Symposium

The ALI's Corporate Governance Proposals: Law and Economics

New York City
September 22-23, 1983

The American Corporate Counsel Association
And
The Emory University Law and Economics Center

Preface

This special feature is an edited transcript of the proceedings at a seminar on The ALI's Corporate Governance Proposals: Law and Economics, held on September 22-23, 1983, in New York City. The seminar was sponsored jointly by the American Corporate Counsel Association and the Emory University Law and Economics Center.

Part I, which consisted of the first four speakers, was designed to set the stage for the debate to follow. The first speeches were by a corporate executive, giving his view of the role of law reform in corporate governance, and by a federal judge and former academic. The next two speakers presented alternative analytical models of corporate governance—Professor Herman presenting the "managerialist" view of management power, while Professor Easterbrook contrasted the view of markets as the principal constraint on managers. The luncheon speaker, Mr. Vincent, questioned whether the ALI reforms were really as radical as had been suggested and tried to place both sides of the debate in perspective.

The substantive part of the debate was divided into two parts, with two law professors presenting opposing views on the topic and comments by an economist. Part II dealt with the market for corporate control, and Part III with the structure and management of the corporation.
KEYNOTE ADDRESS: THE DYNAMICS OF CORPORATE GOVERNANCE

DONALD V. SEIBERT*

I appreciate the honor you have conferred on me by asking me to be your keynote speaker. I consider it not only an honor but an opportunity. Until about three weeks ago, I was the chairman and C.E.O. of the J.C. Penney Company, one of America's great corporations, and will continue to be a director of that corporation. I am, and will continue to be, a director of four other major corporations. I welcome the opportunity to share with you my insights into how the American free enterprise system is governed. My active participation in the process has made me aware of its strengths. I would like to tell you about them. I would also like to talk about some problems and concerns I have about tinkering with (or "reforming") the process.

For my theme and starting point today, I would like to borrow a quotation from Oliver Wendell Holmes who wrote, "The life of the law has not been logic: it has been experience. . ." For me, Holmes' teaching is particularly relevant and I would like to devote the time I have been allotted today to discussing my experiences in the corporate governance area—both as a corporate officer and as a member of boards of other corporations—and what implications I think these experiences have for the current corporate governance debate.

The focus of my remarks today arises from my strong belief that issues of corporate governance—in particular the role of management, the board, and the management-board relationship—are in a dynamic state of development and evolution—all for the better—and that it would be wise policy to permit this dynamism to continue unfettered by rigid rules and requirements which may inhibit its development. My reasoning is simple: changes I have observed in management structure, in board structure and function, and in the relationship between management and the board, I believe, have resulted in marked improvements for companies, their stockholders, their customers, and, indeed, for all of the corporation's other constituents.

I completely endorse the statement of my colleague, Irving Shapiro, when he stated:

---

*Director and Former Chairman J.C. Penney Company, Inc.

My position, based on a career in industry and personal observation of corporate boards at work, is that significant improvements have been made in recent years in corporate governance, and that more changes are coming in an orderly way; that with these amendments, corporations are accountable and better monitored than ever before; and that pat formulas or proposals for massive restructuring should be suspect. The formula approach often is based on ignorance of what it takes to run a large enterprise, on false premises as to the corporate role in society, or on a philosophy that misreads the American tradition and leaves no room for large enterprises that are both free and efficient.2

I have no doubt that the next few years will bring still further changes and improvements in corporate governance, all to the betterment of corporations, their constituents, and society. I would be unhappy to see the process of change and evolution stop or be cast in stone at this time.

What I would specifically like to focus on today are my own experiences; those at my own company, J.C. Penney, and those as a member of boards of other companies. I believe that my experiences and observations reflect what is happening in the bulk of corporate America, and demonstrate that corporations are searching for and adopting better governance mechanisms and must remain free to do so. Responding to the needs of society and the pressures of the economy, corporate structure and governance is developing so as to promote increased corporate efficiency and accountability. Superfluous and premature constraints must not be adopted; they will retard the significant advances that have already been made.

