BOOK REVIEW

CORPORATE GOVERNANCE IN THE ERA OF INSTITUTIONAL OWNERSHIP

OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY. By Margaret M. Blair. Washington, D.C.: The Brookings Institution. 1995. Pp. v, 371. $42.95.

Reviewed by
MARTIN LIPTON
THEODORE N. MIRVIS
STEVEN A. ROSENBLUM*

Institutional investors today own over fifty percent of the common stock of most major corporations in the United States.[1] By acting in common, institutional investors thus have voting control of these corporations. This basic fact explains why, in the short period from its inception in 1984 to the present, the Council of Institutional Investors (Council), an organization that is still virtually unknown to the general public, has become one of the most powerful forces in the business and financial world.[2] The extent of institutional equity ownership has allowed the Council, and institutional investors generally, to effect a massive shift in power from management to shareholders,[3] a shift that has attracted and deserves close attention.

* Members of Wachtell, Lipton, Rosen & Katz, New York City. The authors' colleague, Benjamin A. Powell, assisted in the preparation of this review.

[1] See Carolyn K. Brancato, Institutional Assets and Equity Holdings Increase, Corp. Governance Advisor, May-June 1995, at 31, 31 (noting that institutions held all-time high of 51.5% of total outstanding United States equity at end of third quarter of 1994).

[2] The Council of Institutional Investors includes among its approximately 100 members most of the major public-employee pension funds and a number of union and private funds. See Council of Institutional Investors Membership List (June 1995) (Council of Institutional Investors, Washington, D.C.). The California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System are Council members, as are the General Motors Investment Management Corporation and other major companies' retirement funds.

[3] See William T. Allen, Address at Stanford University Director's College (Mar. 23-24, 1995), in Chancellor Allen on Corporate Boards, Corp. Control Alert, May 1995, at 14, 15 ("The agglomeration of stock in investment institutions is undoubtedly the most elemental factor in creating pressure for change in corporate governance."); Judith H. Dobrzynski, A Quiet Board Room Revolution: Power Shifts to Outside Directors, N.Y. Times, May 25, 1995, at D1 (reporting results of survey that shows greater involvement in board decisions

The Council and some of its members have been at the forefront of activist institutional investors seeking to influence the management of companies in which they invest.[4] In the past ten years, activist institutional investors have learned to use their potential voting power to reshape the thinking in boardrooms across the nation.[5] They have induced a large number of companies to "restructure" by spinning off businesses and "focusing" on core operations.[6] In an unprecedented display of their power, in just the past three years, they have toppled the chairmen and chief execu-

---

by outside directors and quoting Professor Michael Useem of the Wharton School of the University of Pennsylvania: "'These are the things that the big institutions have been calling for . . . .'").

[4] See, e.g., Allen, supra note 3, at 14, 15; Vineeta Anand & Marlene G. Star, Protest Considered by CII, Pensions & Investments, Feb. 21, 1994, at 25, 25 (reporting that Council of Institutional Investors may encourage its members to withhold votes for reelection of directors at some companies, and noting that Council's executive committee had agreed to continue publishing list of "worst-performing companies" in order to help members "target companies for shareholder activism campaigns"); Elizabeth Lesly, Are These 10 Stretched Too Thin?, Bus. Week, Nov. 13, 1995, at 78, 78 (referencing target lists of poorly performing companies published by Council of Institutional Investors and by CalPERS); Kevin G. Salwen & Joann S. Lublin, Activist Holders: Giant Investors Flex Their Muscles More at U.S. Corporations, Wall St. J., Apr. 27, 1992, at A1 (noting CalPERS, a member of the Council of Institutional Investors, as one of the very active institutional investors); Leslie Wayne, Shareholders Exercise New Power with Nation's Biggest Companies, N.Y. Times, Feb. 1, 1993, at A1 (naming CalPERS as leader of shareholder-activism movement).

[5] See, e.g., CalPERS Says Challenge to Boards Is Working, L.A. Times, June 1, 1995, at D3 (noting CalPERS's efforts to make companies more responsive to shareholders); Dobrzynski, supra note 3, at D1 (discussing procedural changes occurring in boardrooms in accordance with institutional investors' suggestions); Salwen & Lublin, supra note 4, at A1 (reporting that "boards are feeling the immediate heat" from shareholders); Wayne, supra note 4, at A1 (noting major changes at American Express, IBM, and other large corporations due to pressure from activist institutional shareholders).

[6] Sears, Kmart, and W.R. Grace are prominent examples of companies that have faced and responded to this type of pressure. See Christina Duff, Kmart Weighs Its Options After Defeat by Shareholders of Stock-Sale Proposal, Wall St. J., June 6, 1994, at A2, A6 (discussing large institutional investors' desire for Kmart to focus on discount stores); Kmart Files with SEC to Sell a 51% Stake in Sports Authority, Wall St. J., Sept. 2, 1994, at B8 (reporting that Kmart is "peeling off layers of its specialty-store division" and that "[s]hareholders hope the restructuring will force Kmart to focus on its 2,300 core discount stores"); James P. Miller, Grace Signals It Is Prepared To Shed Unit: Chief's Remarks Convince Analysts, Holders of Fate of National Medical, Wall St. J., May 9, 1995, at A3, A12 (discussing institutional investors' growing influence on company and signals given by Grace CEO at meeting with institutional investors of company's plans to spin off National Medical Care subsidiary); Laurie Morse, Names in the News: Sears' Shareholders Get Their Man, Fin. Times, July 31, 1995, at 7 (noting that former chairman's strategy that "neglected" Sears's merchandising core had led to sluggish share performance and near revolt by institutional investors); Sears Directors Give Approval to Spinoff of Stake in Allstate, Wall St. J., June 21, 1995, at C6 (discussing Sears's return to retail roots under pressure from shareholders).

tive officers of such major corporations as General Motors,[7] IBM,[8] Westinghouse,[9] American Express,[10] and Kodak,[11] among others. Maurice Saatchi's statement to his former employees vividly illustrates the power of an activist group of shareholders to oust a chairman:

> "Saatchi & Saatchi has been taken over . . . . The new 'owners'—a group of shareholders owning around 30% of the shares—have found a simple, if crude, method of controlling the Company. By threatening the Directors with an Extraordinary General Meeting—at which they could outvote others—they have given the Directors their orders: 'Take your Chairman into a corner and shoot him quickly—we don't want the fuss of a public trial.'"[12]

The functioning of boards of directors, the rules governing proxy fights and takeover bids, the essentially unregulated power of institutional investors, and the compensation of directors and chief executive officers have become hot topics for public debate.[13] A multitude of

---

[7] See, e.g., Dana W. Linden & Nancy Rotenier, Good-bye to Berle & Means, Forbes, Jan. 3, 1994, at 100, 102 ("[D]uring the third straight year of huge losses, institutional investors [of General Motors] stepped up the pressure by talking to the board about performance. [CEO] Stempel was history.").

[8] See, e.g., Michael W. Miller & Laurence Hooper, Signing Off: Akers Quits at IBM Under Heavy Pressure; Dividend Is Slashed, Wall St. J., Jan. 27, 1993, at A1, A6 (attributing CEO Akers's resignation in part to pressure from big institutional investors that pressed for meetings with IBM and its directors).

[9] See, e.g., Stuart Mieher, Westinghouse's Paul E. Lego Resigns as Chief: Exit of Latest Executive To Be Pushed by Firms Sets Off Race for Job, Wall St. J., Jan. 28, 1993, at A3 (crediting CEO's departure in part to pressure from shareholders and directors, and noting how company already had announced plans to sell credit unit to mollify "institutional investors that had been pressing Westinghouse for rapid change").

