to limit defensive tactics, including proposals to require shareholder approval before more than 10 percent of a company's stock can be placed with a white squire, proposals to cause the company to opt out of Delaware's anti-takeover law, proposals to prohibit greenmail payments, and proposals to require shareholder approval of golden parachutes.¹⁶

mutual funds so as to enable the funds to purchase more than 10% of a portfolio company's stock, join in a proxy fight against incumbent management, or seek the sale of a company. In particular, Fidelity's general counsel has urged restricting the duration of poison pills. See *Fidelity Goes Activist, Suggests Time-Limited Poison Pill*, 6 CORP. GOVERNANCE BULL. 153 (1989).

13. See James A. White, *Calpers' Chief Wields Big Stick For Institutional Shareholders*, Wall St. J., Apr. 3, 1990, at C1, col. 4. This typology is incomplete, however. A fourth category, directed at voting procedures, can also be identified. Typical of this cluster are proposals for confidential shareholder voting, present on the ballots of at least 49 companies this proxy season. See *Assault on Proxy Voting System Highlights Shareholder Agenda*, 6 CORP. GOVERNANCE BULL. 146-47 (1989).

14. The results of these efforts are summarized in RONALD J. GILSON & REINIER KRAAKMAN, 1989 SUPPLEMENT TO GILSON'S THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 120-24.

15. *Assault on Proxy Voting System Highlights Shareholder Agenda*, *supra* note 13, at 148-49.

16. *Id.* at 148-50.

Institutional investors had good reason to enter the corporate governance arena when management began its efforts to escape the market for corporate control: Few other issues highlight so starkly the relation between the value of an indexed portfolio and principles of corporate governance. Critics dismiss the involvement of institutional investors in control issues as a childish short-term demand for large premiums today when current management can produce even larger returns tomorrow.¹⁷ Yet, the relationship between takeovers and passively managed portfolios is far more complicated than these criticisms suggest, and for two reasons. First, a takeover typically cannot benefit an indexed portfolio *directly* unless it increases the combined value of the acquiring and target companies. Second, and more important, the chief effect of takeovers on the value of indexed portfolios is indirect: The mere potential of a hostile offer is likely to improve the management of a portfolio company.

To understand the first point, remember that an investor holding an indexed portfolio has a weighted position in both the acquiring company and the target company. Such an investor will not benefit if the premium paid for a target company's stock simply transfers wealth from the shareholders of the acquiring company to those of the target. To benefit an indexed investor, a transaction must increase the combined value of the acquiring and the target companies' stock. Fortunately, the empirical evidence indicates that hostile takeovers *do* yield a combined benefit. Although the shareholders of bidder companies earn normal returns or even experience small losses in takeovers,¹⁸ target company shareholders receive substantial gains; consequently, indexed portfolios experience *net* positive gains on average as a result of hostile takeovers.¹⁹

This direct increase in value, however, is not the most important effect of

17. The criticism can be formulated as an empirically testable statement: Shareholders in target companies that defeat hostile tender offers and remain independent do better, in present value terms, than they would have if the offer had been accepted. However, there is substantial empirical evidence to the contrary. The studies uniformly show that, on average, target shareholders lose significantly when offers are defeated and the company is not subsequently acquired by an alternative bidder. See, e.g., Michael Bradley, Anand Desai & E. Han Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 J. FIN. ECON. 183 (1983); John A. Pound, *Takeover Defeats Hurt Stockholders: A Reply to the Kidder Peabody Study*, MIDLAND CORP. FIN. J., Summer 1986, at 33; Richard S. Ruback, *Do Target Shareholders Lose in Unsuccessful Control Contests?*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 137 (A. Auerbach ed. 1988). While the data does not support the criticism that a favorable orientation to premium tender offers reflects only a short-term orientation, it does not resolve whether takeovers are good for indexed investors since their portfolios usually include target and acquiring companies. For indexed investors, takeovers are desirable only if they result in a net gain, taking into account the impact on both targets and acquirors. This point is considered in text accompanying notes 18-19 *infra*.

18. For surveys of the empirical literature, see Gregg A. Jarrell, James A. Brickley & Jeffrey M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988); Gregg A. Jarrell & Annette B. Poulsen, *The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades*, FIN. MGMT., Autumn 1989, at 12; Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

19. For the most recent study, see Larry H.P. Lang, René M. Stulz & Ralph A. Walking, *Managerial Performance, Tobin's Q and the Gains from Successful Tender Offers*, 24 J. FIN. ECON. 137 (1989). Earlier studies are summarized in Jarrell, Brickley & Netter, *supra* note 18, and Jensen & Ruback, *supra* note 18. Where the bidder is privately held, as in many recent LBO transactions, a

takeovers on indexed portfolios. Hostile takeovers also influence the stock value of the majority of portfolio companies that are neither targets nor bidders by altering the behavior of their managements. As Alfred Rappaport recently observed in the *Harvard Business Review*, "[i]t is impossible to overstate how deeply the market for corporate control has changed the attitudes and practices of U.S. managers. . . . [That market] represents the most effective check on management autonomy ever devised."²⁰ For example, consider the impact of hostile takeovers on conglomerate organizations. Given that the conglomeration strategy of the 1960s and 1970s has had a "dismal" track record (in the words of Professor Michael Porter²¹), it is hardly surprising that many hostile takeovers during the 1980s aimed at breaking up conglomerate corporations that had accumulated unrelated businesses.²² Yet break-up takeovers affected only a small number of conglomerates directly. Arguably, the chief impact of these takeovers on the value of indexed portfolios was that it encouraged a much larger number of companies to ward off hostile offers by restructuring voluntarily. Thus, one study reported that in 1985 alone, 23 percent of the nation's 850 largest corporations experienced an "operational restructuring," which usually involved the sale or spinoff of a division.²³

Given the contribution of hostile takeovers to portfolio values during the 1980s, institutional investors were quite right to target defensive tactics in their initial foray into the corporate governance debate. Currently, however, other corporate governance strategies appear more promising for improving portfolio performance. The hostile takeover has proved to be an expensive

wealth transfer from bidder to target will increase the value of the institutional investor's portfolio unless the investor also has invested in the LBO sponsor's investment vehicles.

20. Alfred Rappaport, *The Staying Power of the Public Corporation*, HARV. BUS. REV., Jan.-Feb. 1990, at 96, 100.

21. Michael E. Porter, *From Competitive Advantage to Corporate Strategy*, HARV. BUS. REV., May-June 1987, at 43. Professor Porter investigated the aftermath of the diversification efforts of 33 large U.S. companies. Where the company entered an unrelated line of business by acquisition prior to 1975, 74.4% of the acquisitions were subsequently divested. Where the entry occurred by start-up, the new business was subsequently divested 40.9% of the time. Finally, when the entry occurred by joint venture, the acquisition was subsequently divested 48.9% of the time. *Id.* at 50-51 (exhibit III). Porter's findings were recently confirmed by a study of 271 large acquisitions occurring between 1971 and 1982. When the target company's businesses were unrelated to those of the acquiror, over 60% of the acquisitions had been divested by 1989. Steven Kaplan & Michael S. Weisbach, *Acquisitions and Diversification: What is Divested and How Much Does the Stock Market Anticipate?* (Managerial Economics Research Center, Simon Graduate School of Business, University of Rochester, Working Paper No. 90-02, Mar. 28, 1990) (on file with the *Stanford Law Review*).

22. Randall Morck, Andrei Shleifer & Robert W. Vishny, *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31, 47 (1990) (offering empirical evidence "that the source of bust-up gains in the 1980s is the reversal of the unrelated diversification of the 1960s and the 1970s. Hostile bust-up takeovers simply undo past conglomeration."); see also Amar Bhide, *The Causes and Consequences of Hostile Takeovers*, J. APPLIED CORP. FIN., Summer 1989, at 36, 52 ("real source of gains in hostile takeovers lies in splitting up diversified companies"); Sanjai Bhagat, Andrei Shleifer & Robert W. Vishny, *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 1 (1990) (same).

23. See V.R. Buzzotta, *A Quiet Crisis in the Work Place*, N.Y. Times, Sept. 4, 1985, at A27, col. 2.

and inexact monitoring device that is better suited for correcting management's mistakes than preventing them. A corporate governance mechanism that might have shunted the conglomeration wave in its nascency would have been far more efficient—if it had been in place during the 1960s and 1970s—than a decade of dealmaking to reverse the damage.²⁴ Even more to the point, the future of hostile takeovers is now in doubt. The junk bond market has collapsed and management has been extraordinarily successful in persuading state legislatures to enact laws that bypass shareholders by making any change in control without management's approval very costly. For example, the recent Pennsylvania legislation—admittedly the worst of the bunch—not only discourages hostile tender offers with the threat of a disgorgement remedy if the offer fails, but extends this same threat to shareholders who seek to displace management through a proxy contest.²⁵

Thus, institutional investors can no longer rely on the market for corporate control to remedy defects in the corporate governance system. Instead, other improvements in the corporate governance system will be necessary to protect takeover attempts from political action in the future.²⁶

B. *Shareholder Advisory Committees*

A second approach to reforming corporate governance advanced by institutional investors—the shareholder advisory committee—seems designed to compensate for some of the failings of the market for corporate control. As advocated by CalPERS and recently adopted by Lockheed's management to win institutional votes in its 1990 proxy contest with Harold Simmons, this strategy calls for the establishment of an advisory committee representing a company's largest shareholders, who are typically its institutional investors.²⁷ Such a committee is designed to receive management's reports on

24. To be sure, the threat of a hostile takeover has a general deterrent effect, as we saw in connection with bust-up takeovers. However, this effect seems far better suited for reversing decisions that the market has already recognized as mistakes than for determining whether proposed actions are mistakes in the first place. Thus, although the general deterrent effect of hostile takeovers certainly accelerated the break-up of conglomerates, there is good reason for doubting whether hostile takeovers, had they been on the scene at that time, would have significantly deterred the original conglomerate movement.

25. 15 PA. CONS. STAT. §§ 2571-2575 (1990). Pressure by institutional investors is credited with causing a number of large Pennsylvania corporations—including Westinghouse Electric Corporation, the H. J. Heinz Company, Allegheny Ludlum, Mellon Bank, and the Sun Company—to opt out of all or a part of the Pennsylvania legislation. See Leslie Wayne, *Many Companies in Pennsylvania Reject State's Takeover Protection*, N.Y. Times, July 20, 1990, at A1, col. 1. Massachusetts recently displayed a similarly cooperative attitude toward management by enacting, virtually overnight, a statutory requirement for staggered boards of directors to assist a local corporation in defeating a hostile takeover. See Lawrence Ingrassia & David B. Hilder, *Norton Wins a Round Against BTR Bid as Massachusetts Lawmakers Clear Bill*, Wall St. J., Apr. 18, 1990, at A12, col. 1.

26. If managers can so successfully influence legislatures, institutional investors may have to rely on influencing the board of directors to keep the generals in their barracks.

27. CalPERS recently withdrew its shareholder proposal to establish a shareholder advisory committee at Occidental Petroleum when the company agreed to have four directors, including at least two independent directors, meet biannually with CalPERS officials to discuss the company's business plans. James A. White, *Occidental Agrees to Meet Twice a Year With Officials of Big California Fund*, Wall St. J., Mar. 22, 1990, at A20, col. 5.

the company's progress and convey shareholders' concerns to management. This exchange, the argument goes, presents a textured alternative to the limited choice that a takeover allows between the raider and the status quo. Moreover, an advisory committee might be able to resolve problems at an early stage, before they become serious enough to invite a takeover.

Notwithstanding these claims, however, the advisory committee is likely to prove an ineffective tool for reform. Its only real virtue is that corporate management might be expected to perceive it as an appealingly "moderate" measure: It is, in fact, so moderate that it would merely formalize existing management-shareholder exchanges in many companies. Moreover, precisely because the advisory structure proposes what amounts to a "shadow board," while not contesting the composition of the "real board," it is doomed to failure. Such a shadow board would suffer all of the structural shortcomings that critics have identified in actual boards of directors, while exercising none of an actual board's power. If boards of directors today meet too infrequently and have too little information to monitor management effectively except during occasional crises,²⁸ an advisory committee would presumably meet even less frequently and receive even less information from management. Similarly, if the outside directors of public corporations, who are largely senior executives of other public corporations,²⁹ lack the time for real monitoring, shareholder representatives assigned to numerous portfolio companies presumably would lack not only the time but also the expertise of the executive outsiders.

In short, the advisory committee strategy correctly identifies the problem—institutional investors do need a tool for continuously monitoring management—but fails to offer a serious solution. It neglects the one existing instrument that *might* be able to compensate for the shortcomings of the market for control: the board of directors itself.

C. *Reforming the Board: The Role of Outside Directors*

By contrast, the final and most aggressive of the existing strategies for reforming corporate governance does focus on the board of directors. Quite recently, institutional investors have sought direct influence over the selection of outside directors of their portfolio companies. For example, to win support in its proxy fight with Carl Icahn, Texaco's management agreed to select one board member from a list provided by CalPERS. The result was the addition of the President of New York University to the Texaco board.³⁰ Similarly, Lockheed recently agreed to allow institutional investors to influence the selection of three board members as a means of gaining their sup-

28. Among more recent, albeit sympathetic critics, see J. LORSCH, *supra* note 1, at 84-88; Elmer W. Johnson, *An Insider's Call for Outside Direction*, HARV. BUS. REV., Mar.-Apr. 1990, at 46 (former executive vice-president and director of General Motors).