I would like to break my talk into three parts. First, I’ll discuss my observations concerning the role of management in modern corporate affairs. Second, I’ll focus on my experiences with the board, commenting on both its structure and function, and the board-management relationship. Finally, I’ll discuss some factors which, I think, can play a significant role in and substantially affect the success of managements, boards and their corporations.

Let’s first turn to corporate management. What I have observed, both in my own company and in other major American corpora-

tions, is a move away from a highly centralized form of management to an extended form of corporate management. Instead of three or four people, e.g., C.E.O., chairman, and two or three senior vice presidents comprising "senior management" and directing the affairs of the entire company, many corporations now have a management group consisting of many more individuals. I think the reason for this is simple: as corporations become more diverse in their affairs, handling or manufacturing more products in a larger geographical market, and become more involved in what were traditionally public sector activities, management groups are being expanded to include more and more individuals, particularly those individuals who are directly responsible for the different operations of the company and who may be able to provide valuable input or a new and different perspective on an old problem.

This observation is not unique to management. Corporate policies and procedures currently being implemented at many major corporations in the United States and elsewhere call for widening the participation in all facets of corporate decision-making to include many more individuals. Thus, on one level there is the significant increase in the use of quality control circles and groups, and the participation of blue collar workers in them. At the management level, corporations are tending toward the involvement of more and more people in the decision-making process for precisely the same reasons: to provide a sense of belonging and participation. More importantly, this process unleashes the intellectual and creative talents existing in many people which lie dormant until tapped.

My experience at J.C. Penney became increasingly rewarding as we learned more and more about utilizing the management wisdom and experience available within our company. The flexibility of developing new organizational forms was a key to the evolution we experienced. Team management has become more than a philosophy—it has become a practice.

The key point is that the decision-making process in management is now diverse and involves many more people than it did ten or even five years ago. While this may complicate the picture, for the lawyers and the assumption of management as having a pyramid structure, this development is a fact, and in the opinion of most top level corporate managers, is a good evolutionary step. It is certainly one that needs to be experimented with and encouraged.

Now let's turn to the corporate board. I almost hate to use the phrase "The corporate board," for my experiences clearly tell me that
there are almost as many different types of boards as there are corporations. I have not seen two boards exactly alike. This is not just in surface matters, but also in composition, in the board’s relationship to management, and in their participation in corporate affairs. I believe that the particular board of each company I have observed has evolved in its own unique way precisely because that board’s structure and function is what is good for that specific company and is what works for that company. On the other hand, the exact same structure and function may not work for another company—even one in the same industry. Such diversity of board structure and function is, in my opinion, a good thing which must be highly encouraged.

I believe that boards and managements acting together—taking into account the needs of their particular company—do what’s best for that company by tailoring their function, structure and relationship to the corporation’s specific needs. This can only be accomplished by insuring corporate flexibility in this area. In this connection, I wholeheartedly agree with the astute corporate observer who wrote:

A tacit assumption in the debate on corporate governance—regardless of the view one takes on the issue—has been that there is a model for proper composition of the board, and that if only the particulars of that model can be determined, corporate governance reform will follow. Surprisingly, this view has met with relatively little organized opposition. Yet it should, for a case can be made that there is no such thing as a model board.3

A “good” board—one that is accountable, diligent, active, responsible, and successful—has little to do with whether directors are insiders or outsiders, or whether the board has certain committees. Rather, I believe, a “good” board depends on the presence of other factors:

A good board is something more than a combination of good directors, and that, among other things not all directors—even skilled and qualified directors—fit all boards equally well; that there has to be some mix in a board—a mix of skills, backgrounds or personalities that create a “chemistry” in the board; that there has to be an attitude toward the board—and especially an “environment,” in board meetings—that encourages board participation; and finally, that there has

---

to be board management or leadership that directs and coor-
dinates that board and its work.  