[10] See, e.g., Peter Pae, Outsider Gets Top American Express Post—Furlaud Named Chairman in an Effort To Improve Relations with Holders, Wall St. J., Feb. 2, 1993, at A3, A5 (reporting that "acrimonious" meeting between CEO and company's largest institutional investors was cited by James D. Robinson III as one reason for his resignation as chairman).

[11] See, e.g., Joan E. Rigdon & Joann S. Lublin, Kodak Seeks Outsider To Be Chairman, CEO, Wall St. J., Aug. 9, 1993, at A3 (noting outside directors' unanimous vote to replace Kay B. Whitmore as chairman and CEO).

[12] Stephen Schiff, Master of Illusion, New Yorker, May 15, 1995, at 52, 66 (quoting Maurice Saatchi).

[13] See, e.g., Bevis Longstreth, Reflections on the State of Corporate Governance, 57 Brook. L. Rev. 113, 113 (1991) ("[C]orporate governance . . . has become the new 'hot' topic among academics (Richard M. Buxbaum, Ronald J. Gilson and Reinier Kraakman, Louis Lowenstein, George W. Dent, Jr.), lawyers (Martin Lipton, Steven A. Rosenblum and A.A. Sommer, Jr.), businessmen (Elmer Johnson) and institutional investors (CalPERS)."); Allen, supra note 3, at 14 ("The institution of the corporate board of directors is just now the subject of enormous interest.").

The corporate governance articles published by the authors cited in Longstreth's article include Richard M. Buxbaum, Institutional Owners and Corporate Managers: A Comparative Perspective, 57 Brook. L. Rev. 1 (1991); Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev.

newsletters and publications focus on corporate governance,[14] business schools and law schools offer courses in the subject,[15] and governmental and private commissions have been established to study it.[16] The business press and now even the popular media are quick to sensationalize corporate governance failures. For their part, activist institutional investors have spawned a number of service organizations to advise them,[17] as well as a new industry of trade associations to represent and lobby for them in Washington and key state capitals.[18]

The growing dominance of institutional shareholdings, and the manner in which institutional investors operate, have sharpened the focus on basic questions of corporate governance and the allocation of corporate power. Much debate has revolved around whether institutional activism is helpful or harmful to the corporation and whether the interests of institutional investors are consistent with or diverge from the interests of the corporation and its other constituencies.[19] Of

---

863 (1991); Louis Lowenstein, Why Managements Should (And Should Not) Have Respect for Their Shareholders, 17 J. Corp. L. 1 (1991); George W. Dent, Jr., Toward Unifying Ownership and Control in the Public Corporation, 1989 Wis. L. Rev. 881; Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187 (1991); A.A. Sommer, Jr., Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later, 16 Del. J. Corp. L. 33 (1991); Elmer W. Johnson, Making the Board of Directors Function in the Age of Pension Fund Capitalism, in 21st Annual Institute on Securities Regulation 601 (PLI Corp. Law and Practice Course Handbook Series No. 663, 1989).

[14] Examples include the *Corporate Governance Advisor*, *Corporate Governance Bulletin*, *Corporate Governance Digest*, *IRRC Corporate Governance Highlights*, and *ISSue Alert: The Monthly Corporate Governance Resource*.

[15] See, e.g., 1995 course catalogs for Columbia, Harvard, and New York University Law Schools.

[16] Examples include the Competitiveness Policy Council, established by the U.S. Congress; the Council on Competitiveness, a privately sponsored, nonprofit research organization; and, in the United Kingdom, the Cadbury Commission.

[17] For example, Institutional Shareholder Services (ISS) advises institutional clients on proxy voting, while the Investor Responsibility Research Center (IRRC) collects and provides information on a variety of subjects, including shareholder proposals and corporate governance initiatives.

[18] The Council of Institutional Investors, and other groups such as the Interfaith Center on Corporate Responsibility, have lobbied Congress, the SEC, and other agencies on various policy matters. See, e.g., Vineeta Anand, Investors Want SEC To Re-examine Ruling, Pensions & Investments, Aug. 21, 1995, at 26, 26 (reporting that Interfaith Center on Corporate Responsibility and more than two dozen other institutional investors petitioned SEC to reconsider ruling on proxies); Vineeta Anand, Institutions Backing Lawsuit Reform Bill, Pensions & Investments, July 10, 1995, at 4, 40 (noting lobbying efforts of several of nation's largest institutional investors).

[19] See, e.g., Allen, supra note 3, at 15-16 ("[W]hether, in fact, institutional investors will likely contribute to efficient performance of public corporations in the U.S. is an open question."). Compare Lipton & Rosenblum, supra note 13, at 205-13 (arguing that short-term bias of institutional investors has had detrimental effect on American corporations) with Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L.J. 445, 453 (1991) (noting "optimists' vision of the institutional inves-

particular concern is the short-term orientation of many institutional investors and their primary focus on the current market price of the corporation's stock.[20]

The institutional focus on immediate stock price stems from a number of external constraints. First, many institutional investors hold large stock portfolios and simply do not have the time or expertise to evaluate a portfolio company adequately other than on the basis of its immediate stock price.[21] Moreover, the managers of these portfolios have their own performance evaluated over a short time frame, typically quarter-to-quarter or year-to-year, on the basis of the portfolio's market value during the period compared to the market indices.[22] Thus, a manager trying to outperform the market average in the short run has a strong incentive to accept, even seek, any short-term premium for a portfolio stock. This is true even if the investment manager understands that stockholders as a whole, and the economy as a whole, would be better off encouraging and promoting the long-term business development of the corporation.

Another factor that has exacerbated short-term performance competition is the growth of hedge funds. In sharp competition with each other for the most aggressive and speculative investment dollars, these funds in recent years have acted like arbitrageurs, and even provocateurs, leading stockholder attacks on corporations in an at-

---

tor as the shareholders' champion, replacing the outside director as the primary monitor of managerial behavior," but concluding that this vision will prove "illusory") and Gilson & Kraakman, supra note 13, at 868, 883-92 (applauding efforts of shareholder activists but suggesting creation of corps of professional directors who would be elected by and responsive to institutional shareholders).

[20] See, e.g., Salwen & Lublin, supra note 4, at A6 (noting that "[t]he biggest worry [of executives] is that holders want only the highest-possible short-term return on their investments").

[21] See Gilson & Kraakman, supra note 13, at 866 (arguing that growth of institutional investor funds whose strategy simply is to track market performance reflects inability or unwillingness of those stockholders to track performance of individual corporations); Martin Lipton & Jay W. Lorsch, A Modest Proposal for Improved Corporate Governance, 48 Bus. Law. 59, 60-61 (1992) (discussing difficulty institutional investors have in monitoring companies); Lipton & Rosenblum, supra note 13, at 206 ("[A]s their stock portfolios have grown in size, institutional stockholders have increasingly lost the ability to assess adequately the business performance of each portfolio company.").