29. In his study, Professor Lorsch found that 63% of all Fortune 1000 outside directors are chief executive officers of other corporations. J. LORSCH, *supra* note 1, at 18.

30. James Flanigan, *Texaco Stresses the "Share" in Shareholder*, L.A. Times, Jan. 25, 1989, at D1, col. 1.

port in the 1990 proxy fight initiated by Harold Simmons.³¹

This ad hoc strategy of attempting to affect the composition of the board is an important step beyond the shareholder advisory committee. Nevertheless, it has two serious flaws. First, it is reactive: Someone else must initiate a proxy fight to give institutional investors negotiating power. Second, it is misdirected: It aims at nominating independent directors who, like the President of New York University, resemble existing outside directors. Ad hoc efforts to nominate outside directors presume that the existing institution of outside directors is effective. All too often, however, outside directors who are selected in the usual way from the usual pool turn out to be more independent of shareholders than they are of management.

Nonetheless, institutional investors have correctly focused on the boardroom. In the corporate governance debate, all arguments ultimately converge on the role of the board of directors in general, and on the role of outside directors in particular. Ever since Adolph Berle and Gardiner Means first analyzed the separation of ownership and management,³² commentators have searched for the corporate equivalent of the Holy Grail: a mechanism to bridge the separation by holding managers accountable for their performance. At this point in the quest, one solution to the accountability problem has attained the status of conventional wisdom. Whether one asks the Business Roundtable,³³ the Conference Board,³⁴ the American Bar Association³⁵ or the American Law Institute,³⁶ the answer to the question of who should monitor management is the same: independent outside directors elected by the shareholders. And it is important to understand how pervasive an institution the outside director has become. As of 1987, 74 percent of the directors of publicly held companies were not company employees.³⁷

The justification for relying on outside directors as a monitoring mechanism is straightforward. Because such directors are "independent"—that is, they do not have a personal financial stake in retaining management—they can act as shareholder surrogates to assure that the company is run in the long-term best interests of its owners. From the outset, however, this analysis has not provided an analytically satisfying answer to the question of who

31. A somewhat different motive for attempting to influence the identity of outside directors was reflected in the efforts of institutional investors to cause Exxon to name an environmentalist to its board following the Exxon Valdez oil spill. See Matthew L. Wald, *Exxon Head Seeks Environmentalist to Serve on Board; Pension Fund Pressure*, N.Y. Times, May 12, 1989, at A1, col. 4.

32. ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

33. The Business Roundtable, *Corporate Governance and American Competitiveness*, 46 BUS. LAW. 241 (1990); *Statement of Position Concerning the Role of Corporate Directors of the Business Roundtable*, 33 BUS. LAW. 2083 (1978).

34. JEREMY BACON & JAMES K. BROWN, *CORPORATE DIRECTORSHIP PRACTICES: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD* (1973).

35. Committee on Corporate Laws, Section of Corporation, Banking & Bus. Law, American Bar Ass'n, *Corporate Director's Guidebook*, 33 BUS. LAW. 1595 (1978).

36. *SEE AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 3.03 (Tent. Draft Nov. 1, 1982).

37. See J. LORSCH, *supra* note 1, at 17.

will monitor the monitors.³⁸

Two inadequate answers have been proffered that appeal to the preconceptions of two very different participants in the corporate governance debate. The managerialist explanation for why outside directors can be trusted to monitor effectively rests on noblesse oblige. The personal character of prominent individuals with professional and social ties to the business community, the argument goes, assures that they will discharge their duties as outside directors without any need for additional monitoring. In stark contrast, some academic economists have proposed quite a different reason for trusting outside directors to monitor management faithfully: The market will punish them if they fail. Eugene Fama stated the argument most explicitly: "In a state of advanced evolution of the external markets that buttress the corporate firm, the outside directors are in their turn disciplined by the market for their services which prices them according to their performance as referees."³⁹

Unfortunately, neither of these explanations for why outside directors would discharge their functions effectively is very persuasive. Good character and financial independence from management may be necessary condi-

38. Dr. Suess had highlighted precisely this problem, in rhyme no less, almost twenty years ago:

Oh, the jobs people work at!
 Out west, near Hawtch-Hawtch,
 there's a Hawtch-Hawtcher-Bee-Watcher.
 His job is to watch . . .
 is to keep both his eyes on the lazy town bee.
 A bee that is watched will work harder, you see.
 Well . . . he watched and he watched.
 But, in spite of his watch,
 that bee didn't work any harder. Not mawtch.
 So then somebody said,
 'Our old bee-watching man
 just isn't bee-watching as hard as he can.
 He ought to be watched by *another* Hawtch-Hawtcher.
 The thing that we need is a Bee-Watcher-Watcher!
 WELL . . .

The Bee-Watcher-Watcher watched the Bee-Watcher.
 He didn't watch well. So another Hawtch-Hawtcher
 had to come in as a Watch-Watcher-Watcher.
 And today all the Hawtchers who live in Hawtch-Hawtch
 are watching on Watch-Watcher-Watching-Watch,
 Watch-Watching the Watcher who's watching that bee.
 You're not a Hawtch-Hatcher. You're lucky, you see!

T. GEISSEL (DR. SUESS), DID I EVER TELL YOU HOW LUCKY YOU ARE? 26-29 (1973) (emphasis in original).

39. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 294 (1980). Some interested observers apparently believe both the noblesse oblige and the market for directors stories. In commenting on the provisions of the American Law Institute's Corporate Governance Project dealing with transactions in control, prominent takeover lawyer Martin Lipton writes: "The structure of the modern public corporation has many means of aligning the interests of managers and shareholders An executive must answer to a board of independent directors, who face their own social and economic pressures to ensure that the corporation they direct is successful." Memorandum from Martin Lipton to the Chief Reporter for Principles of Corporate Governance: Analysis and Recommendations, American Law Institute 5-6 (May 4, 1990) (comments on Tentative Draft No. 10) (on file with the *Stanford Law Review*).

tions for effective monitoring, but they are hardly sufficient. First, even financially independent outside directors depend on management for their tenure as directors, since management typically selects its own outside directors. Thus, directors who wish to retain their positions are not independent of management. Second, most outside directors share management's ideological disposition toward the single issue most central to their monitoring responsibilities: how intensely outside directors *should* monitor management.⁴⁰ Some 63 percent of the outside directors of public companies are chief executive officers of other public companies.⁴¹ These directors are unlikely to monitor more energetically than they believe they should be monitored by their own boards. Third, outside directors are not socially independent. As Victor Brudney put it, "[n]o definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose [performance] he is asked to assess."⁴² Finally, in addition to these dependency, ideological, and social obstacles to monitoring, outside directors typically lack an affirmative incentive to monitor effectively. The corporation cannot simply pay outside directors a large sum to induce careful monitoring because the prospect of a large payment would itself undercut their financial independence. Yet any serious effort to monitor inevitably imposes large personal costs on outside directors. As many commentators have pointed out, outside directors lack the time, expertise, staff, and information to challenge management, while management controls not only these resources but also has a direct and powerful incentive to direct corporate policy without interference.⁴³

Belief that a market for outside directors will supply the missing incentive for independent directors is no less a myth than belief in the efficacy of directorial noblesse oblige. This argument reflects what might be called the "perfect market" or, more lightly, the "can opener" fallacy.⁴⁴ The major

40. For example, Professor Lorsch's recent study of more than 900 outside directors of Standard & Poor's 400 companies discloses just such an ideological bias: "[O]ur data reveal that despite serious motives for joining boards, many directors still feel they are serving at the pleasure of the CEO-chairman. This is true even though 74% of directors are now outsiders . . ." J. LORSCH, *supra* note 1, at 17.

41. *Id.* at 18.

42. Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 613 (1982). Elmer Johnson, former executive vice-president and director of General Motors, has more recently made a similar comment. Johnson, *supra* note 28, at 47 (observing a "club ethos among members of the board").

43. Professor Lorsch argues persuasively that outside directors can function effectively in times of crisis—when events demand that outside directors invest the required amounts of time and the crisis itself shifts control of staff and other corporate resources from management to outside directors. J. LORSCH, *supra* note 1, at 97-139. In this case, the exception proves to be no more than an exception. A governance system that can operate only in response to crisis has the unfortunate effect of assuring that crises in fact occur.

44. The "can opener" reference comes from a standard economist joke (which lawyers collect as a defense to the lawyer jokes economists direct at them). Three survivors of a shipwreck were marooned on a desert island: a chemist, a physicist, and an economist. Their only source of food was a can of vegetables that they had no apparent way to open. After surveying the beach, the chemist observed that the chemicals in the sand, when combined with minerals in the nearby soil,

premise of this fallacious syllogism is that a perfect market generates the right incentives for everyone; the minor premise is that such a market exists, and the conclusion, in our case, is that directors have the right incentives to monitor. So stated, the argument's fallacy is apparent: It assumes that the market for directors operates effectively, let alone perfectly. However, there is simply no evidence that anything like an effective market for outside directors exists at all.⁴⁵

This, then, is where the problem stands. On the one hand, the board of directors is the only existing device for monitoring managers. On the other, both more⁴⁶ and less⁴⁷ sympathetic observers of boards of directors have come to acknowledge what should have been obvious all along: The traditional corporate solution of introducing outside directors to bridge the separation between ownership and control has dramatic limitations.

III. ALTERNATIVE CORPORATE GOVERNANCE STRUCTURES: THE LBO ASSOCIATION AND JAPANESE AND GERMAN CORPORATE GROUPS

Effective reform of corporate governance requires a new approach since even the best institutional strategy to date—influencing the selection of outside directors—cannot succeed in its present form. To begin the search for a new strategy, it is useful to consider two radical approaches that fall outside the traditional boundaries of the debate: one from the United States and the other from Japan and Germany. Although neither approach offers institutional investors an attractive agenda, each serves to highlight elements that a workable agenda must contain.

would eat through the can's lid if heated to the proper temperature. However, the sun would not generate sufficient heat and no one in the party had any matches. Then, the physicist told her companions that if they propelled a rock into the air with enough force and with the proper trajectory, it would land on the can and break through the lid. None of them, however, could throw the rock sufficiently high to give it the necessary velocity. The chemist and physicist then turned to the economist, who had remained smugly aloof. When angrily asked for his solution to their food problem, the economist responded that his discipline provided a ready answer to their plight: "Simply assume a can opener!"

45. Steven Kaplan and David Reishus provide data that they believe "suggest that top managers face an external labor market as described by Fama." Steven Kaplan & David Reishus, *Outside Directorships and Corporate Performance*, — J. FIN. ECON. — (forthcoming). They studied what happened to outside directors who also were senior executive officers of other companies when their own companies performed poorly, as measured by a 25% dividend cut in the prior 12 months. The data show that only approximately one such senior executive in six actually loses an outside directorship in the three years following announcement of the dividend reduction in the executive's own company. Thus, the authors conclude that although "perceived managerial ability matters in the external labor market, it may not matter a great deal. Top executives of the poorer performers are not significantly more likely than better performers to lose outside directorships they already have." *Id.* at —. Rather than evidence of the existence of market constraints on outside director performance, the data suggest to us that such market as may exist is quite ineffective. For similar data, see Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default* (Mar. 29, 1990) (paper presented at conference on The Structure and Governance of Enterprise, Harvard Business School, March 1990) (on file with the *Stanford Law Review*).

46. See, e.g., J. LORSCH, *supra* note 1; Johnson, *supra* note 28.

47. See Brudney, *supra* note 42.

The domestic alternative to the traditional corporate governance structure of the public corporation is what Michael Jensen calls the "LBO Association."⁴⁸ This structure bridges the separation of ownership and management by eliminating public shareholders, typically through a leveraged management buyout. Three groups compose the LBO Association: a sponsoring partnership, which controls at least 20 percent of the equity and monitors the company's management; the company's managers, who also own a substantial equity stake that may be financed with personal, full recourse loans; and the institutional investors, who provide the balance of the debt and equity necessary for the acquisition. Separation of ownership and management is minimized because both the managers and the monitors are major equity holders, with interests that closely track those of the passive investors in the company. Indeed, the highly leveraged sponsor and management groups stand to gain or lose proportionately even more than the passive investors when the company performs well or poorly. In addition, the company's large debt load is an important control device in its own right: It allows the managers little room for mistakes before the institutional investor can take remedial actions specified in the terms of the debt contract.⁴⁹

As described by Jensen, the LBO Association contains a useful lesson for institutional investors: A professional monitor that is suitably motivated, such as an LBO sponsor, can be an invaluable means of bridging the separation of ownership and control. Nevertheless, the LBO structure is unsuitable for institutional investors because it "solves" the governance problem largely by eliminating it through the wholesale substitution of debt for equity and the introduction of overwhelming financial incentives. The LBO recipe not only prescribes withdrawal from the public market; it also requires a massive reassignment of equity to insiders. In addition, the LBO capital structure is simply inappropriate, by Jensen's own description, for large numbers of public corporations that require the cash flow flexibility to fund R&D or to compete in growing markets.⁵⁰ Indeed, notwithstanding Jensen's forceful account of its virtues, the LBO Association may be a temporary organizational form even in its natural habitat of stable industries.⁵¹

The second radical alternative—the typical governance structures of Japanese and German corporations—initially appears to be more compatible with the orientation of American institutional investors toward the public

48. Michael Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61.

49. The incentive for the sponsor and management groups to be less risk averse than the passive investors because their investment has the character of an option is at least partly ameliorated by these enforcement techniques available to the passive investors.