[22] See Jean A. Crockett, Takeover Attempts, Economic Welfare, and the Role of Outside Directors 8, 30 n.8 (Rodney L. White Ctr. for Fin. Research Working Paper No. 23-89, 1989) (short time horizons of institutional stockholders result from "emphasis . . . placed on short-term performance in evaluating and rewarding fund managers"); Michael L. Dertouzos et al., Made in America: Regaining the Productive Edge 62 (1989) (noting that fund managers are judged on current value of their investment portfolio); Martin Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. Pa. L. Rev. 1, 7-8 (1987) (noting that managers of institutional shareholders, because compensated on the basis of their investment performance, are driven to maximize short-term profits).

tempt to force takeovers, spinoffs, or other transactions designed to create short-term increases in stock prices.[23]

Finally, institutional investors also must worry about lawsuits by beneficiaries or the Department of Labor (DOL). The typical institutional investor is a fiduciary, managing other people's money, whether in a pension fund, a mutual fund, or some other pool of assets. While fiduciary duty does not automatically require a short-term orientation, the DOL in its administration of the Employee Retirement Income Security Act of 1974 (ERISA),[24] which governs the management of most pension funds, has threatened action against ERISA managers who fail to act solely to maximize shareholder value.[25] In July 1994, the DOL issued an interpretive bulletin that set forth the legal requirements of ERISA investment managers to vote their proxies and advocated an activist role for pension plans.[26] The DOL bulletin, together with other statements and speeches by DOL officials, leaves the clear impression that an ERISA manager risks liability in failing to seek or accept a premium for her plan's shares or in failing to vote for a shareholder resolution designed to instruct or induce the board of directors of a portfolio company to seek such a premium.[27]

---

[23] See, e.g., Nicholas Denton, Less of an Art and More of an Industry—The Surge in Acquisitions Carries Little of the Old 1980s Style, Fin. Times, May 4, 1995, Survey of International Corporate Finance, at I, I (noting that hedge funds, "searching for a new source of high returns after the collapse of the bond market," have explored making acquisition bids); Does the Boom in M&A Pack Staying Power?, Mergers & Acquisitions, Jan.-Feb. 1995, at 13, 18 (quoting Marko Remec, Managing Director at Morgan Stanley & Co., stating that "[y]ou will see more activity like Dickstein Partners going after Hill's Department Stores, where a hedge fund takes an equity position and in effect grabs the tree and shakes it as hard as it can hoping some fruit will fall off"); Seth Lubove, Any Offers?, Forbes, May 8, 1995, at 93, 94 (noting that hedge funds and money managers hold over 50% of Glendale Federal Bank's common stock and these investors expect some type of sale to occur).

[24] 29 U.S.C. §§ 1001-1461 (1988).

[25] See Letter from Alan D. Lebowitz, Deputy Assistant Secretary, U.S. Dep't of Labor to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (Feb. 23, 1988), in 15 Pens. Rep. (BNA) No. 9, at 391, 392 n.4 (Feb. 29, 1988) (explaining that plan fiduciary must consider those factors which would affect value of plan's investment and act prudently in voting of proxies); Peg O'Hara, DOL Launches New Investigation of Proxy Voting by Pension Funds, Corp. Governance Bull., Jan.-Mar. 1995, at 1, 3 (explaining that DOL investigators will be examining conduct of pension plan fiduciaries in area of proxy voting and that, according to DOL Assistant Secretary, pension fund fiduciaries "'have a duty to manage assets. The vote is a plan asset and must be managed to enhance the value of the portfolio.'").

[26] U.S. Dep't of Labor, Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 59 Fed. Reg. 38,863 (1994) (to be codified at 29 C.F.R. § 2509.94-2); see James E. Heard & Jill Lyons, Labor Unions and Public Funds Set *Active Shareholder Agenda for* 1995, Insights, Dec. 1994, at 3, 6-7; Mark A. Vogel, Department of Labor Encourages Shareholder Activism by Plan Fiduciaries, Corp. Governance Advisor, Nov.-Dec. 1994, at 14, 14.

[27] See U.S. Dep't of Labor, Interpretive Bulletins Relating to the Employee Retirement *Income Security* Act of 1974, 59 Fed. Reg. 38,860, 38,862 (1994) (summarizing inter-

The Chicago School of economists accepts, even embraces, this focus on immediate stock price as an economic good. The efficient capital market hypothesis developed by the Chicago School, which has dominated the academic literature over the past two decades, holds that the market price of a corporation's stock at any given time accurately reflects the value of the corporation, including its future profitability.[28] Accordingly, the argument continues, any action that increases the immediate stock price must be good.[29]

This reasoning was utilized in the 1980s, not only by academics but also by takeover artists and arbitrageurs, to promote the social value of hostile takeovers.[30] The willingness of an acquirer to pay a premium to the market price, they argued, necessarily implies that the acquirer can increase the value of the corporation by better managing the assets, thus demonstrating the inefficiency of the existing manage-

pretive bulletins) ("The Department believes that . . . plan fiduciaries should make proxy voting decisions with a view to enhancing [share value], taking into account the period over which the plan expects to hold such shares."); U.S. Dep't of Labor, supra note 26, 59 Fed. Reg. at 38,863 ("[F]iduciary duties . . . require that, in voting proxies, the responsible fiduciary consider those factors that may affect the value of the plan's investment and not subordinate the interests of the participants and beneficiaries to unrelated objectives."); Patrick S. McGurn, DOL Issues New Guidelines on Proxy Voting, Active Investing, Corp. Governance Bull., July-Aug. 1994, at 1, 4, 7 (reporting further explanations made by Secretary of Labor Reich on DOL Bulletin); Reich Says Pension Funds Should Not Sacrifice Return for Public Benefits, 20 Pens. Rep. (BNA) No. 13, at 699, 699 (Mar. 29, 1993) (reporting Secretary Reich's remark that he would support pension fund investments in nation's infrastructure and in other projects that serve public good only if investments did not jeopardize financial return to fund beneficiaries); U.S. Dep't of Labor, USDL 94-360, Secretary Reich Advocates Corporate Activist Role for Pension Plans (July 28, 1994) (news release).

28 See Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161, 1165-68 (1981) (embracing "efficient capital market hypothesis" that price of shares "reflects the collective wisdom of all traders about the value of the stock," and that price reflects assumptions about the future); Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383, 413-16 (1970) (explaining efficient market theory's concern with whether prices at any point in time fully reflect available information); Jonathan R. Macey, State Anti-Takeover Legislation and the National Economy, 1988 Wis. L. Rev. 467, 482 ("A firm's share price reflects all events, past, present and future, that bear on the firm's present value.").

29 See Macey, supra note 28, at 481-82 (stating that favorable stock market reaction in present is perceived to mean that anticipated future earnings will also rise).

30 See, e.g., Easterbrook & Fischel, supra note 28, at 1169 (suggesting that tender bidding process polices management); see also Finnegan v. Campeau Corp., 915 F.2d 824, 831 (2d Cir. 1990) (stating that Congress realized "that takeover bids should not be discouraged because they serve a useful purpose in providing a check on entrenched but inefficient management" (quoting S. Rep. No. 550, 90th Cong., 1st Sess. 3-4 (1967)); Lipton & Rosenblum, supra note 13, at 197-98 (noting that others' enthusiasm for hostile takeovers rested on assumption that acquirer's willingness to pay premium over market price would increase value of corporation in future through acquirer's better management of corporation's assets).

ment.[31] If present management is inefficient, the argument continued, then it is economically desirable to move the assets to better management.[32] Similar arguments were used to support other short-term value enhancing actions, such as spinoffs,[33] increased leverage,[34] and reduction in research and development and capital investment.[35]

Much of academia still espouses the efficient capital market hypothesis,[36] despite the October 1987 stock market crash and other market drops and run-ups that have provided what we and many economists believe to be irrefutable evidence of its shortcomings.[37]

---

31 See, e.g., Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 705-06 (1982).

32 See, e.g., id. (arguing that control transaction that leads to better managers reduces agency costs and increases wealth of investors).

33 See, e.g., Frank H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. Corp. L. 540, 568 (1985) ("Spinoffs may reallocate assets to managerial teams that can make better use of them.").

34 See, e.g., Michael C. Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept.-Oct. 1989, at 61, 67 ("Overleveraging creates the crisis atmosphere managers require to slash unsound investment programs, shrink overhead, and dispose of assets that are more valuable outside the company.").

35 See, e.g., Edson Spencer, The U.S. Should Stop Playing Poker with Its Future, Bus. Week, Nov. 17, 1986, at 20, 20 (arguing that Wall Street has adopted the view that "the higher the stock price, the better management has done its job," leading managers "to put short-term earnings growth before such interests as market development, product quality, research and development, and customer and employee satisfaction").

36 See Lawrence A. Cunningham, From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis, 62 Geo. Wash. L. Rev. 546, 548-50 (1994) (explaining that efficient market hypothesis is fundamental since it is major premise for substantial body of corporate and securities law and scholarship).

37 See, e.g., E. Victor Morgan & Ann D. Morgan, The Stock Market and Mergers in the United Kingdom 74 (1990) ("There are powerful reasons for believing that equity markets, in the UK and elsewhere, are unlikely to be fundamental-valuation efficient but, in view of the difficulty of testing and the paucity of factual evidence, the question must remain open."); Gavin C. Reid, Efficient Markets and the Rationale of Takeovers 19-23 (1990) (describing "bubbles," in which "prices rise rapidly without apparent good reason, trading volumes accelerate, and prices finally crash"; and "fads," in which "social convention or fashion makes certain assets desirable"); Robert J. Shiller, Do Stock Prices Move Too Much To Be Justified by Subsequent Changes in Dividends?, in Market Volatility 105, 105-25 (Robert J. Shiller ed., 1989) (noting and attempting to explain excessive market volatility); Stephen F. LeRoy, Efficient Capital Markets and Martingales, 27 J. Econ. Literature 1583, 1616 (1989) ("The evidence suggests, contrary to the assertion of [one] version of efficient markets theory, [that] large discrepancies between price and fundamental value regularly occur."); Andrei Shleifer & Lawrence H. Summers, The Noise Trader Approach to Finance, 4 J. Econ. Persp. 19, 29 (1990) (arguing that "stock in the efficient markets hypothesis—at least as it has traditionally been formulated—crashed along with the rest of the market on October 19, 1987," when "a 22 percent devaluation of the American corporate sector" occurred in one day).

One adherent to the Chicago School, while acknowledging that "the absence of any new information concerning the value of assets in the economy that can plausibly explain the stock market crash is frustrating," nevertheless argues that the crash does not undercut the efficient market theory by asserting that "the crash does not imply that any better model exists for determining security prices than the present value of future cash flows

The Chicago School explanation for takeover activity overlooks alternative explanations, including the possibility that an acquirer is mistaken in its valuation of the target and in its own ability to improve the target's performance and therefore is overpaying to acquire the target.[38] It also ignores the evidence that, as was the case during the climactic 1986-90 period of the 1980s takeover and leveraged buyout (LBO) boom, bank lenders and junk bond buyers who misjudge the risk factor in their loans and supply "cheap" currency for speculation by acquirers may abet the overvaluation by acquirers.[39] There are those, like us, who believe that the resultant damage to acquirers and lenders, and their shareholders, not only outweighs the benefit of the takeover premium received by the target's shareholders, but also causes significant harm to the economy as a whole.[40]

In *Ownership and Control*,[41] Margaret Blair examines the institutional investor phenomenon and the impact of stockholder activism

---

generated by a firm's assets." Daniel R. Fischel, Efficient Capital Markets, the Crash, and the Fraud on the Market Theory, 74 Cornell L. Rev. 907, 916 (1989); see also Eugene F. Fama, Perspectives on October 1987 *or* What Did We Learn from the Crash?, in Black Monday and the Future of Financial Markets 71, 73-76 (Robert Kamphuis, Jr. et al. eds., 1989) (theorizing that crash may have been rational response to abrupt change in investor expectations, while acknowledging lack of any explanation for why such change in expectations would have occurred). These efforts to harmonize the crash with the efficient market hypothesis admittedly amount to little more than unsubstantiated speculation.

[38] As Warren Buffett states:

> The sad fact is that most major acquisitions display an egregious imbalance: They are a bonanza for the shareholders of the acquiree; they increase the income and status of the acquirer's management; and they are a honey pot for the investment bankers and other professionals on both sides. But, alas, they usually reduce the wealth of the acquirer's shareholders, often to a substantial extent.

Warren E. Buffet, Chairman's Letter, in Berkshire Hathaway, Inc., 1994 Annual Report 5, 9-10 (1995); see John Pound, The Promise of the Governed Corporation, Harv. Bus. Rev., Mar.-Apr. 1995, at 91, 91 ("Many takeover bids themselves represent flawed decisions by the acquirer.").

[39] See Jonathan P. Charkham, Keeping Good Company: A Study of Corporate Governance in Five Countries 219 (1994) (noting that bankers were among increased number of players in LBO game and that "prices rose to amazing levels"); Allen D. Boyer, Activist Shareholders, Corporate Directors, and Institutional Investment: Some Lessons from the Robber Barons, 50 Wash. & Lee L. Rev. 977, 1004-05 (1993) (explaining that as LBOs increased and junk bonds became popular, new group of investors entered and expanded market for low-grade debt); Richard L. Stern & Edward F. Cone, Scarlett O'Hara Comes to Wall Street, Forbes, Sept. 21, 1987, at 37, 37-38 (reporting competition to provide financing for leveraged acquisitions and suggesting that valuations were driven up to insupportable levels).

[40] See, e.g., Charkham, supra note 39, at 224 (arguing that placing great emphasis on shareholders' immediate values may result in competitive disadvantage compared to other nations' systems that take a longer-term view).

[41] Margaret M. Blair, Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century (1995).

on corporate governance. In the context of a general discussion about how the various claims, rights, and responsibilities for corporate performance are, and should be, divided among the participants in the corporate enterprise, Blair considers what the rights and responsibilities of stockholders are, and should be. She rejects, as we do,[42] the concept that stockholders are the "owners" of a major public company in the classic sense of property ownership that would carry with it the exclusive and unfettered power to determine the destiny of the company.[43] Blair recognizes that the rights and claims of a public company's various constituencies are far more complex than the rights involved in the simple ownership of personal property.[44]

Blair also endorses the basic premises that we and others have long advanced[45]—that the corporate governance system should have as its fundamental objective the long-term health of the business enterprise, and that, to achieve this objective, the corporate governance system must align the interests of the corporation's stockholders, managers, employees, customers, suppliers, lenders, and communities to promote such long-term health.[46] A long-term view is necessary to permit corporations to invest in the future, maintain their vitality, and compete in the world economy.[47] A corporation must be permitted to sacrifice some immediate value to investments in capital assets, research and development, new ventures, and market share. To the extent the corporation is not permitted to invest in the future, it inevitably will lose customers and profits to those corporations that are permitted to do so.[48]

In 1979, a law review article written by Martin Lipton[49] sparked a sharp debate over the proper role of a board of directors in responding to a takeover bid and, more fundamentally, over the basic corporate governance roles of a corporation's board of directors, stockholders, and other constituencies. Lipton advanced the proposition that the directors of a corporation have the power under the "business judgment rule" to reject a takeover bid at a premium to the

---

[42] See Lipton & Rosenblum, supra note 13, at 191-95 (arguing that corporation is not private property like any other private property but rather is central productive element of United States economy).

[43] See Blair, supra note 41, at 4-5, 223-34 (arguing that notion that shareholders of large corporations are "owners" is highly misleading statement).

[44] See id.

[45] See, e.g., Lipton & Rosenblum, supra note 13, at 202-03 (arguing that corporation has interest in its own long-term business success, which is also in society's interest, and that this long-sighted view is proper organizing principle of corporate governance).

[46] See Blair, supra note 41, at 275-82.

[47] See id. at 136-42.

[48] See id.