50. See Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987) (comparing characteristics consistent with leveraged buyouts with those consistent with dual class recapitalizations); Kenneth Lehn, Jeffrey Netter & Annette Poulsen, *Consolidating Corporate Control: The Choice Between Dual-Class Recapitalizations and Leveraged Buyouts*, — J. FIN. ECON. — (forthcoming) (empirical test of Gilson's hypothesis).

51. See Bhagat, Shleifer & Vishny, *supra* note 22, at 3 (describing the LBO as a "transitory arrangement used to allocate assets to corporations managing other similar assets").

market, even though it is more remote from a cultural or legal perspective. Jensen notes that an LBO Association behaves much like a Japanese keiretsu, a business grouping in which a company's main bank is also a major shareholder and a dominant influence on management.⁵² Mark Roe describes a similar German structure, where three banks control more than 40 percent of outstanding stock (for example, 28 percent of Daimler-Benz is held by a single bank).⁵³ As with the LBO Association, the model of bank ownership—or any similar structure of active expert monitoring by an influential shareholder—also contains a lesson for institutional investors: The governance problem can be solved without abandoning the public market if a single shareholder with sufficient voting power and expertise emerges to become a representative monitor.

Again, however, the "banker model" remains largely inapposite to the circumstances of the American institutional investor. Like the LBO model, the banker model unifies, rather than bridges, ownership and control. It combines massive equity ownership with the expertise of in-house professionals who, in this case, are bankers skilled in monitoring by their primary occupation.⁵⁴ Pension funds and other American institutions lack a comparably skilled pool of employees. Moreover, even if American institutions possessed the requisite expertise, the obstacles to importing the banker model to the United States would remain formidable. Not only are there legal barriers to active share ownership by financial intermediaries in the United States but, equally important, there are substantial political and regu-

52. Jensen, *supra* note 48, at 73; see also Stephen D. Prowse, Institutional Investment Patterns and Corporate Financial Behavior in the U.S. and Japan 5-6, Table 2, (Nov. 1989) (paper presented at a conference on the Structure and Governance of Enterprise, Harvard Business School, March 1990) (on file with the *Stanford Law Review*) (reporting that, on average, a Japanese company's largest debtholder owned 6.2% of the company's equity; that the 5 largest debtholders owned 18.2% of equity; and that of 133 sample companies, the largest debtholder was also the largest shareholder in 57 companies, while in an additional 67 companies, the largest shareholder and largest debtholder were members of the same keiretsu). The parallel to an LBO association is not perfect, however. Companies within the same keiretsu typically have supplier as well as financial links.

For an interesting comparison of LBO associations and Japanese and German bank-centered models, see Richard M. Buxbaum, Institutional Owners and Corporate Managers: A Comparative Perspective 47-48 (1990) (unpublished manuscript) (on file with the *Stanford Law Review*).

53. Mark J. Roe, *Legal Restraints on Ownership and Control of Public Companies*, — J. FIN. ECON. — (forthcoming); see also John Cable, *Capital Market Information and Industrial Performance: The Role of West German Banks*, 95 ECON. J. 118, 129 (1985) ("West German banks provide industry with substantial long-term finance, have extensive control over shareholders' voting rights and are widely represented on company boards."); Louis Lowenstein & Ira M. Millstein, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad?*, 3 COLUM. BUS. L. REV. 739, 747 (1988) ("On one end of the spectrum is the German experience, where there is a substantial concentration of voting rights in a relatively small number of large banks. It is through the exercise of those voting rights that the large banks directly influence the selection of corporate executives and managing boards and indirectly influence all fundamental business decisions.").

54. Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LIT. 1, 14-20 (1989); Takeo Hoshi, Anil Kashyap & David Scharfstein, *The Role of Banks in Reducing the Costs of Financial Distress in Japan* (Feb. 1990) (paper presented at conference on The Structure and Governance of Enterprise, Harvard Business School, March 1990) (on file with the *Stanford Law Review*); and Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. ECON. BEHAV. & ORG. 399 (1989), analyze the monitoring role of Japanese "main" banks, particularly in the setting of a group company's financial distress.

latory barriers deeply rooted in our populist character.⁵⁵ As Roe concludes in his historical analysis of these obstacles, American “[c]orporate history can be seen as an effort to find substitutes for the direct monitoring [of management] that politics disallowed.”⁵⁶

IV. THE NEED TO REINVENT OUTSIDE DIRECTORS: DESIGN CRITERIA AND THE LIMITS OF CURRENT PROPOSALS

As this brief review suggests, the range of existing solutions to the problem of corporate governance leaves institutional investors in a dilemma. On the one hand, the reform strategies that they now pursue—limiting anti-takeover defenses, establishing advisory committees, and attempting to install traditional outside directors—are too limited. In particular, outside directors tend to be far more independent of a company’s shareholders than of its managers. On the other hand, the radical solutions that might solve the governance problem—that is, the LBO Association and banker models—clash with the existing role and basic identity of institutional investors. These models call for combining high-powered expertise with concentrated equity ownership in ways that American institutions neither wish to, nor are able to, undertake on their own. The challenge for institutional investors, then, is to weld the existing governance structure of public companies, including the board of directors, with the existing ownership pattern of public companies so as to create a new structure that duplicates the monitoring capabilities of the LBO and banker models.

A. *Design Criteria*

To create this new structure, institutional investors must possess the voting power and the incentive to monitor corporate performance, as well as the means to monitor and subsequently influence management. These elements, moreover, cannot be combined within a single entity, such as an LBO Association or a “main” bank. Rather, they must be harmonized with the existing capabilities of institutional investors, the existing securities market, and the prevailing legal and political constraints on financial intermediaries.

The good news is that half of the battle has already been won: Institutional investors already *have* the necessary voting power. As a result of the growth of institutional holdings during the 1980s, manageable numbers of institutions now command what would be, if it were voted in a coordinated

55. See Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

56. Roe, *supra* note 53, at —. Of course, which institution substitutes for which depends on your perspective. While Roe characterizes takeovers as a substitute for the banker model in the United States, Sheard characterizes the banker model in Japan as a “substitute[] for the missing takeover market in Japan.” Sheard, *supra* note 54, at 399. More specifically, “the main bank performs a role that closely parallels in its effect the external takeover market: in particular in bringing about the displacement of ineffectual management and the reorganization of corporate assets to improve efficiency.” *Id.* at 409.

fashion, a controlling block of stock in many public companies.⁵⁷ Moreover, institutional interest in corporate governance demonstrates that these investors have the requisite monitoring incentives. Our earlier effort to offer a normative model of the relationship between the institutional investor and its portfolio companies was not designed to spark institutional interest in corporate governance; it was intended to explain a commitment to reform that is currently well developed.

The bad news, however, is that half the battle has not even been fought: The expertise for monitoring management and the organizational mechanism for influencing it are still missing. Because institutional investors lack the expertise to monitor on their own, they must delegate the monitoring function to outside experts. In addition, because individual institutions lack the votes to affect corporate policy, they must cooperatively delegate the monitoring function to *representative* outside professionals.

This returns us, full circle, to the outside director. An ideal mechanism for delegated monitoring would seem to be the expert director, chosen cooperatively by institutional investors. There is just one hitch: As we have already argued, outside directors today are simply not reliable representatives of shareholder interests. Thus, if the new monitoring structure depends on the use of outside directors, the system of outside directors itself is in need of reform.

B. *The Limitations of Current Proposals: Independence from Shareholders and the Need for Implementation*

Precisely because the current governance system of outside directors so clearly fails to monitor effectively, numerous commentators have proposed ways to reform the system by eliminating the dependence of outside directors on management. These proposals typically locate the problem in management's control of the proxy process, and advocate a more or less extensive expansion of shareholder access to the proxy machinery. For example, Melvin Eisenberg has recommended permitting shareholders who hold more than 5 percent of a corporation's stock to nominate directors on the corporation's proxy statement.⁵⁸ Somewhat more expansively, Louis Lowenstein has urged that shareholders receive the exclusive right to nominate one-fifth to one-quarter of the board.⁵⁹ At the extreme, George Dent has suggested lodging exclusive access to the proxy machinery in a committee of the corporation's ten or twenty largest shareholders.⁶⁰

57. See text accompanying notes 89-92 *infra*.

58. MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 117-21 (1976).

59. LOUIS LOWENSTEIN, *WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER* 209-11 (1988).

60. George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 *Wis. L. REV.* 881, 907-08.

One commentator has suggested a strategy for influencing the behavior of the board of directors that does not require a major revision of existing rules governing director nomination or election. With an eye more to conducting a guerrilla war than effecting a change in the system, Joseph Grundfest has urged institutional investors to "just vote no." Joseph Grundfest, *Just Vote No* or

These proposals all share two failings: first, they merely make outside directors independent of management, rather than *dependent* on shareholders; and second, implementing them requires cooperation from one of three unlikely sources—a state legislature, the federal government, or the corporation itself.

The first failing reflects the familiar problem that when shareholdings are dispersed, no one remains to monitor the monitors. If directors have no affirmative incentive to monitor, all that can be done is to make directors financially independent from management and, in Peter Drucker's words, to elect "'professional' directors, men or women of public standing and proven competence who, as members of the board, can be truly independent of management."⁶¹ As we have seen, however, this is no substitute for giving directors an incentive to monitor effectively in the interest of shareholders. Moreover, selecting outside directors by a committee of shareholders rather than by management does not produce outside director dependence on the shareholder committee. For example, when, in connection with its proxy fight with Carl Icahn, Texaco allowed CalPERS to help select one new board member, the nominee who emerged was the president of a major university. Independent of management, perhaps; but dependent on shareholders, hardly⁶² (not even if this particular university president happened to

Just Don't Vote: Minimalist Strategies for Dealing with Barbarians *Inside* the Gates (Nov. 7, 1990) (paper presented at the fall meeting of the Council of Institutional Investors) (on file with the *Stanford Law Review*). Grundfest suggests that if enough institutions simply mark their proxies so as to "withhold authority" to vote for management's slate of directors or take other steps to assure that their shares will not be counted toward the quorum necessary to conduct a shareholders' meeting, management's slate will not be elected (although neither will anyone else's). While that result would not change the identity of the board—under corporate law existing directors continue to serve until their successors actually are elected—it would amount to a shareholder vote of no confidence. Such an event, Grundfest plausibly argues, would likely focus management's attention on the extent of shareholder dissatisfaction.

61. PETER F. DRUCKER, *THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA* 91 (1976).

62. The problem appears starkly in the recent amendment to the Michigan Business Corporation Act that creates a statutory independent director. MICH. COMP. LAWS § 450.1505 (1989) (MICH. STAT. ANN. § 21.200(505)(3) (Callaghan 1990)). Under the statute, either the board of directors or the shareholders can designate a director as "independent" provided that the individual meets standard conflict of interest limits on other relations with the corporation or its executives and has not been a director for more than three years. Once designated independent, a director can be paid special compensation, will have corporate funds available for expenses related to his duties and, most significant, may communicate with shareholders, at the corporation's expense, in any communication the corporation sends to its shareholders. The statute encourages corporations to appoint independent directors by giving special weight to their determinations concerning indemnification, ratification of interested transactions, and terminating derivative litigation.

While Michigan's effort is the most far-reaching to date in terms of achieving independence, it also highlights the continued absence of any accountability to shareholders. Indeed, the statute's drafters are explicit in disclaiming any accountability to shareholders: "[T]he independent director is intended to represent the corporation as a business enterprise and evaluate proposals in light of the corporation's best interests. As a result, deliberations will include a representative of the corporation itself instead of only managers and shareholder groups who may not always have the business enterprise as their primary concern." Cyril Moscow, Margo Rogers Lesser & Stephen H. Schulman, *Michigan's Independent Director*, 46 BUS. LAW. 57, 59 (1990).

have the time and the skills to monitor management of a vertically integrated natural resources company).

The second failing common to past reform proposals—that they require too much cooperation from the company or the government—simply reflects political realities. The chance of immediate action to reform the selection of outside directors, either by corporate management or by state legislatures, the SEC, or Congress, seems remote. To date, corporations have allowed institutional investors to participate in the selection of board members only when, as in the Texaco and Lockheed cases, management needed votes in a hard-fought proxy contest. Prospects are no more favorable for a regulatory initiative. State legislatures are curtailing, not expanding, shareholder access to the proxy machinery.⁶³ Although the SEC seemingly has authority under section 14(a) of the Securities Exchange Act to mandate broader access to the proxy machinery,⁶⁴ and CalPERS⁶⁵ and the United Shareholders Association⁶⁶ have urged it do so, none of the SEC's public statements suggests that action is imminent. And there is no reason to expect congressional action. In the current political climate, Congress is likely to treat access to the proxy machinery as part of the debate over hostile takeovers and to view expanded access as a pro-raider position. Moreover, since Congress has declined to deal directly with the takeover phenomenon at its height,⁶⁷ legislative action is even less likely now.