[49] Martin Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979).

market price.[50] In exercising their business judgment, Lipton argued, the directors may take into account not just the interests of the stockholders, but of the corporation itself, including all of its constituencies.[51]

Shortly thereafter, this position was attacked by Professors Frank H. Easterbrook and Daniel R. Fischel (as well as a number of other academics), in a series of articles arguing that directors should remain passive, and should not actively apply their business judgment, in considering a takeover bid.[52] They urged that the board "should relax, not consult any experts, and let the shareholders decide."[53] Easterbrook and Fischel premised their passivity proposal on the efficient capital market hypothesis, arguing, first, that takeovers improve the economy by moving assets to more efficient management and, second, that the economy would not be harmed (indeed, would be benefited) by a rule that removed all restraints on takeovers and forced companies to try to increase their market price by emphasizing short-run profits rather than long-run planning.[54] In a 1991 iteration of the theories they originally advanced in 1981, Easterbrook and Fischel argued that shareholders are the residual claimants to a corporation's income, after the creditors who have fixed claims and the employees, customers, and suppliers who are able to negotiate contractual rights before they perform their part of the bargain.[55] As residual claimants, Easterbrook and Fischel contended, shareholders have the appropri-

50 See id. at 130. The "business judgment rule" provides that as long as a director acts in good faith and with due care, he will be protected from liability, even where his decision may not have been that of the ordinary prudent person. See Robert W. Hamilton, Corporations Including Partnerships and Limited Partnerships: Cases & Materials 751-52 (5th ed. 1994).

51 See Lipton, supra note 49, at 130.

52 See, e.g., Frank H. Easterbrook & Daniel R. Fischel, Takeover Bids, Defensive Tactics, and Shareholders' Welfare, 36 Bus. Law. 1733, 1750 (1981) (arguing that decisions as to tender offers do not involve management of corporation's affairs in any meaningful sense and can be made by shareholders); Easterbrook & Fischel, supra note 28, at 1191, 1198, 1201 (defending their proposal of director passivity in response to tender offers by distinguishing between board's role in tender offers and its role in other situations); Lucian A. Bebchuk, The Case for Facilitating Competing Tender Offers, 95 Harv. L. Rev. 1028, 1029, 1054 (1982) (agreeing with Easterbrook & Fischel position that directors should remain passive); Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 878-79 (1981) (explaining that in face of tender offer no action should be taken by management of target company because "certain actions are simply outside management's authority").

53 Easterbrook & Fischel, supra note 52, at 1750.

54 See Easterbrook & Fischel, supra note 28, at 1182-84.

55 See Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 67-68 (1991).

ate incentives to make discretionary decisions affecting the destiny of the corporation.[56]

The basic theme of *Ownership and Control* is a rejection of the Easterbrook and Fischel Chicago School argument. The very real investments made by the corporation's other constituencies, Blair argues, may also give them rights to have meaningful input in determining the direction of the corporation.[57] As noted in *Ownership and Control*, legislative and judicial bodies have largely rejected the passivity argument since it was advanced in 1981 and, instead, have endorsed both the constituency theory and the business judgment rule as the proper analyses and responses to unsolicited takeovers.[58] Over the same period, events such as the bankruptcy of many of the junk-bond-financed, highly leveraged takeovers of the 1980s[59] and the stock market crash of October 1987 have undermined the economic theories on which the passivity rule was based.

Over the fifteen years since the debate first began, an unbroken line of decisions has evinced the judicial rejection of the director passivity argument and its underlying economic theories. In its 1981 decision upholding Marshall Field's successful defense of a premium takeover bid by Carter Hawley Hale, the United States Court of Appeals for the Seventh Circuit held that the directors' "desire to build value within the company, and the belief that such value might be diminished by a given offer is a rational business purpose."[60] The court observed that to straitjacket directors faced with a takeover offer "is in direct conflict with the duty of directors to evaluate proposed business combinations on their merits and oppose those detrimental to the well-being of the corporation even if that is at the expense of the short term interests of individual shareholders."[61] In so ruling, the court affirmed the district court's decision, which had relied upon the Lipton article in endorsing the view that directors faced with a premium takeover bid properly may decide that the best interests of the corporation and its stockholders lay in continued independence.[62]

---

56 See id. at 68.

57 See Blair, supra note 41, at 237-40, 262-74.

58 See Blair, supra note 41, at 218-23; see also infra notes 60-81 and accompanying text.

59 See Sharon Reier, A Banquet for Fat Cats: Bankruptcy, Fin. World, Oct. 16, 1990, at 36, 37 (noting that prior two years had produced 13 of 25 largest United States bankruptcies, and citing as examples of failed LBOs in bankruptcy Campeau (Allied/Federated), Revco, and Resorts International).

60 Panter v. Marshall Field & Co., 646 F.2d 271, 296 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

61 Id. at 298-99.

62 See Panter v. Marshall Field & Co., 486 F. Supp. 1168, 1186 (N.D. Ill. 1980) (citing Lipton, supra note 49, at 130), aff'd, 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

Four years later, in the seminal *Unocal* case,[63] the Delaware Supreme Court similarly rejected the view that a board faced with an unsolicited effort to effect a control change should be a "passive instrumentality," ruling that "the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source."[64] After recognizing and citing the Lipton-Easterbrook-Fischel debate,[65] the court ruled that a board facing a takeover bid "has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders."[66] Even in 1985, the *Unocal* court was already able to reference the uniform rejection of the passivity argument by both courts and legislatures.[67] The *Unocal* court listed the proper areas for director concern: "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange."[68]

As if to underscore the recognition of a strong director role, and to give directors the means to satisfy their protective duties, the Delaware Supreme Court shortly thereafter upheld the basic validity of shareholder rights plans—so-called "poison pills"—in *Moran v. Household International, Inc.*[69] And to remove any lingering doubt, the Delaware courts in the *Time-Warner*[70] merger case thereafter forcefully made clear that market efficiency theory was no substitute for director decisionmaking. As the Delaware Supreme Court put it, a corporate board of directors "is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a

---

63 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

64 Id. at 954.

65 See id. at 954 n.9.

66 See id. at 954.

67 Id. at 954 (citing Delaware court opinions and statutes for proposition that "in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality," and citing provisions of Delaware Code as proof that even in traditional areas of fundamental corporate change, director action is prerequisite to ultimate disposition of such matters). The court went on to announce a modified, enhanced form of judicial review in the takeover context, calling for directors taking defensive steps to show "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and for the defensive measure to be "reasonable in relation to the threat posed." Id. at 955.

68 Id. at 955 (citing Martin Lipton & Andrew R. Brownstein, Takeover Responses and Directors' Responsibilities—An Update (A.B.A. Sec. Corp. Banking Bus. L. Nat'l Inst. on Dynamics of Corp. Control, Dec. 8, 1983), reprinted in 40 Bus. Law. 1403 (1985)).

69 500 A.2d 1346, 1348 (Del. 1985).

70 Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989).

takeover."[71] The court added that "it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value" and that "[d]irectors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy."[72]

These landmark decisions have been followed by courts throughout the nation. Rights plans are now commonplace[73] and legally unquestionable.[74] They have proven their worth by enabling directors to implement strategic plans and, if a sale is deemed desirable, to achieve optimal terms and conditions.[75] Virtually without exception, courts have applied business judgment rule concepts, in one form or another, to the definition of the proper role and province of directors faced with a threatened change in corporate control.[76]

---

[71] See id. at 1150.

[72] Id. at 1150 n.12, 1154; see also Theodore N. Mirvis, Efficient Market Theory Doomed in Delaware, Nat'l L.J., Nov. 6, 1989, at S4.