In sum, the range of current proposals for reforming the selection of outside directors is neither politically feasible nor likely to be effective. Yet the outside director remains key to any plausible effort to introduce effective monitoring. A qualitatively different approach to the selection and motivation of outside directors is needed.⁶⁸

63. See text accompanying note 25 *supra*.

64. 15 U.S.C. § 78n(a) (1988).

65. Letter from Dale M. Hanson, California Public Employees' Retirement Systems, to Linda C. Quinn, Director, Division of Corporate Finance, Securities and Exchange Commission (Nov. 3, 1989) (on file with the *Stanford Law Review*).

66. See 22 Sec. Reg. & L. Rep. (BNA) 464 (1990) (reporting United Shareholder Association request for rule-making proceeding).

67. The only significant congressional action with respect to acquisitions has been through the tax law. Most important, the Tax Reform Act of 1986 repealed the General Utilities doctrine that allowed stepping up the basis of a target company's depreciable assets without incurring a corporate level tax. 26 U.S.C. § 311(b) (1988). Additionally, Internal Revenue Code § 5881 imposes a penalty tax on the payment of greenmail, § 4999 imposes a similar tax on excessive golden parachute payments, and § 275(a)(6) makes the payment of such taxes nondeductible.

68. Martin Lipton and Steven Rosenblum recently have proffered a quite different kind of proposal to reform the corporate electoral process: election of directors for a five-year term during which no hostile takeovers would be allowed. Martin Lipton & Steven A. Rosenblum, *A Proposal for a New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. — (1991) (forthcoming). In their view, the principal failing of American corporate governance is that directors are *too* responsive to shareholders, rather than not responsive enough. The threat of a hostile tender offer (and, necessarily, the belief that shareholders will accept an offer if made), they argue, makes management manage in the short run. Assuring management an extended term of office—five years—allows them to take the long view. At the end of five years, shareholders would then have the opportunity to evaluate management's performance, aided by three proposed changes in the electoral process: (1) management would be required to prepare a five-year plan at the beginning of its term setting forth goals for its term of office; (2) at the end of the term, an independent

V. AN AGENDA FOR INSTITUTIONAL INVESTORS: CREATING A CORE OF PROFESSIONAL DIRECTORS

Thus far we have sketched an aspirational objective for corporate governance reform on behalf of institutional investors: the introduction of outside directors who will actively monitor public corporations in the shareholders' interest, much as LBO sponsors and Japanese and German banks

agent would review the extent to which management met its self-prescribed goals and provide that evaluation to shareholders; and (3) in each quinquennial election, large shareholders would have access to management's proxy statement if they desired to nominate candidates for directors.

Lipton and Rosenblum's argument for their proposal is puzzling. They begin by asserting that the familiar paradigm that directors should be responsive to shareholders is flawed because it rests on the belief that shareholders "own" the corporation in some metaphysical sense. In fact, they argue, the modern corporation is not private property at all, but a state-created entity in which shareholders have only the rights the state gives them. Unfortunately, Lipton and Rosenblum misunderstand the paradigm they criticize. That shareholders "own" the corporation is the *outcome* of economic analysis of corporate governance, not its premise. As one of us stated 10 years ago, the "description of shareholders as the 'owners' of the corporation does not suggest that [their] role . . . flows, normatively from their 'ownership.' It derives, rather from the need for those holding the residual interest in corporate profits to have the means to displace management which performs poorly. . . . [T]his position is based on matters other than a preconception of the rights associated with 'ownership'; indeed, if the statute did not provide for shareholders we would have to invent them." Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 834 n.56 (1981); see, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983).

The second difficulty with the Lipton-Rosenblum analysis is that they assume their premise: that management manages in the short run to avoid a hostile takeover. First, the authors neither offer empirical support for their proposition nor refer to the empirical studies that fail to find evidence of short-term behavior. See, e.g., ACADEMY INDUSTRY PROGRAM, NATIONAL ACADEMY OF SCIENCES, CORPORATE RESTRUCTURING AND INDUSTRIAL RESEARCH AND DEVELOPMENT 8-20 (1990) [hereinafter CORPORATE RESTRUCTURING] (presentation of Joseph Grundfest summarizing empirical evidence). Second, they simply ignore the developing literature concerning the circumstances that would be necessary for short-term management to be a rational self-protective response to the threat of a hostile takeover. See, e.g., Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148 (Papers & Proc. May 1990); Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988). These models are both quite restrictive in the assumptions necessary for their derivation and are not concerned with establishing whether the assumptions fairly describe the world. Moreover, Lipton and Rosenblum ignore a far more parsimonious explanation for the short-term orientation they assert exists. If the cost of capital is higher in the United States than in Japan (the standard comparison for assertions that American managers have too short-term an outlook), then the preference of American managers for projects with shorter horizons than their Japanese counterparts will result simply from the Americans making capital budgeting decisions according to the net present value rule. Because American managers must apply a higher discount rate, the longer the project life, the more likely it will be a positive net present value project for Japanese companies and a negative net present value project for United States companies. The available empirical evidence describes precisely this cost of capital differential. See CORPORATE RESTRUCTURING, *supra*, at 6-8 (summarizing empirical evidence).

The most troubling difficulty with the Lipton-Rosenblum analysis, however, is its internal inconsistency. On the one hand, Lipton and Rosenblum laud the German and Japanese governance models as a "means of promoting long-term wealth creation and stability while effectively monitoring the business and performance of their corporations' managements." Lipton & Rosenblum, *supra*, at -. As discussed in the text accompanying notes 52-56 *supra*, the German and Japanese models provide for continuous monitoring by bank professionals, rather than the episodic, all-or-nothing monitoring that characterizes the takeover process. Yet the quinquennial proposal, by eliminating hostile takeovers and proxy fights for five-year periods, hardly results in the ongoing monitoring of management that is central to the German and Japanese models. At best, the proposal merely recreates the episodic, all-or-nothing monitoring originally sought to be eliminated.

now monitor their client companies. The time has come to propose how such a class of directors might arise and how it might function. To be persuasive, our proposal must meet four criteria. First, it must be *feasible* to organize at an acceptable cost. Second, it must promise real *operational improvements* in monitoring portfolio companies. Third, it must be *politically practical* for institutional investors to implement by themselves, without the unlikely assistance of portfolio companies or governmental authorities.⁶⁹ And fourth, it must be *legally practical* under the constraints imposed by prevailing law. This Part sketches a proposal that we believe is organizationally and operationally feasible. The next Part addresses the proposal's political and legal practicality.

A. *Introducing Professional Directors*

Our earlier analysis identifying the obstacles to monitoring by traditional outside directors also indicates the characteristics that a new generation of professional directors must have.⁷⁰ Outside directors presently lack an incentive to act as ongoing monitors of management performance.⁷¹ Although outside directors are financially independent, they are traditionally selected by management and remain socially and ideologically tied to management (recall that 63 percent of outside directors are chief executive officers who must face their own boards of directors). In addition, outside directors presently lack the time to monitor, except during corporate crises,⁷² because they are either CEOs themselves or hold equally demanding full-time positions. Indeed, if a director supported himself as a full-time member of the board of a particular corporation, he would no longer be an *outside* director at all. It follows that a new class of outside directors must have the time and skill to monitor energetically on behalf of shareholders; they must have the independence from management to perform their monitoring function without inhibitions or constraints; and they must have the incentive to actually perform this function.

We propose to create a novel position, that of the professional outside director, that would exist prior to, and apart from, the election of other directors to the boards of portfolio companies.⁷³ The key organizational issues

69. We do not object to cooperation by companies, state legislatures, or Congress; rather, based on history, we simply do not expect it. Consequently, proposals that require such cooperation lack the potential to be helpful now.

70. See text accompanying notes 40-43 *supra*.

71. To be sure, outside directors seem much more effective in sharply defined crisis situations. See note 43 *supra*. In these situations, events—Lorsch's examples are takeovers and unanticipated executive turnover—force directors into the monitoring role. The goal, however, is to design a system in which monitoring precedes, and therefore sometimes prevents, the onset of a crisis.

72. Again, crises provide the exception, forcing directors to spend vastly more time on them, which necessarily results in increased information.

73. Our proposal to create a position for professional outside directors is not entirely novel. In some aspects, it was anticipated more than 50 years ago by William O. Douglas, then chairman of the SEC. Joel Seligman recounts that Douglas delivered a key address "urging smaller boards made up of adequately paid directors, whose primary business would be to serve on the boards of a few

are how to design such a position and how institutional investors can act, collectively or individually, to create it.

1. *Designing the position of professional director.*

First imagine the kind of person who should become a professional director. Consider, for example, a 50-year-old professor of finance at a graduate school of business, or a partner at either a Big Six public accounting firm or a major management consulting firm. Many such individuals are likely to have the skills to monitor the management of a public corporation. The challenge, then, is to design a position that these experts would willingly accept and that would also provide them with the time and the incentive to monitor effectively.

Now imagine that the new position would require a full-time commitment, and would obligate each expert to serve on the boards of perhaps six portfolio companies. In this case, an expert's annual compensation solely from board memberships easily might exceed \$250,000: the aggregate of the board fees, committee fees, and fringe benefits that six large public companies would ordinarily pay to their directors. In all likelihood, this sum alone would attract top-flight business professionals, even without additional compensation (although extra pay could be provided if necessary). The experts we describe could undoubtedly earn more in other employment, but they would be hard-pressed to match the intrinsic interest of the professional director's work or the social prestige that multiple directorships would confer.

Once individuals with the requisite skills agreed to serve as professional directors, moreover, they would automatically enjoy the two most essential resources for effective monitoring: a focused mandate and the time to familiarize themselves with their companies. Because they would serve as full-time directors, their corporate positions would not be ancillary to other work. Further, because they would have no other duties, they would have far more time to devote to each of their companies than outside directors now have, and they would have greater flexibility to apportion time among their companies as the need arose.⁷⁴ For example, during periods of crisis or poor performance, they would be free to concentrate on their neediest companies. Of course, this relative flexibility and specialization would lead professional directors to accept more active roles on their boards than traditional outside directors could afford to take, including perhaps a dispro-

corporations so that each director could acquire a thorough knowledge of the corporations." JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 207 (1982).

74. The average outside director now devotes about 14 days a year to each board on which he or she serves, including travel, preparation time, and committee work. HEIDRICK & STRUGGLES, INC., *THE CHANGING BOARD* 9 (1988). Professor Lorsch identifies time constraints as the most pressing issue facing talented business executives and professionals who are asked to join boards. J. LORSCH, *supra* note 1, at 23. By contrast, a professional director who serves on six boards would be able to devote an average of 40 days a year to each board. In addition, the professional director's flexibility to allocate time among companies would further magnify his advantage. Thus, on the dimension of time alone, the resources of professional directors would dramatically exceed those of traditional outside directors.

portionate number of important committee assignments. But this is precisely what institutional investors should hope for. Only professional directors who are central to the board's operation could act as effective monitors.

Most importantly, the professional director avoids the incentive problem presented by either the full-time inside director or the conventional outside director. Unlike other plans for full-time directorships, our proposal would not tie directors to particular companies: Our directors would serve full-time only with respect to the *combination* of companies to which they are elected by institutional investors. Thus, they would remain financially *independent* of the managements of particular companies.⁷⁵ Unlike other plans for electing independent outside directors, however, our proposal departs from the old model of financial independence by making professional directors financially *dependent* on their performance, just like the sponsors of LBOs and the shareholder directors of Japanese and German bank-centered corporate groups. If institutional shareholders were dissatisfied with a professional director, they could refuse to reelect him—not just to one board, but to every board on which he served.⁷⁶

2. *Implementing the new position.*

The professional outside director is a way to realize Eugene Fama's idyllic vision of an external directors market operating to ensure optimal corporate governance.⁷⁷ Yet the market we envision would be far more organized than the one postulated by Fama because the "buyers" in our market (that is, institutional investors) could elect professional directors only by coordinating their voting efforts. In other words, professional directors are a public good for institutional investors. All investors would benefit from the services of these directors, yet no single investor could obtain their services without at least some cooperation from other shareholders. A market for professional directors is possible today only because institutional investors have aggregated shareholdings to the point where the costs of collective action, although still important, have reached manageable proportions.

The precise amount of coordination required to support professional directors depends on the scope of the market. In many respects, this market might operate most efficiently if it were institutionalized through a permanent and organizationally distinct clearinghouse. For example, institutional

75. The continuing support of institutional investors would also secure the independence of professional directors. Presumably, institutional investors would be inclined to support such directors in any principled disputes with management, in which case management could remove these directors only at the risk of a proxy fight.

76. In addition to the de facto power to discharge professional directors who fail to perform satisfactorily, institutional investors might also experiment with more graduated incentive devices, such as offering directors stock appreciation rights (SARs). Although such incentive plans might be an appropriate area of experimentation once a system of professional directors was in place, they would present risks at the outset. See note 88 *infra*.

77. More bluntly, we might characterize the goal of our proposal as making an honest man out of Eugene Fama. See text accompanying note 39 *supra*.

investors might collectively finance a nonprofit organization charged with recruiting directors and performing the routine processing and filing tasks that coordinated action among institutional investors would inevitably generate.⁷⁸ One or more of the industry groups and consulting organizations that now promote the collective interests of institutional investors might initiate such a clearinghouse.⁷⁹ Indeed, several groups have already introduced databases that might be useful in operating a directors' clearinghouse.⁸⁰

A centralized organization could enhance the effectiveness of a core of professional directors in several ways. For example, it might negotiate with the managements of individual corporations on behalf of institutional investors and continue to monitor professional directors after they were elected to office. In both these capacities, the clearinghouse would provide an organizational buffer between institutional investors and portfolio companies. Professional directors selected and monitored by the clearinghouse would in no sense be "delegates" of particular investors. In fact, institutional investors would not even have to commit their votes to professional directors in advance. To function effectively, the clearinghouse would merely need to know that institutional investors, out of self-interest, ordinarily *would* vote for its nominees, who would be selected expressly to promote shareholder interests.

To be sure, even an established clearinghouse that attempted to elect a critical mass—according to Lowenstein, one-quarter⁸¹—of the directors of major portfolio companies would face a collective action problem. Some institutional investors would freeride on its services by refusing to fund its activities. However, this freeriding would not be fatal. As recent shareholder rights initiatives suggest, there are many public-spirited institutions that would support a clearinghouse, even without a formal mechanism for assessing contributions. Furthermore, modest support for the clearinghouse would signal the commitment of institutional investors to the financial interests of their beneficiaries. Contributing institutions would also gain a voice in clearinghouse selection and monitoring policies, and might also gain access to ancillary services, such as comparative ratings of corporate performance.

During the period before the establishment of a working clearinghouse, however, the collective action problem is obviously more serious. For this reason, we emphasize that formal cooperation among numerous institutional investors *would not be necessary* to demonstrate the merits of our proposal. A single large investor, such as CalPERS, could easily initiate the market for professional directors on its own, merely by picking a dozen companies to

78. See text accompanying notes 95-145 *infra*.

79. Such groups include, for example, the Council of Institutional Investors ("CII"), the Investor Responsibility Research Center ("IRRC"), the Institutional Shareholder Services ("ISS"), the United Shareholder Association ("USA"), and the Analysis Group, Inc.

80. A partial list of databases known to us includes the ISS Director Data Base and the corporate governance and performance indices developed by USA and the Analysis Group.

81. See text accompanying note 59 *supra*.

target during the proxy season, announcing its intentions, and enlisting the informal cooperation of other institutional investors along the way.⁸² Such a modest effort by one or a small number of institutional investors would initially result in a less equitable distribution of costs than a central clearinghouse funded by many investors. Nevertheless, the modest expenditure would be both legally and financially prudent. A small-scale initiative to develop professional directors promises direct gains from improving the management of targeted companies to a greater extent than can be expected from institutions' current corporate governance initiatives. More importantly, however, it would lay the organizational foundation for expanding the range of professional directors in subsequent proxy seasons, and would thus contribute indirectly to improving returns from all portfolio companies. As large shareholders should know, freeriding by other investors is no reason for inaction if even a pro rata fraction of potential gains can justify the cost of decisive measures.⁸³

B. *Professional Directors as Monitors*

Given that a core of professional directors can be organized, through either a clearinghouse or a single institution's pioneering efforts, the issue shifts to how effective such directors are likely to be. Professional directors must have more than the skills, time, and initial motivation to monitor on behalf of institutional investors. To be successful, professional directors must also have the information to evaluate management performance and the sustained motivation to discharge their task in the face of tepid cooperation or even outright resistance from management. We believe that professional directors would possess these qualities in significantly greater measure than outside directors now do.

Consider first the dynamic changes that would occur on the boards of portfolio companies following the introduction of professional directors. A critical mass of professional directors (again, 25 percent of the board) would be large enough to make its voice heard clearly but small enough to leave control with management's nominees. Ideally, this structure would promote cooperation with management. Professional directors could neither displace incumbent managers nor shift corporate policy without the cooperation of

82. Again, such a pioneering investor might find it useful to initiate its efforts through an organization that presently advises institutional investors. See note 79 *supra*. These organizations could not only serve as a buffer between the investor and its portfolio companies, but they would also be likely to have the expertise on hand for the selection of target companies and potential nominees.

83. In a forthcoming article, Professor Edward Rock argues that our proposal is unlikely to garner institutional support because of an *intra*-institutional agency problem: Fund managers for major institutional investors lack an incentive to pursue the long-term interests of fund beneficiaries because these managers are compensated chiefly in terms of how successful they are in reducing short-term costs. See Edward Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 139 U. PA. L. REV. — (1991) (forthcoming). Professor Rock's observation sounds a cautionary note. Institutional investors are well advised to separate the functions of fund management and corporate governance reform. However, the active interest that Dale Hansen and other top executive officers of public pension funds have taken in corporate governance indicates that these officers do have the long-term interest of fund beneficiaries very much at heart.

management's own nominees to the board. At the same time, however, such a minority block of professional directors would hardly be without beneficial influence.

Paradoxically, one source of such influence arises because portfolio companies would also retain a substantial complement of traditional outside directors. As a practical matter, most boards would divide into three groups after the introduction of professional directors: inside management directors, traditional outside directors nominated by management, and professional directors. Any issue that divided management and the professional directors would thus leave the balance of power with the traditional outside directors. In effect, the traditional outsiders would assume a quasi-judicative function—a role that, unlike the monitoring function, they might be expected to perform capably. Although traditional outside directors may be structurally disposed to favor management, we are convinced that they are also men and women of conscience who take their fiduciary responsibilities seriously. The irony is that they rarely exercise their judgment today, except during crises, not only because they lack the time and the incentives to do so, but also because board meetings are dominated by a management ethos of forced collegiality and agreement.⁸⁴ If, in contrast, professional directors accept the onus of posing hard questions and framing strategic alternatives, traditional outside directors could be drawn into real discussions of company policy and might well reject management's views when warranted. Thus, far from displacing traditional outside directors, introducing professional directors would create an institutional structure in which, for the first time, outside directors could display the independence their proponents have long claimed for them.

A skeptic might respond that this tripartite structure would sacrifice the traditional collegiality of the boardroom for little apparent gain because management could neutralize the board's power simply by withholding information. We see no reason to lament the possible loss of collegiality. If a company were performing well, open discussion would strengthen director relationships. It would give management the satisfaction of receiving support and approval for its achievements from a truly independent board. Alternatively, if a company were performing poorly, decorous collegiality would have no place in the boardroom. In this case, management should be compelled to account for its performance and address alternative strategies because it would have lost its only legitimate basis—success—for expecting deference from the board.

The more serious charge that management might neutralize the board by withholding information is also easily answered. Accounts of boardroom life suggest that many managements *now* suppress information and discus-

84. Professor Lorsch describes the "subtle set of unspoken norms" that dominate boardroom behavior, including norms against openly criticizing the CEO or contacting fellow directors outside the boardroom. J. LORSCH, *supra* note 1, at 91-96. The consequence of these norms is that outside directors may never discuss the most alarming or serious issues facing the company. *Id.*

sion with impunity under the existing system of outside directors.⁸⁵ By contrast, introducing professional directors with a mandate to challenge unsatisfactory performance would force management to produce information in order to defend its policies. Management's only credible response to the hard questions and the alternative strategies of professional directors would be to share more information, not less. In addition, management would have little incentive to distort information because the consequence of losing credibility would be higher with a board that included a minority of professional directors than with a traditional board.

Moreover, professional directors nominated by an organized clearinghouse or other intermediary could, like directors selected by Japanese or German banks, tap information from sources outside the firm. They would have the time to conduct independent research. They could press the board to employ outside experts when the circumstances warranted. Indeed, a directors' clearinghouse or other nominating organization could, at relatively little cost, supply directors with routine outside information, such as comparative rankings of corporate performance or reports of respected securities analysts. At the very least, outside information introduced by professional directors could help to structure the board's agenda by eliciting comments and explanations from management. Somewhat more optimistically, outside information could also make the flow of information in the boardroom a two-way street for the traditional outside directors, and perhaps for management as well.

The remaining operational issue is whether professional directors could sustain the motivation to monitor energetically. We have already stressed that, under our proposal, professional directors would be *financially dependent* on shareholders. Institutional investors would not reelect directors who failed to perform satisfactorily or, more realistically, the organizational intermediary or clearinghouse would not resubmit these directors for nomination in the first instance. Thus, the ultimate incentive for professional directors to sustain their efforts on behalf of shareholders would be the prospect that they might otherwise—in blunt language—be fired.

Of course, this disciplinary mechanism could only function as an incentive if institutional investors could monitor the performance of professional directors. At first glance, the need for such secondary monitoring might seem troubling, since institutional investors would presumably lack the access and the expertise to evaluate the performance of individual directors.

Several considerations, however, suggest why the secondary monitoring of professional directors is much less troublesome than it might initially seem. First, institutional investors need not perform the monitoring function themselves. Regardless of how institutional investors organize and fund the recruitment of professional directors, an organizational intermediary would be likely to make the actual selection of director nominees and would

85. See, e.g., *id.* at 75-96.

also be well situated to assume the monitoring function.⁸⁶ Second, although board deliberations are secret, there are objective indices of improved corporate governance that the intermediaries could monitor at little cost. For example, one of these indices, which is germane to all portfolio companies, is the structure of management's compensation package. Recent research reveals a strikingly low correlation between the compensation of top managers and the economic performance of their companies.⁸⁷ An important issue that one might expect professional directors to press on virtually every board is the alignment of management compensation with company performance and shareholder interests. Similarly, other performance indices for specific industries or categories of companies could doubtlessly be constructed at little cost. Third, although no agency could review the participation of professional directors in particular board deliberations, sustained bad corporate management would not remain a boardroom secret forever. Dramatic business mistakes would come to light in the business press, in which case professional directors could expect to be called upon to explain what efforts they had made to avert disaster.

But the final, and most important, reason why we are not troubled by limitations on the ability of institutional investors to monitor professional directors is that discharge would serve as an incentive of last resort for these directors. We expect few directors to be fired because very few talented experts would accept the post of shareholder advocate without the ambition to do the job effectively. The experts who chose to become professional directors would have sacrificed other, more remunerative jobs to enter a position with great autonomy and a clear institutional mandate. Moreover, they risk their reputations. The immediate quality of their contributions would be known, if not always to institutional investors, then at least to their fellow board members—including their fellow professional directors—in six public corporations. Under these circumstances, the informal incentives to press shareholder interests, even in the face of resistance, would be extremely powerful.⁸⁸

Our proposal shows how a core of professional directors can command

86. The intermediary organization would also be strongly motivated to monitor carefully. After all, if the directors proposed by such an intermediary failed to produce results for institutional investors, the intermediary itself would eventually lose its credibility and its funding.

87. See Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990). Professors Jensen and Murphy summarize and discuss the implications of their results in *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138.

88. The intrinsic idealism of the position, the likely power of reputational incentives for professional directors, and the need to maintain financial independence are among the reasons why we hesitate to propose monetary incentives that would tie the compensation of professional directors directly to company performance. See note 76 *supra*. Although we do not oppose experimentation with such incentives, we are concerned that they might adversely affect the screening of dedicated professionals. Conversely, however, secondary monitoring and the occasional discharge of a director after poor performance are central to our proposal. The risk of discharge is not only an incentive but also a means of defining the institutional mandate of professional directors. Thus, the fact that these directors could truthfully speak as if their jobs were on the line would lend their voices special weight.

the motivation, information, and influence to serve as effective monitors on behalf of institutional shareholders. We do not suggest that it is a panglossian cure for all that ails corporate governance in the United States. The professional director structure that we propose might often fail to improve the corporate governance of particular companies. In some companies, professional directors would be outvoted and isolated by management's nominees; in others, management would successfully disguise problems and close off alternative strategies before professional directors could act. In no event would professional directors enjoy as much influence as an LBO Association or a major Japanese or German bank. Inevitably, the separation of ownership and control, and the consequent loss of accountability, would persist after the introduction of professional directors—narrowed, but not eliminated. In our view, however, these are not very interesting criticisms of professional directors. The appropriate yardstick for judging our proposal is not the norm of the controlling shareholder who personally manages the business, but the norm of the traditional outside director who may be barely familiar with the business. When measured against traditional outside directors, we are confident that a core of professional directors would prove a major step forward in reforming the governance of American corporations.

VI. CAN INSTITUTIONAL INVESTORS ELECT PROFESSIONAL DIRECTORS?

Our proposal depends upon the ability of institutional investors to select a critical minority of the directors of their portfolio companies. Whether institutional investors can accomplish this depends on two issues. The first is purely political: Can institutional investors actually get their directors elected? The second is legal: Will existing regulatory barriers deter institutional investors from trying?

A. *Do Institutional Investors Have the Votes?*

In a substantial number of companies, institutional investors clearly do have the votes to elect a critical minority of professional directors. A 1989 study found that institutional investors held 50 percent of the equity of the fifty largest American corporations, 53.2 percent of the equity of the largest hundred, and 48.1 percent of the equity of the largest thousand.⁸⁹ General Motors, which has recently performed notoriously poorly, illustrates both the potential power of institutional investors and the need to exercise it. Institutional investors hold 82 percent of GM's equity.⁹⁰ Both the power and, given GM's performance, the need for professional directors on its board

89. Brancato, *supra* note 7, Table 7.

90. Another study examined the proportion of institutional holdings in 100 randomly chosen issuers of actively traded equities. Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 MICH. J. L. REFORM 117, 132-35 (1989). Institutional holdings in the sample ran from as high as 90% to as low as 6%, with 30 companies having institutional holdings of more than 60% and 60 companies having institutional holdings of more than 40%. Only seven companies had institutional holdings of less than 20%. *Id.* at 132.

clearly exist; only the willingness of the institutions to use their power is lacking.