[73] See Robert Comment & G. William Schwert, Poison or Placebo? Evidence on the Deterrent and Wealth Effects of Modern Antitakeover Measures, 39 J. Fin. Econ. 3, 4 (1995) (stating that by 1991, 87% of exchange-listed companies were covered by poison pill, business combination law, or control share law); Patrick S. McGurn, Investor Responsibility Research Ctr., Corporate Governance Service 1995 Background Report: Poison Pills, Jan. 3, 1995, 1, 8 (reporting that rate of increase in number of companies using poison pills is expected to rise and that pills "appear to be in vogue again").

[74] In addition to Moran v. Household Int'l, Inc., 500 A.2d 1346, 1348 (Del. 1985), see, e.g., Dynamics Corp. of Am. v. CTS Corp., 805 F.2d 705, 717-18 (7th Cir. 1986); WLR Foods, Inc. v. Tyson Foods, Inc., [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,673 (W.D. Va. Dec. 6, 1994); Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984, 1010-11, 1013-14 (E.D. Wis.), aff'd on other grounds, 877 F.2d 496 (7th Cir.), cert. denied, 493 U.S. 955 (1989); Desert Partners, L.P. v. USG Corp., 686 F. Supp. 1289, 1298 (N.D. Ill. 1988); CRTF Corp. v. Federated Dep't Stores, Inc., 683 F. Supp. 422, 438-42 (S.D.N.Y. 1988); Gelco Corp. v. Coniston Partners, 652 F. Supp. 829, 849-50 (D. Minn. 1986), aff'd in part and vacated in part on other grounds, 811 F.2d 414 (8th Cir. 1987); see Jeffrey N. Gordon, Corporations, Markets and Courts, 91 Colum. L. Rev. 1931, 1938-44 (1991) (suggesting that, in wake of *Paramount*, "[w]e may be back to the earlier era of simple business judgment review of defensive measures"); Joseph A. Grundfest, Just Vote No: Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 Stan. L. Rev. 857, 858-59 (1993) ("Courts have significantly increased managements' latitude in using [the poison pill] . . . ."); Randall S. Thomas, Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?, 46 Vand. L. Rev. 503, 517 & n.58 (1993) (noting that *Paramount* seems to sanction use of rights plans in wide variety of situations and that courts will not second-guess board's defensive tactic, such as use of rights plan, where board acts in good faith and after reasonable investigation).

[75] Comment & Schwert, supra note 73, at 1, 30 (rights plans are "reliably associated with higher takeover premiums").

[76] See, e.g., Gearhart Indies, Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 720-21 (5th Cir. 1984) (citing Texas business judgment rule that absent fraudulent transaction or ultra vires act, Texas courts will not find director liable); Panter v. Marshall Field & Co., 646 F.2d 271, 293-95 (7th Cir.) (applying business judgment rule in takeover context), cert. denied, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357, 382-83 (2d Cir.

Indeed, even when directors decide to agree to a change in corporate control—thereby triggering the duty to seek to obtain for the stockholders the highest value reasonably available[77]—there remains a wide range of alternatives available to the directors, who remain charged in that circumstance with the exercise and implementation of their best judgments.[78]

State legislatures also have made substantial efforts to recognize and enhance the role of directors in takeover decisionmaking, and to sanction director consideration of a wide range of corporate interests beyond those of the stockholders alone and beyond short-term share prices. Responding to the takeover waves of the late 1970s and 1980s, over half of the states' legislatures have enacted "constituency" statutes, which typically provide that directors may consider the interests of a variety of corporate constituencies other than shareholders, including those of employees, customers, suppliers, and communities.[79]

The uniform and now deeply ingrained judicial rejection of director passivity and Chicago School economic theory, and the demonstrated state legislative propensity to favor a strong directorial role, together largely have ended the debate insofar as legal forums are concerned. It is a fact of modern corporate life that directors are expected, indeed obliged, to be "front and center" on issues of corporate control.[80] By the same token, directors are now generally expected to balance constantly the needs and objectives of a wide range of corporate constituencies, albeit without the ability to calculate mathemati-

1980) (holding that directors enjoy presumption of business judgment rule in takeover context); Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980) (finding defendant directors protected by business judgment rule), cert. denied, 450 U.S. 999 (1981); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1387-89 (Del. 1995) (stating that if board's defensive response is within "range of reasonableness" and is not coercive, board's judgment may not be replaced by that of court); see also supra note 74.

77 Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 44 (Del. 1993); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

78 See *QVC*, 637 A.2d at 44 (noting that under Delaware law there is "'no single blueprint'" that board of directors must follow to fulfill its obligations in sale of control context (quoting Barkan v. Amsted Indus., 567 A.2d 1279, 1286-87 (Del. 1989))); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1175 n.30 (Del. 1995) (same). In *QVC*, the Delaware Supreme Court pointedly noted that, once fully informed, "*the directors* must decide which alternative is most likely to offer the best value." 637 A.2d at 45 (emphasis added).

79 See Charles Hansen, Other Constituency Statutes: A Search for Perspective, 46 Bus. Law. 1355, 1355 (1991) ("During the last two decades, some 28 states have passed so-called other constituency statutes."); Terry A. O'Neill, Employees' Duty of Loyalty and the Corporate Constituency Debate, 25 Conn. L. Rev. 681, 682 (1993) (stating that in response to wave of hostile takeovers of 1980s, "thirty-one states . . . enacted 'other constituency' statutes").

80 See Martin Lipton & Theodore N. Mirvis, Enhanced Scrutiny and Corporate Performance: The New Frontier for Corporate Directors, 20 Del. J. Corp. L. 1, 4 (1995).

cally how to achieve the greatest good for the greatest number. The exercise of informed judgment is inescapable.[81]

Coming from a business and economic perspective, Blair's work provides compelling support for these legal principles. For example, Blair notes that in many corporations, a highly trained work force is perhaps the most important factor in success,[82] while in other corporations, the critical factor may be the major investments made by customers, suppliers, or communities.[83] In many companies, a combination of both of these factors, and perhaps additional ones, is essential to success and far outweighs the importance of the equity of the shareholders.[84] Furthermore, in highly leveraged companies, creditors may bear greater residual risk than even shareholders.[85] In light of a corporation's unique balance of the relative importance of, and the relative investment by, each of its various constituencies, a board must retain discretion in order to make informed decisions for the company.

Recognizing the importance of constituencies other than shareholders, Blair embraces the stakeholder theory.[86] She supports the right of the board of directors of a company to make decisions based on the impact on all the stakeholders and the ultimate effect on the

---

81 See id. at 4 n.19 ("According to *Van Gorkom*, directors may not abdicate to shareholders the directors' responsibility to be active and informed participants in the sale of the enterprise." (citing Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985))); Allen, supra note 3, at 17, 18 ("Outside directors should function as active monitors of corporate managements, not just in crisis, but continually.").

82 See Blair, supra note 41, at 233, 234 & n.58, 238, 281, 290.

83 See id. at 239-40, 278-79, 326 (arguing that management and boards of directors should consider themselves representatives of both shareholders and those other parties who have contributed inputs to the enterprise and have at risk investments that are highly specialized to the enterprise).

84 See id. at 239 (noting that to maximize "total wealth-creating potential of the enterprise they direct," corporate managers must consider effect of their decisions on all parties who contribute to and invest in enterprise).

85 See id. at 44 n.29 (noting ability of corporate financial structures, such as those produced through LBOs and use of junk bonds, to raise value of common stock by shifting residual risk to creditors).