Of course, data on aggregate equity provide a reliable measure of the power of institutional investors only if they can act in unison. Based on their prior conduct, this expectation may seem unreasonable. Institutional investors have historically not voted monolithically to oppose management's slate of board nominees, or even to reject controversial management policies such as poison pills.⁹¹ Not only have institutional investors failed to oppose management's candidates for the board with their own nominees, but many institutions have even voted with management in proxy fights, including the Texaco and Lockheed contests, that were financed by an insurgent. Despite this history, however, more cohesive voting by institutional investors on professional directors can be expected for several reasons.

First, electing a core of professional directors would neither require, nor even suggest, the possibility of replacing management. In the Lockheed proxy fight, for example, institutional investors might have voted for management out of mistrust for the insurgent's talented but managerially inexperienced team, despite their preference that management be monitored more effectively. In other cases, institutional investors seem to have voted to subject incumbent management to greater monitoring (by approving proposals that would more fully expose the company to the market for corporate control),⁹² while at the same time voting to retain management's board slate. In our view, a core of professional directors would be a better monitoring mechanism than the market for corporate control. Thus, institutional investors that now vote against management by favoring proposals to subject the company to the market for control should be even more willing to vote for a core of professional directors.

Second, management would have much more difficulty justifying opposition to the election of a minority of professional directors than it now has in opposing a full slate of dissident directors. In contrast to the recent contests by Simmons at Lockheed and the Belzberg family at Armstrong, an effort by institutional investors to elect a minority of professional directors would not threaten an immediate replacement of operating management or a major shift in corporate strategy. Certainly, institutional investors themselves can distinguish between raiders and monitors. For example, only one of the Belzberg nominees for the Armstrong board was actually elected (necessarily with institutional investor support): a nominee with top-notch monitoring credentials—Michael Jensen, Edsel Bryant Ford Professor of Business

91. The companies targeted for shareholder proposals with respect to poison pills were selected because of their high institutional ownership. Of the 32 companies chosen for anti-pill proposals in 1987, institutional holdings varied from a low of 36% to a high of 78%, with an average of 56.6%. While four of the proposals received more than 40% of the votes cast, the average vote for the proposals was only 29.4%, although this average had increased to 39.5% by 1989. R. GILSON & R. KRAAKMAN, *supra* note 14, at 121-22. In all events, the proposals failed to garner the support of substantial numbers of institutional investors.

92. The proposals are described in the text accompanying notes 12-13 *supra*.

Administration at the Harvard Graduate School of Business.⁹³

Thus, we believe that the institutional votes for implementing a professional director governance structure would be forthcoming. More speculatively, it is possible that management would not even oppose a determined effort to propose such a structure. Precisely because management would lack both a good reason for opposing professional directors and a solid assurance of success, its best strategy might well be to cooperate with institutional investors in placing a core of professional directors on the board. Indeed, management might actually solicit cooperation if it feared a takeover bid, since alienating large shareholders by opposing professional directors—and possibly losing a proxy fight as well—would hardly be an auspicious way to begin a takeover defense. Finally, and most speculatively of all, management might embrace the concept of professional directors simply because it is a good idea.

B. *Regulatory Barriers to Electing Professional Directors*

While the foregoing analysis indicates that institutional investors would have the aggregate votes and the disposition to elect a core of professional directors over a wide range of portfolio companies, a potential problem remains. Commentators have pointed to a number of regulatory barriers to cooperative electoral action by institutional investors that might significantly inhibit, if not preclude, such a proactive strategy.⁹⁴ Although these barriers exist, in our view their importance is exaggerated. In some cases, the applicability of a supposedly preclusive regulation is in doubt and, even if it were finally held to apply, would carry only minimal sanctions. In other cases, compliance with the regulation is simply not very costly.

1. *The federal proxy rules.*

The litany of regulatory barriers to coordinated action by institutional investors typically begins with an expansive account of the application of the federal proxy rules. These rules reach any solicitation of more than ten shareholders,⁹⁵ with the term "solicitation" being broadly defined.⁹⁶ If a communication falls within the scope of the proxy rules, the solicitor must file a proxy statement with the Securities and Exchange Commission⁹⁷ that is subject to the antifraud provisions of Rule 14a-9.⁹⁸

The problem posed by the proxy rules is most acute in two circum-

93. *Armstrong Proxy Victory Claimed*, N.Y. Times, May 1, 1990, at D5, col. 2.

94. See, e.g., A. A. SOMMER, JR., CORPORATE GOVERNANCE IN THE NINETIES: MANAGERS vs. INSTITUTIONS 22-27 (1990); Conard, *supra* note 90, at 152-63; Dent, *supra* note 60, at 903-07; Johnson, *supra* note 28, at 52; Bernard S. Black, Streamlining the Proxy Process: Access and Deregulation (Nov. 1989) (unpublished manuscript) (on file with the *Stanford Law Review*).

95. SEC Rule 14a-2(b)(1), 17 C.F.R. § 240.14a-2(b)(1) (1990).

96. The term extends to "[t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." SEC Rule 14a-1(l)(iii), 17 C.F.R. § 240.14a-1(l)(iii) (1990).

97. SEC Rule 14a-2(b)(1), 17 C.F.R. § 240.14a-2(b)(1) (1990).

98. SEC Rule 14a-9, 17 C.F.R. § 240.14a-9 (1990).

stances: (1) when institutional investors oppose a management-sponsored proposal; or (2) when they support a shareholder-sponsored proposal that, under Rule 14a-8, management must both include in the company's proxy statement and place on the company's proxy card so that shareholders have the opportunity to vote in favor of it.⁹⁹ In these settings, institutional investors are said to be chilled in their participation in the proxy process by the risk that, if they were to discuss proposals in these categories among themselves, they might be found after the fact to have engaged in "solicitation" under the broad terms of the proxy rules. Perversely, however, this chilling effect occurs only because Rule 14a-8 offers institutional investors the opportunity to act collectively *without* complying with the normal proxy filing requirements. In the absence of Rule 14a-8, shareholder proponents would have to mail out their own proxy cards rather than piggybacking on management's card. This would clearly constitute a solicitation requiring a proxy filing. But where Rule 14a-8 does apply and the shareholder proponents share management's proxy card, filing is necessary only if discussions between shareholders constitute "solicitation."

The critical fact for present purposes, however, is that Rule 14a-8 does not require a company to include an institutional investor's nominees for director in the company's proxy statement or to provide a place on the company's proxy card for shareholders to vote for such nominees.¹⁰⁰ By their very breadth, the proxy rules operate to deter institutional investors from electing professional directors. The only issue, then, is whether the *cost* of compliance ought to deter institutional investors, or an organizational intermediary operating on their behalf, from nominating professional directors.

We offer what may be a controversial position: The compliance burden associated with an effort to elect a minority of professional directors would not be significant. Because the professional director strategy does not require its proponents to contest control of any company, they would merely need to submit simple proxy statements containing little more than a description of the nominees' background and their nominators' goals. Such a statement would not be expensive to prepare in today's competitive market for legal services. Moreover, the costs of distributing the statement and receiving the proxies would also be low. Although competitive proxy solicitations using prominent newspaper advertisements placed by professional solicitors are expensive, institutional investors would hardly need such a costly public campaign to communicate with each other. In any case, vigorous opposition by management might well provide would-be professional directors with the most effective publicity, since the natural inference to be drawn from such opposition would be that management was seeking to preserve its power. Indeed, given the weakness of the case for opposing professional directors, we suspect institutional investors would only need to conduct a few campaigns before companies began to include institutional

99. SEC Rule 14a-8, 17 C.F.R. § 240.14a-8 (1990).

100. SEC Rule 14a-8(c)(8), 17 C.F.R. § 240.14a-8(c)(8) (1990).

nominees voluntarily in the official management slate, which would impose no proxy expenses at all.

To be sure, reform of the proxy rules to facilitate more active participation by institutional investors is still a desirable goal. Elmer Johnson, for example, has sensibly suggested that, just as financial dealings between large investors are now exempt from the Securities Act of 1933 by Rule 144A, electoral dealings between large investors should be exempt from the proxy rules.¹⁰¹ Others have suggested that large shareholders ought to have access to management proxy statements, thereby allowing institutional investors to sponsor director nominees in the same way they now sponsor shareholder proposals.¹⁰² Our point is not to oppose such reforms. Rather, we mean only to argue that institutional investors need not wait for reform before acting.

2. *Securities Exchange Act § 13(d).*

The second filing requirement that is said to constitute a significant barrier to collective action by institutional investors is a family of regulations promulgated under Section 13(d) of the Securities Exchange Act of 1934.¹⁰³ The first of these regulations are Rules 13d-1 and 13d-2. Rule 13d-1 requires any shareholder, or group of shareholders, that acquires over five percent of an issuer's stock to file a Schedule 13D statement with the SEC setting forth information concerning the beneficial owner of the securities, including the number of shares owned, and the purpose and method of finance of the acquisition.¹⁰⁴ Rule 13d-2, in turn, requires that a Schedule 13D be amended in the event of a material change, including a change of one percent or more in the percentage of the issuer's stock held.¹⁰⁵

Because most institutional investors do not own more than five percent of an issuer's stock, this filing requirement seems irrelevant at first. However, the filing obligation imposed by Rules 13d-1 and 13d-2 is also triggered by the formation of any group "for the purpose of acquiring, holding, voting or disposing of" a company's stock that, in the aggregate, holds more than five percent of a class of an issuer's equity securities.¹⁰⁶ In addition, a determination concerning whether and when a group has formed is treated as a question of fact that does not require a formal agreement among the putative group members.¹⁰⁷ Thus, if several institutional investors were to communicate and subsequently take parallel action, a court might later conclude that these investors had formed a group and, therefore, had violated Section 13(d) if a filing had not been made within ten days after the date on which

101. See Johnson, *supra* note 28, at 52.

102. See text accompanying notes 58-60 *supra*.

103. 15 U.S.C. § 78p (1988).

104. SEC Rule 13d-1, 17 C.F.R. § 240.13d-1 (1990).

105. SEC Rule 13d-2, 17 C.F.R. § 240.13d-2 (1990).

106. SEC Rule 13d-5(b)(1), 17 C.F.R. § 240.13d-5(b)(1) (1990).

107. See RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 943-44 (1986).

the court concluded the group was formed.¹⁰⁸ Rules 13d-1 and 13d-2(b) do relieve eligible institutional investors of most of the burden of Section 13(d) by allowing them to make a very abbreviated filing, which must be initially made and subsequently updated only at the end of the calendar year, and whose contents are limited to essentially a statement of the number of shares held.¹⁰⁹ However, this relief is available only if each institution in the group has no purpose of "changing or influencing control of the issuer."¹¹⁰ The conventional wisdom, as stated by Professor Conard, is that "[t]he practical effect [of Section 13d] is to deter prudent investors from nominating and electing directors."¹¹¹

We are deeply skeptical whether Section 13(d)(1) is appropriately applied to concerted action by institutional investors to elect a minority of professional directors and whether such activity would appropriately preclude an abbreviated filing under Rule 13d-1(b). Moreover, even if a full Schedule 13D filing were required, we believe that the conventional wisdom greatly exaggerates the burden of the obligation.

The first step in analyzing the application of Section 13d(1) to a group of institutional investors (or their organizational intermediary) that wishes to implement our agenda is to understand that, under Rule 13d-5(b)(1), only the formation of a special kind of group imputes to the group beneficial ownership of the securities belonging to the group's members. In the context of Section 13(d), aggregation is required only if the members of a group have agreed to act together "for the purpose of . . . voting . . . equity securities of an issuer."¹¹² But as we have previously stated, an effort to elect a minority of professional directors does not require that institutional investors agree to vote their shares in favor of particular nominees. Indeed, the fiduciary obligation that institutional investors owe to their beneficiaries might prevent many of these investors from giving more than a revocable proxy with respect to their shares, an act that does not amount to beneficial ownership.¹¹³

Of course, institutional investors who wish to elect professional directors will find it helpful (although not strictly necessary¹¹⁴) to coordinate selection of appropriate nominees or, as is more likely, to agree to share the election expenses of an intermediary organization. However, no regulatory barrier

108. *See id.*

109. SEC Rules 13d-1(b) & 13d-2(b), 17 C.F.R. §§ 240.13d-1(b), 13d-2(b) (1990). Rule 13d-1(b)(2) also requires a separate abbreviated filing when eligible institutions exceed 10% of a class of equity securities and an update within ten days of a calendar month in which holdings fluctuate by more than 5% of the class.

110. SEC Rule 13d-1(b)(1)(i)-(ii), 17 C.F.R. § 240.13d-1(b)(1)(i)-(ii) (1990).

111. Conard, *supra* note 90, at 162.

112. SEC Rule 13d-5(b)(1), 17 C.F.R. § 240.13d-5(b)(1) (1990).

113. *See Calumet Ind., Inc. v. MacClure*, 464 F. Supp. 19, 26-29 (N.D. Ill. 1978); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1355 (Del. 1985). A revocable proxy would not constitute beneficial ownership under the definition in Rule 13d-3(a) because the revocability of the proxy prevents the transfer of the voting "power" that the rule requires. It would be an awkward, if not bizarre, construction of Rule 13d-5 for the formation of a group for the purpose of holding a revocable proxy to result in beneficial ownership when the actual holding of the proxy falls outside the definition of beneficial ownership.

114. *See text accompanying note 82 supra.*

seems to apply to either of these activities. They simply do not involve "voting equity securities." Thus, even if undertaken by a formal group, nominating directors or sharing expenses does not, under the language of Rule 13d-5, result in the formation of the kind of group that is deemed to acquire the beneficial ownership of its members' shares. In the absence of aggregation under Rule 13d-5's definition of beneficial ownership, no filing under Section 13(d)(1) would be required unless an individual institution owned more than 5 percent.¹¹⁵

We do not deny that the SEC or a court could construe the word "voting" in Rule 13d-5 more broadly than the plain language of the rule supports. For example, just as the SEC broadly interprets the term "solicitation" under the proxy rules to include very preliminary acts that ultimately lead to the giving of a proxy,¹¹⁶ it could also interpret the term "voting" under Rule 13d-5 to include all actions by a group that ultimately lead to a corporate vote on a matter, even if the group does not dictate how its members actually vote on the matter. Yet no public policy would be served by such an interpretation. Casting so broad a net under Rule 13d-5 would accomplish little at great cost. During an actual voting contest, a Schedule 13D filing would add nothing to the disclosures already required by the proxy rules or forced by the political exigencies of a proxy fight. Further, by burdening the efforts of institutional investors to make corporate elections meaningful, the proxy process would be made less, not more effec-

115. Joseph G. Connolly & David B.H. Martin, Jr., *Shareholder Communications—Legal Restraints Governing Group Activity: Part II*, 4 INSIGHTS 16 (1990), provides three examples of institutional investor activity that they suggest might result in the formation of a Section 13(d) group. In each case, however, their conclusion is puzzling. The first example reports, seemingly with approval, that a group of institutional investors filed a Schedule 13D because they had written a letter to a special committee of the board of directors that had been formed to consider a proposal by the company's majority shareholder, a purchase of the remaining outstanding shares. The letter asserted that the proposal was inadequate and requested that the Special Committee take unspecified actions in connection with its consideration of the proposal. *Id.* at 18. The authors offer no explanation why this behavior had the purpose of "acquiring, holding, voting or disposing of equity securities of an issuer" so as to trigger the group aggregation requirements of Rule 13d-5. While the character of the unspecified actions might explain the result, the authors apparently did not think so since they were not disclosed.

The second example reports the SEC staff's belief that an agreement to co-sponsor a shareholder proposal would result in the formation of a Section 13(d) group. *Id.* at 19. Here, however, the group's purpose is not to vote securities, but to give shareholders the opportunity to vote. The Rule's language fails to support aggregation in the absence of an agreement among group members to vote their shares in a specified manner, especially if the group members signed a written acknowledgment that no voting agreement existed. A carefully framed no-action letter request to the SEC might provide the SEC with the opportunity to set out clearly the justification for its position with respect to this situation.

The third example also reports a staff position, this time agreeing that soliciting support for a shareholder proposal would result in a Section 13(d) group. *Id.* Yet urging other shareholders to vote in a particular way—a solicitation for purposes of the proxy rules—is quite different from binding members to vote that way. Again, a fair reading of the Rule suggests that it is directed at the latter and that a no-action request that required the staff to consider the Rule's actual language would be a useful exercise.

116. See Joseph G. Connolly & David B.H. Martin, Jr., *Shareholder Communications—Legal Restraints Governing Group Activity: Part I*, 3 INSIGHTS 14 (1989).

tive. One does not secure more effective corporate governance by needlessly raising its costs.

Even if the SEC were to construe Rule 13d-5 broadly to require the aggregation of shares owned by institutional investors pursuing the election of a minority of professional directors for purposes of the Section 13(d)(1) filing requirement, Rule 13d-1(b)(1) would greatly reduce the cost imposed by the filing requirement. Institutional investors that meet the Rule's requirements may file Schedule 13G instead of Schedule 13D. Schedule 13G requires disclosure only of the identity and type of entity of the filer and the number of shares beneficially owned, rather than the detailed description of such things as the purpose of the acquisition and the sources of its financing required by Schedule 13D.¹¹⁷ Perhaps more important, the initial filing is required only within 45 days after the end of the calendar year in which the obligation accrues, and the burden of updating the filing is significantly reduced. Unlike a Schedule 13D filing, which must be updated "promptly" to reflect any material change, including an ownership change of more than one percent,¹¹⁸ a Schedule 13G filing need be amended to reflect a change in share ownership only within 45 days after the end of each calendar year.¹¹⁹

In order to be eligible to file a Schedule 13G, the person filing (in our case the group) must certify that it acquired the securities (by the formation of the group under Rule 13d-5) "not with the purpose nor with the effect of changing or influencing the control of the issuer."¹²⁰ Commentators have stated without pause (albeit also without citation or analysis) that "[a]ctivity such as nominating a candidate for the board of directors of the issuer, proposing corporate action requiring stockholder approval or soliciting proxies would generally prevent [compliance] with the 'investment purpose' requirement of Schedule 13G."¹²¹ This conclusion does not seem to us self-evident.

Our agenda contemplates the election of a minority of professional directors by passive institutional investors that explicitly do not wish to change or influence the identity of the parties who exercise control over the company. The goal is simply to better monitor—and, if need be, to persuade—those who do control the company.¹²² To reach the broad application stated above, the phrase "influencing the control of the issuer" must be construed to include not only an effort to influence the identity of the actors who control the company, but also any effort to influence, or in our case to monitor, how these actors exercise control. This would be an oddly expansive construction of the concept of "control." For example, SEC Rule 405 defines control as "the possession, direct or indirect, of the power to direct or cause

117. SEC Rule 13d-2, 17 C.F.R. § 240.13d-2 (1990).

118. Securities Exchange Act of 1934 § 13(d)(2), 15 U.S.C. § 78m(d)(2) (1988); SEC Rule 13d-2(a), 17 C.F.R. § 240.13d-2(a) (1990).

119. SEC Rule 13d-2(b), 17 C.F.R. § 240.13d-2(b) (1990). An amended Schedule 13G must also be filed within 10 days after the close of the first month in which ownership exceeds 10%. SEC Rule 13d-1(b)(2), 17 C.F.R. § 240.13d-1(b)(2) (1990). See note 109 *supra*.

120. SEC Rule 13d-1(b)(1)(i), 17 C.F.R. § 240.13d-1(b)(1)(i) (1990).

121. Connolly & Martin, *supra* note 115, at 20.

122. See text accompanying notes 74-76 *supra*.

the direction of the management and policies of a person."¹²³ Seeking to elect a minority of directors who *could not* exercise control does not influence the possession of the power to direct management; it merely provides the power to monitor management.¹²⁴ The likelihood that these institutional investors would not themselves nominate professional directors, but merely fund an organizational intermediary to recruit and select nominees, would make an extension of the "control" concept to our proposal even more curious.

As with the term "voting" in Rule 13d-5, one could insist upon a broad construction of the term "control" in Rule 13d-1(b) without embarrassment. But just as with Rule 13d-5, there is no public policy reason to do so. Whatever else one may say about the purpose of our agenda, it necessarily contemplates a proxy solicitation. The proxy rules provide sufficient disclosure without burdening recourse to the proxy process by superimposing another layer of rules that were designed to regulate changes in control, and not the corporate governance activity of passive institutional investors.¹²⁵

But if institutional investors still fear that Rule 13d-5 or 13d-2 may be applied (even if erroneously), this uncertainty itself might deter them from implementing our agenda. The deterrent effect of such uncertainty depends on the real burden of compliance with Section 13(d) or, in cases where institutional investors are uncertain about the point at which joint action gives rise to a group, the real burden of remedial action following a violation of the Section 13(d) filing requirement. In contrast to the apparent conventional wisdom, we believe that filing and updating a Schedule 13D is less burdensome than is commonly thought. The content of a filing would not be difficult or expensive to prepare because the goal—the "purpose of the transaction" in Item 4—is merely to elect professional directors to improve the monitoring of management. The goal is *not* to undertake a complex strategic change, such as a restructuring, whose description would inevitably be

123. SEC Rule 405, 17 C.F.R. § 230.405 (1990). The American Law Institute's Corporate Governance Project adopts a similar definition: "'Control' means the power . . . to exercise a controlling influence over the management or policies of a business organization . . ." AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.05(a) (Tent. Draft No. 10, Apr. 16, 1990).

124. The assertion that by proffering *any* shareholder proposal, an institutional investor is seeking to influence control of the issuer—that is, to direct management—is simply difficult to understand.

125. The release accompanying the SEC's recent proposed amendments of the rules governing the availability of Schedule 13G makes apparent that the goal of Schedule 13G is to limit the number of Schedule 13D filings so as to "allow the marketplace, as well as the staff of the Commission, to focus more quickly on acquisitions involving a potential change in control." Reporting of Beneficial Ownership in Publicly-Held Companies, Exchange Act Release No. 26,598, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,410 (Mar. 6, 1989). Indeed, as evidence that "the vast majority of persons filing Schedule 13D have such a passive intent," the release states that a study of Schedule 13D filings "by the Commission's Office of Economic Analysis indicate[s] that 74 percent of the Schedules 13D [sic] studied reported *no intention to change control of the issuer* at the time of the initial filing." *Id.* (emphasis added, citation omitted). Institutional investors seeking to elect a minority of professional directors to monitor management more effectively also have no intention to change control of the issuer. As the release makes clear, Section 13(d) is concerned with changes in control, not with corporate governance activity by passive investors.

subject to disputation. Moreover, the obligation to update, while inconvenient, should be merely mechanical. For indexed investors, portfolio changes would be minimal. Even trading by active portfolio managers would likely involve less than one percent of an issuer's stock and therefore not trigger an obligation to amend.¹²⁶

Nor should the risk of an inadvertent violation, resulting from a retroactive determination that a group had been formed for purposes of a Schedule 13D filing, deter institutional investors from pursuing a professional director strategy in light of the inconsequential remedies that typically follow a Section 13(d) violation. Although courts have occasionally granted relief beyond mandating after-the-fact compliance with the Section 13(d) filing requirements, they have done so chiefly in situations involving either outright stock parking¹²⁷ or premeditated efforts to acquire control that were not disclosed in an earlier Schedule 13D filing.¹²⁸ Thus, institutional investors seeking to elect a core of professional directors have little to fear from either the costs of filing, or the costs of inadvertent failure to file, a Schedule 13D.¹²⁹

3. Filings under Hart-Scott-Rodino.

The final filing requirement purported to deter active participation in corporate governance by institutional investors¹³⁰ is Section 7A of the Clayton Act,¹³¹ which was added by Title II of the Hart-Scott-Rodino Antitrust Improvement Act of 1976.¹³² In order to give federal enforcement agencies sufficient time to prevent anticompetitive acquisitions, this statute requires a party who intends to acquire a significant amount of an issuer's voting stock to file a lengthy notification form and wait thirty days before actually acquiring the stock. A broad exemption relieves institutional investors from the duty to comply as long as their acquisition is solely for investment purposes and involves less than *either* 15 percent of the outstanding stock or securities valued at less than \$25 million.¹³³ Yet, the phrase "solely for the purpose of investment" requires that the holder have "no intention of participating in the formulation, determination, or direction of the basic business decisions

126. Rule 13d-2 requires filing an amended Schedule 13D in the event of a "material change." 17 C.F.R. § 240.13d-2(a) (1990). The Rule deems changes in holdings of 1% or more of the issuer's outstanding stock to be material. Changes "of less than such amounts may be material, depending upon the facts and circumstances." *Id.* In the context of electing a minority of professional directors, such small changes would hardly be material.

127. See *SEC v. First City Fin. Corp.*, 688 F. Supp. 705 (D.D.C. 1988), *aff'd*, 890 F.2d 1215 (D.C. Cir. 1989) (disgorgement remedy).

128. See generally James M. Tobin & James J. Maiwurm, *Beachhead Acquisitions: Creating Waves in the Market Place and Uncertainty in the Regulatory Framework*, 38 BUS. LAW. 419 (1983).

129. Once again, it is also worth noting that a single large institutional investor, such as CalPERS, that initiated a professional director program for a handful of companies would have nothing to fear under even the wildest construction of the § 13(d) rules.

130. See A. SOMMER, *supra* note 94, at 27.

131. 15 U.S.C. § 18a (1988).