86 See id. at 274 (proposing that "governance systems should be devised to assign control rights, rewards, and responsibilities to the appropriate stakeholders"). The importance of stakeholders other than shareholders in corporate governance has been widely recognized and is reflected in the widespread adoption by state legislatures of "constituency" statutes. See supra note 79 and accompanying text. Drawing on the findings of a research project sponsored by the Harvard Business School and the Council on Competitiveness, Professor Michael Porter has recommended recognizing other constituencies by nominating customers, suppliers, employees, and community representatives to a corporation's board of directors. See Michael E. Porter, Capital Disadvantage: America's Failing Capital Investment System, Harv. Bus. Rev., Sept.-Oct. 1992, at 65, 65, 79.

company's long-term health.[87] Blair cogently summarizes her position as follows:

> In this context, corporate governance discussions that start from a premise that shareholders are the sole owners of corporations, that measure wealth creation only in terms of the share price of corporate stock, and that focus only on the power relationship between shareholders and managers may have the emphasis wrong. Reforms built on this premise may even destroy wealth-creating capacity. To be sure, the shareholder-management nexus is important. But it is not the only relationship within the corporation that is important to wealth creation. Corporate governance discussions need to acknowledge this reality explicitly.
>
> Most of the participants in the corporate governance debates of the last few years have discredited the notion that corporations should be run in the interests of all of the stakeholders, rather than just for the shareholders. But if stakeholders are defined to mean all those participants who have substantial firm-specific investments at risk, then this idea is actually a reasonable and appropriate basis for thinking about corporate governance reforms. Far from abandoning the idea that firms should be run for all the stakeholders, contractual arrangements and governance systems should be devised to assign control rights, rewards, and responsibilities to the appropriate stakeholders—the parties that contribute specialized inputs.[88]

Up to this point in her thesis, we are in basic agreement with Blair. First, we agree with her position that the rules of the corporate governance system should remain flexible, subject to adaptation to firm-specific needs and variations, as well as to changing economic conditions generally.[89] This requires that managers and directors have the freedom to take actions that may hurt the immediate stock price or may be unpopular in the short run with the majority of shareholders or other stakeholders. The board must have the ability to balance all the interests at any given time as may be required to anticipate the future needs of the corporation.

Second, we agree that partial employee ownership can have a very significant beneficial effect on corporations, particularly those that are dependent on a highly trained, firm-specific labor force. As Blair correctly observes:

---

[87] Blair, supra note 41, at 325-26.

[88] Id. at 274.

[89] Chancellor Allen recently stated that "one of the strengths of Delaware corporation law is its great flexibility, allowing for the design of an endless number of permissible variations in a corporation's governance structures." Allen, supra note 3, at 17.

> The view that employee ownership will always be inefficient is based on a model of production in which the specialized asset is the physical plant and equipment and labor is relatively unskilled, doing routine work that can be effectively monitored. The share of total economic activity for which these assumptions are reasonable is rapidly shrinking.
>
> . . . .
>
> . . . All the different forms the corporation may take are not apparent yet, but it is a good bet that human capital will be at least as important to the wealth-creation process in the coming century as it is today, and probably more so.[90]

We have long advocated the use of management stock ownership as a means to provide significant incentives to corporate managers and to balance institutional ownership.[91]

Third, we believe that Blair accurately describes the fundamental role of the board of directors:

> A system that is flexible and responsive is also a system that is subject to abuses. The first and most important line of defense against abuses must be effective and responsible boards of directors. Each firm is engaged in a unique and complex balancing act to encourage and reward innovation and wealth creation, to satisfy providers of capital, and to discourage waste and empire-building. Only management and directors who understand the business intimately, who are willing to devote the time and energy necessary, and who are properly motivated can be expected to accomplish this balancing act.
>
> Directors must have wide latitude to set strategy and decide how to use the company's resources. Nonetheless, they must be guided by clear standards for what constitutes success. The goal of wealth creation by the enterprise as a whole can provide that standard. This standard should be taught in management schools and supported by the law and by the culture of the boardroom. Measurement tools should be developed to provide information to the board about how well the company is doing at creating wealth.[92]

We part company with Blair, however, when she recommends changes in the corporate governance system that would assign control rights to stakeholders other than shareholders. More specifically, we disagree with Blair's apparent adoption of Michael Porter's position[93]

---

90 Blair, supra note 41, at 321, 324.

91 See, e.g., Lipton & Rosenblum, supra note 13, at 238-40 (recommending plan that makes allocation of shares to management contingent on set percentage increase in share market price over five-year period as means of fostering interest in long-term success of corporation).

92 Blair, supra note 41, at 325.

93 See Porter, supra note 86, at 65, 79.

that individuals who explicitly represent stakeholders other than shareholders as a whole should be put on boards, which in her view would "give those stakeholders some assurance that their interests will be taken into account."[94] We believe that such a system of corporate governance will lead to balkanization of the board and render it incapable of making hard decisions. Special stakeholder representatives would, by definition, have too narrow a focus on the interests of the group they represent. The long-term health of the corporation, and the long-term interest of all its constituencies, may require decisions that work to the disadvantage of one or another constituency at any given point in time.

We believe that to achieve consensus on a board composed partially or entirely of stakeholder representatives, there would be a strong impetus to compromise away from the risky entrepreneurial decisions that have built our economy and made it the most efficient in the world. During the 1980s, the competitive successes of German and Japanese companies, at the expense of American companies, sparked interest in comparative corporate governance and led to calls, such as those of Professor Porter, for changes in American corporate governance so as to mimic the German and Japanese systems.[95] As the global competitive situation reversed in the 1990s, and the serious defects in the German and Japanese corporate governance systems became apparent,[96] observers began to recognize that the American system has the flexibility to adapt to changing conditions and may not need radical reform.[97]

We also part company with Blair's "wealth creation by the enterprise" standard for the measurement of performance by corporate management, at least to the extent that it is something other than long-term increase in the value of the stock of the corporation or to

---

[94] Blair, supra note 41, at 326.

[95] See, e.g., Porter, supra note 86, at 72, 75, 76-82 (observing focus in German and Japanese corporate governance on importance of company continuity, long-term returns, and societal returns and proposing reforms to American corporate governance reflecting those goals).

[96] See, e.g., Japan Inc Frays at the Edges, Economist, June 3-9, 1995, at 67, 67-68 (suggesting that cross-shareholdings that bind together Japanese *keiretsu*, or families of financial and industrial companies, have resulted in overleveraging that has made Japanese companies vulnerable to economic downturn); Those German Banks and Their Industrial Treasuries, Economist, Jan. 21-27, 1995, at 71, 71-72 (suggesting that close links between German banks and Germany's biggest companies tend to stifle entrepreneurial investment, and reporting proposals to curb influence of German banks).

[97] See Charkham, supra note 39, at 233 ("There is a feeling that U.S. industry is leaner and fitter than it was and that Japan and Germany have troubles of their own . . . ."). But see id. at 233-34 (noting lingering concerns about United States system and possibility of "slow measured series of changes" in coming years).

the extent that it is used to justify stakeholder directors. Blair argues for governance systems that measure and promote "wealth creation."[98] We believe that, while a corporation's immediate stock price at any given point may not be a reliable measure of the corporation's value,[99] the market's long-term valuation of the corporation is the best and most objective performance measurement available. In our experience, most boards of directors today judge management performance by comparison to the performance of peer companies and by the established standards of return on investment, profit margins, market shares, and growth of profits and equity. It is not necessary to develop a new and difficult standard like "wealth creation" in order to shift emphasis from short-term to long-term performance.

We think it would be a serious mistake to develop this proposed new standard for measuring management performance. The interests of all the stakeholders, including those that make firm-specific investments, are best served if the goal of corporate performance is defined as the increase in the long-term value of the corporation, measured by the market. For example, it would not be in the long-term best interests of the employees if the directors representing them were successful in gaining higher wages, and as a result costs were increased to a level that caused the corporation to lose market share and forced it to reduce employment.