132. Pub. L. No. 94-435, 90 Stat. 1383 (1976).

133. 16 C.F.R. § 802.64 (1990).

of the issuer."¹³⁴ The Statement of Bases and Purposes, which accompanies both the exemption rule and the definition of the relevant terms, further states that "nominating a candidate for the board of directors" may constitute conduct inconsistent with an investment intent.¹³⁵

Notwithstanding such ominous language, we believe that, as with the application of Section 13(d), both the need to comply and the burdens that compliance imposes are easily overstated. First, institutional investors might *not* be the parties who nominate directors under our proposal; an organizational intermediary holding no stock at all could recruit and propose nominees. Second, even if institutional investors were to select the candidates directly, nominating a professional director as part of a corporate governance strategy to monitor management *should not* result in a loss of the exemption, since the hallmark of this strategy is precisely that it is designed to support a larger policy of passive investment. Such a strategy is not a concern of the antitrust statute. Finally, even if the enforcement agencies denied institutional investors the exemption, preparing the notification form would not be burdensome for most institutional investors, since preparation would involve little more than describing the contents of their portfolio. Nor would the 30-day waiting period have significant consequences because the enforcement agencies would likely exercise their discretion to provide for its early termination.

4. *Miscellaneous regulatory barriers.*

Commentators seeking to catalogue the legal reasons for passivity also point to miscellaneous additional regulatory barriers to institutional investor activism. As with the more significant issues posed by the proxy rules, Section 13(d), and Hart-Scott-Rodino, the import of these barriers is greatly overstated.

Controlling person and deputation liability. Under both the Securities Act of 1933 and the Securities Exchange Act of 1934, a party that "controls" a firm has a prima facie responsibility for all federal securities law violations committed by that firm.¹³⁶ Professor Conard speculated that institutional investors might incur controlling person liability if they "should combine with others to elect a majority of directors."¹³⁷ For purposes of our agenda, however, this risk is non-existent. We have proposed electing a *minority* of professional directors, which is, as discussed previously,¹³⁸ distinct from an effort to seek control.

Short swing profit liability. Section 16(b) of the Securities Exchange Act¹³⁹ provides that an issuer can recover any profits realized from

134. 16 C.F.R. § 801.1(i)(1) (1990).

135. 43 Fed. Reg. 33,450, 33,465 (1978).

136. Securities Act of 1933 § 15, 15 U.S.C. § 77 (1988); Securities Exchange Act of 1934 § 20A, 15 U.S.C. § 78t (1988).

137. Conard, *supra* note 90, at 159.

138. See text accompanying notes 122-125 *supra*.

139. 15 U.S.C. § 78p(b) (1988).

purchases and sales of its stock within a 6-month period by a director, officer, or beneficial owner of 10 percent of an issuer's outstanding stock. Commentators have raised two concerns about the application of Section 16(b) to institutional investors, which might appear to bear on efforts to elect a minority of professional directors.

First, if a shareholder of a company causes the election of its own representative to serve as a director of the company, and that representative also has authority over the shareholder's investment decisions, the director-representative can be deemed a "deputy" of the shareholder. In that case, Section 16(b) applies to the shareholder as if it were itself the director.¹⁴⁰ Under our proposal, however, the deputization concept should have no application. Institutional investors would elect a minority of professional directors who are *not* otherwise connected with them. Indeed, if an intermediary organization is developed, institutional investors would not play any direct role, even in the selection of director nominees.

Second, concerted action by institutional investors to elect a minority of independent directors might be treated as giving rise to a group that, for purposes of Section 16(b), would be the beneficial owner of all shares in any particular company held by group members. If the group's total stock holdings exceeded 10 percent, any trading by its members would be subject to Section 16(b).¹⁴¹ While the SEC has adopted regulations defining the term "beneficial owner" for purposes of Section 13(d),¹⁴² it has not sought to define this term for purposes of Section 16(b). Moreover, no court has attempted to invoke a disgorgement obligation under Section 16(b) by applying the group concept under Rule 13d-5.¹⁴³

Even if a court were to fashion a Section 16(b) parallel to Rule 13d-5 (despite the SEC's failure to act), it would be unlikely to do so in the context of an effort by institutional investors to elect a minority of professional directors. Rule 13d-5 aggregates the holdings of a group for purposes of the Section 13(d) trigger only when the group has been formed "for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer."¹⁴⁴ Section 16(b) is a prophylactic rule designed to keep large stockholders (among other suspected insiders) from trading on the inside information that a 10 percent shareholder is conclusively presumed to have. A shareholder group formed for the purpose of implementing our agenda, however, lacks any suspect attribute that would justify aggregation of shareholdings to trigger the application of Section 16(b).¹⁴⁵

140. See *Feder v. Martin-Marietta Corp.*, 406 F.2d 260, 263-64 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); Conard, *supra* note 90, at 160-61.

141. See Dent, *supra* note 60, at 905; John Pound, *Reforming Corporate Governance: Deregulation, Not More Regulation* 8 (June 14-15, 1990) (paper presented at Salomon Brothers Center and Rutgers Center Conference on The Fiduciary Responsibility of Institutional Investors) (on file with the *Stanford Law Review*).

142. See text accompanying notes 112-113 *supra*.

143. See Dent, *supra* note 60, at 905 n.135.

144. SEC Rule 13d-5(b)(1), 17 C.F.R. § 240.13d-5(b)(1) (1990).

145. More tenuous arguments can also be constructed. For example, one might argue that

5. Summary.

In short, none of the regulatory requirements most frequently cited as barriers to coordinated action by institutional investors are truly significant in their own right. Like the prospect of determined opposition from man-

institutional investors sponsoring the election of a minority of professional directors could be treated as a group, and therefore as a single "interested person," for purposes of determining whether the combined holdings of the group crossed the ownership percentage that triggers a firm's flip-in poison pill. See Pound, *supra* note 141, at 9. In that case, the resulting dilution of the institutions' investment would make any prospect of joint electoral action unthinkable.

A fair reading of *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985), however, suggests that courts will be reluctant to construe a poison pill to restrict shareholder recourse to the proxy process, at least in the context of joint action by institutional investors that explicitly do not seek control of the board of directors. The court ruled in *Moran* that the holder of proxies was not the beneficial owner of those shares for purposes of a poison pill. Accordingly, the court held that "the mere acquisition of the right to vote 20% of the shares does not trigger the Rights." *Id.* at 1355. If actually securing the proxies does not trigger the pill, then joint action seeking to secure them with respect to a non-control issue should not be a problem.

This conclusion depends, however, on how one reads Chancellor Allen's opinion in *Stahl v. Apple Bancorp, Inc.*, 1990 Fed. Sec. L. Rep. (CCH) ¶ 95,412, at 97,031 (Del. Ch. Aug. 9, 1990). In this case, the court considered the application of a company's poison pill plan to the activities of Stahl, the company's largest shareholder (30.3%), who was conducting a proxy fight to take control of the board. If the proxy fight was successful, the new board majority would redeem the pill so that Stahl could complete his pending tender offer (which was conditioned on the success of the proxy fight). Both Stahl and the company stipulated that if Stahl entered into agreements with other shareholders to nominate directors, share election expenses or indemnify candidates, by its terms the poison pill would be triggered (i.e., a group composed of Stahl and the other parties to the agreement would be deemed to acquire the beneficial ownership of all shares owned by all parties, which shares would exceed the triggering percentage specified in the poison pill plan), even though any commitments concerning how the shares would be voted were revocable. Stahl sought summary judgment that enforcement of these aspects of the poison pill plan were invalid.

Chancellor Allen declined summary judgment in an opinion that invites extended commentary concerning the proper application of poison pill plans to proxy-related activities. For our purposes, however, it is sufficient to recount the opinion's emphasis on the particular circumstances of the case.

[C]onsidering his stock position, his cash offer and the other circumstances, I conclude that the impact of effectively precluding Mr. Stahl from forming a joint slate with other shareholders or otherwise entering into revocable agreements with them concerning the voting of stock is likely to have "minimal" impact upon his proxy campaign (except insofar as it might marginally protect and preserve the board's opportunity to locate a better proposal). Moreover, I conclude also that such minimal impact as it may have is justified in the circumstances by the benefit of preserving to some extent the board's ability to shop the [company] in the interim before the next annual meeting

Id. at 97,037.

While one can understand the attraction of preventing a hostile bidder from using a proxy contest to circumvent a target board's efforts to secure a higher offer, the circumstances surrounding the application of a poison pill to institutional investors seeking to implement our proposal dictate precisely the opposite result of *Stahl*. The application of the pill to prevent concerted action would have far more than a 'minimal' impact on institutional investors. In turn, it is difficult to imagine *any* interest the company might have (let alone an interest that rises to the level of securing a higher bid) in impeding efforts by institutional investors to elect a minority of the board.

A similar argument can be made with respect to state takeover statutes, like the Indiana Control Share Acquisitions Act, IND. CODE ANN. § 23-1-42-1 (West 1989), whose application is triggered by a person acquiring voting power over a specified percentage of a corporation's stock. *Id.* However, institutional investors pursuing the election of a minority of professional directors would not acquire voting power over each other's shares. See text accompanying note 113 *supra*. Moreover, the trigger percentage in some statutes is typically 20%, high enough to eliminate any serious threat posed by the statute even if it applied.

agement, the regulatory obstacles to electing professional directors would be likely to dissolve once institutional investors launch the first such effort.

VII. CONCLUSION

Although reform of corporate governance is a sensible strategy for institutional investors who wish to improve the performance of their portfolios, currently popular reform strategies are unlikely to prove adequate to the task. Eliminating takeover barriers is desirable, but the market for corporate control might not be the best way to monitor management performance. Shareholder advisory committees are poor substitutes for representation on the board. And traditional independent directors have too little time and the wrong incentives for producing the desired results. The focus on outside directors is correctly placed, but the key, we have argued, is not the independence of directors from management but their dependence on shareholders.

The agenda we proffer to institutional investors is simple: Elect to the boards of portfolio companies a core of professional directors who have the skills, time, and incentive to monitor management performance on behalf of shareholders. This could be accomplished by placing a qualified individual on six boards such that the director's total compensation from all boards exceeded \$200,000. The desirability of such a position—together with the ability of institutional investors to remove a director—would be sufficient to create the market for outside directors that Professor Fama once assumed was already functioning. While regulatory reform is desirable, our agenda does not require it. Institutional investors must merely decide to act.

When we described our agenda to a colleague on the faculty of a major graduate school of business, he responded that it could not possibly work. His argument echoed the finance professor's explanation of why the \$20 bill on the sidewalk in front of him could not possibly be lying on a busy sidewalk in full view, regardless of what he seemed to be seeing. If the agenda were as good as it sounded, our colleague rhetorically asked, why had institutional investors not *already* begun to implement it? We responded that we could not think of a reason.¹⁴⁶

146. We can report some movement in the direction toward our proposal. Most significant, Carl Icahn, the largest shareholder of USX Corporation and the unsuccessful proponent of a shareholder proposal to spin off USX's steel business at the 1990 USX annual meeting of shareholders, announced in November 1990 that he would nominate a minority slate of five independent candidates for the USX board, whose function would be to represent shareholder interests and to bring shareholder concerns over the future structure of the corporation inside the boardroom. As originally announced, the members of the slate consisted of the following individuals: John Pound, Associate Professor of Finance at the Kennedy School at Harvard University, who has written extensively on issues of corporate governance; Katherine Schipper, Professor of Accounting at the Graduate Business School at the University of Chicago, who has written extensively on the stock price effects of corporate restructurings; Paul Quirk, Executive Director of the Massachusetts Pension Reserves Investment Management Board and chair of the executive committee of the Council of Institutional Investors; Darius Gaskind, former chief executive officer of Burlington Northern Railroad, which has successfully spun off its energy business; and one of the authors, Ronald J. Gilson.

See Gregory A. Robb, *Icahn Group to Urge USX Sale of Steel Unit*, N.Y. Times, Nov. 15, 1990, at C5, col. 1. Since the announcement of the slate, Paul Quirk has resigned.

While the structure of the initiative at USX differs in important ways from our proposal, especially in the sponsorship of the USX slate by an active rather than a passive investor, the effort does mark the first time that opposition candidates, independent from the sponsoring shareholder, have been offered. Of course, that independence is less desirable than the dependence on shareholders that our proposal contemplates, but the minority character and professional makeup of the USX slate, and the avowed intention not to alter control of the company, marks it as a significant step in the right direction. In all events, USX apparently found the proposal sufficiently threatening to give Icahn the restructuring he had unsuccessfully sought in 1990. See Jonathan P. Hicks, *USX to Issue Stock Linked to Steel Unit*, N.Y. Times, Feb. 1, 1991, at C1, col. 4. As a result, the proposed opposition slate was withdrawn. See USX Corporation, Amendment No. 2 to Schedule 13D (filed with the SEC, February 4, 1991).

Our proposal has also gained acceptance on a second front. An editorial in *The Economist* recently recommended an approach that strikingly matched ours. Noting that traditional independent directors are usually executives in other companies and that, as a result, "[b]acks get scratched," the editorial proposed the following:

[M]ake them [independent directors] truly independent, by creating a class of full-time (or "professional") non-executive directors, each sitting on the board of, say, half a dozen companies. To do this, institutional shareholders would have to get together to identify a pool of potential professionals, whom they would then nominate for boards. The big advantage would be that professional non-executives would be wholly dependent on the shareholders for their jobs. . . . [T]hough still paid by the companies they served, the professionals would be financially dependent on their role as non-executives—and on doing the job well.

Redirecting Directors, *ECONOMIST*, Nov. 17, 1990, at 19-20.

In its working paper version, our proposal was also favorably reviewed by the *Financial Times*. Geoffrey Owen, *Independent Directors with Bite on the Board*, *Financial Times*, Sept. 5, 1990, at 19, col. 6.