We believe that the present system—by which directors are elected by the shareholders but are empowered to exercise their fully discretionary business judgment to balance the interests of all stakeholders—is appropriate for this time in the United States. Effective corporate governance depends on strengthening the board of directors by having a majority of truly independent directors and by improving board practices, not on changing the laws and regulations that define the parameters of corporate governance today.

The past five years have already witnessed a number of efforts to improve the way in which boards of directors function. The objective of these efforts is to increase the involvement of the board in setting the corporation's strategic and financial goals and to improve the board's monitoring of management's performance. For example, in 1992, "A Modest Proposal for Improved Corporate Governance"[100] provided an extensive set of specific recommendations that could be implemented by a board of directors without any changes in the laws

---

[98] See Blair, supra note 41, at 325-39.

[99] See supra note 37 and accompanying text.

[100] Lipton & Lorsch, supra note 21.

and regulations governing corporations.[101] These recommendations were reflected in the Corporate Governance Guidelines adopted by General Motors in 1994,[102] and have also been endorsed by institutional investors.[103] We believe that the heightened awareness by boards of the critical role they play in monitoring corporate performance and the proxy and legal pressures now being felt by boards will be all that is necessary to assure a corporate governance system that works now and in the next century.

Even if the current improvements in corporate governance prove insufficient, we still would not move to the stakeholder-director type of board advocated by Blair and Professor Porter. Instead, we would increase the information available to directors and the pressure on them to monitor performance and to make necessary changes in strategy and management without delay. We would adopt Professor Peter Drucker's recommendation that boards conduct or oversee "business

---

[101] See id. at 67-76; see also Jay W. Lorsch & Martin Lipton, On the Leading Edge: The Lead Director, Harv. Bus. Rev., Jan.-Feb. 1993, at 79, 79 (focusing on recommendation that boards appoint "lead director" to oversee functioning of board). For other recent proposals, see Business Roundtable, Corporate Governance and American Competitiveness, 46 Bus. Law. 241, 246 (1990) (identifying "principal responsibility" of board of directors as "exercise [of] governance so as to ensure the long-term successful performance of their corporation"); American Bar Ass'n Sec. Bus. Law, Corporate Director's Guidebook, 49 Bus. Law. 1243, 1248-49 (1994). The highly regarded Corporate Director's Guidebook defines the directors' duties to include "approving fundamental operating, financial, and other corporate plans, strategies, and objectives," as well as "evaluating the performance of the corporation and its senior management and taking appropriate action, including removal, when warranted." Id. at 1249. To that end, the Guidebook calls for directors' familiarity with the corporation's "principal operational and financial objectives, strategies, and plans" and the "relative standing of the business segments . . . vis-a-vis competitors." Id. at 1250. Additionally, it suggests that directors ensure that they receive periodic, timely reports on "current business and financial performance, the degree of achievement of approved objectives, and the need to address forward-planning issues." Id.

[102] General Motors Corp., GM Board Guidelines on Significant Corporate Governance Issues (1994), reprinted in Corp. Governance Advisor, May-June 1994, at 3, 3-4; see James R. Ukropina, Something Old, Something New, Something Borrowed, Something Blue . . . , Corp. Governance Advisor, May-June 1994, at 7, 7-8 (noting that GM guidelines formally adopt lead-director principle proposed by Lipton and Lorsch).

[103] See, e.g., CalPERS Says Challenge to Boards is Working, supra note 5, at D8 (reporting that CalPERS has called upon 300 companies to follow GM's example and adopt written board practices guidelines); Peg O'Hara & Patrick McGurn, CalPERS Broadens Board Evaluation Program, Corp. Governance Bull., Nov.-Dec. 1994, at 8, 8 (noting same); Lead Director Shareholder Proposal Submitted by CalPERS, Corp. Governance Advisor, Jan.-Feb. 1994, at 38, 38 (reporting that CalPERS submitted proposal to two corporations advocating appointment of lead director); James M. Tobin, The Squeeze on Directors—Inside Is Out, 49 Bus. Law. 1707, 1752 n.265 (1994) ("The Council of Institutional Investors has circulated the GM Guidelines to major corporations, requesting implementation.").

audits"[104] at either regular intervals or in response to performance falling below plan or peers.[105]

To this we would add a warning. There is a tendency today for institutional investors not only to use their voting power to pressure underperforming corporations to make changes in strategy or management, or both, but also to force very successful corporations to accept takeover bids if they are at a premium to the market. Prior to the downturn in takeover activity at the beginning of this decade, proposals began to surface that were designed to shield from such institutional pressure those companies that were performing adequately. Blair discusses some of these proposals in chapter four of *Ownership and Control*. Among the proposals discussed are legislation to tax short-term trading in an effort to force institutional investors to adopt longer holding periods and a longer-term investing horizon,[106] and legislation to eliminate tax deductibility for interest on junk-bond acquisition debt.[107] Proposals were also made to restrict the voting rights of short-term holders, either by requiring a minimum holding period for voting rights or giving shares held for a longer period a greater number of votes per share.[108]

Many of these proposals would restrict the free operation of the market in order to solve a perceived collective action problem in the market. This market problem arises because, even though a focus on

---

[104] See Peter F. Drucker, Reckoning with the Pension Fund Revolution, Harv. Bus. Rev., Mar.-Apr. 1991, at 106, 114 (suggesting business audit based on predetermined standards that would ensure systematic evaluation of business performance).

[105] See id. (suggesting that business audit every three years probably would suffice); see also Lipton & Mirvis, supra note 80, at 8 (noting that law also may develop requirements regarding "business audits"); Lipton & Rosenblum, supra note 13, at 245 (suggesting that implementing five-year report and evaluation system would enhance directors' ability to monitor business by giving "impetus to the growing practice of regular, detailed internal and outside advisor reviews . . . of the corporation's performance, projections, and strategic plan").

[106] See Blair, supra note 41, at 135.

[107] See Peter C. Canellos, The Over-Leveraged Acquisition, Tax Law., Fall 1985, at 91, 115 (1985) (describing and critiquing congressional proposals to deny interest deductions for "'junior obligations' issued in connection with hostile acquisitions"); Ways-Means Democrats' Plan Would Tax Greenmail, Curb Use of Debt in M&As, 19 Sec. Reg. & L. Rep. (BNA) No. 41, at 1571-72 (Oct. 16, 1987) (describing proposed tax provision under which interest deductions would be disallowed for debt incurred to acquire stock or assets of corporation if 20% or more of stock were acquired in hostile purchase).

[108] See Reinier Kraakman, Taking Discounts Seriously: The Implications of "Discounted" Share Prices As an Acquisition Motive, 88 Colum. L. Rev. 891, 938 (1988) ("[M]arket-oriented lawmakers might follow a strategy of restricting the voting rights of 'short term' shareholders."); Mary Fagan, Call To Counter Short-Termism, The Independent, June 26, 1990, at 20, 20 (reporting that chairman of National Westminster Bank "cautiously" suggested that shares in corporation not carry voting rights until held for more than one year).

the long-term health of the corporation's business operations is in the collective best interests of investors (as well as the corporation's other constituencies), the short-term competition among individual money managers and other institutional investors leads them to seek and accept takeover premiums or other short-term measures that produce immediate gains. While the decline in takeover activity in the early 1990s lessened interest in these proposals, interest may be revived if institutional investors are not able to exercise collective restraint and permit boards and managers of companies that are performing well to operate free of short-term pressures. It is up to institutional shareholders to demonstrate the ability to use their considerable, and increasing, corporate governance powers in a responsible manner.

Ownership and Control is an excellent, comprehensive, and well-reasoned review of corporate governance theories. It is essential reading in boardrooms, financial institutions, and legislatures. Even if one does not accept all of Blair's views, the reader is provided with the knowledge and reasoning necessary both to understand the corporate governance debate and to fashion corporate governance practices for the future.