There is no "right" formula to use to determine who should be on
corporate boards. What's good for one company may be unsuited for
another, and corporations must be left unfettered to determine the
specific board composition which suits their particular purposes and
needs.

Let me give you some specific examples.

On some boards, I have found a high degree of homogeneity
among the members. The members who are "outside" members are
business people from other corporations. They bring to the boardroom
the same backgrounds and experiences as the insiders. In these cir-
cumstances the board on which they serve is normally one which
requires business input from its members and desires to have a vari-
ety of different corporate experiences upon which to draw. It may be
that the corporation is a diverse, multifaceted enterprise and believes
that input from a variety of corporate situations will provide the max-
imum experience and options in managing and running the
organizations.

In contrast to the business orientation of some boards, other
boards, typically those involving either single-product or single-industry
corporations, frequently have board members schooled in the sciences
or engineering and are less likely to have board members whose
backgrounds are in financial and progressive management techniques.
For these corporations, having directors whose expertise is in technical
matters can be a significant factor contributing to corporate success.
It does not matter that this valuable director is not going to be able
to provide much guidance to the company in areas outside his specialty,
for the corporation has decided that technical expertise is a valuable
asset in a director.

With respect to these two examples, the question that arises is
whether a company seeking a vertical depth of expertise in its board
members—my second example—is less well served than the company
seeking only C.E.O.'s from major enterprises? Is one board proper
and the other not? The answer in each case is clearly no! Both boards
serve their companies equally well, and both corporations are
remarkably successful. The key is that they have markedly different
needs and can tailor the composition of their boards accordingly.

---

4. M. Lynch, Activating the Board of Directors: A Study of Increasing Board
Effectiveness 333-34 (1979) doctoral dissertation (available in Harvard Business School
Library).
The same questions can be posed with respect to outsiders versus insiders. Again, there are no right answers. Thus, while I personally applaud the notion of increasing the number of outside directors, I can see that this area is a totally open question depending upon the nature of the particular corporation. Where one has a corporation with diverse divisions and subsidiaries, it may be important for the outside board members to be few in number and the inside board members to be greater so that the total board can have in-depth experience to match the company’s diverse business. If any answer is correct, it is that there is no one model which is best suited for all corporations for all times. Corporations must be free to invite those individuals—whether inside or outside, and in any area of expertise—to join the board and thereby benefit the particular corporation.

Corporate board composition is not the only area where flexibility must be preserved and rigidity eliminated, board structure is similar. Thus, while I can understand that the existence of committees lends a certain amount of credibility to the perception of the corporation and the integrity of its actions, I do not think that any particular committee, except perhaps an audit committee, is necessary for every corporation. For example, I am aware of one corporation where the board size is deliberately kept small because it is the view of both management and the board that the company is best served by having the board act as a committee of the whole on most matters. This is a hard working board, and one where the directors are willing to spend time far beyond that ordinarily spent by most board members. I think it would be improper to declare this board “bad” simply because it has a less formal committee structure. Yet, corporate governance proposals that I have seen circulating would do just that.

Perhaps a more important topic than particular board structure and composition is board function, and the board’s relationship with management. Again, I find the critical observation in fact and in practice to be that there is no one correct model of board function. I have observed all kinds of boards and their relationships with management and have found that almost all of them serve their companies well. Each of these companies is relatively successful financially, has existed for quite some period of time, and is, I can say, a socially responsible entity accountable to its corporate constituencies.

In general, I have not observed corporate boards or board members participating in management decisions, that is, in the making of day-to-day decisions concerning the operation of the business. The only boards in which members may be called upon to do anything resembling this are boards of a bank or other financial institution, which may be
called upon to approve loans, and boards of a corporation in extreme crisis, which may be called upon to run the corporation actively for a limited period. In addition, a board member with a high degree of expertise in a particular subject, may, from time to time, participate in some day-to-day operating decisions relating to that area. In my experience, however, these are the exceptions, not the rule. Management runs the day-to-day operations of the corporation, and the board is there to provide assistance. The benefit of the various board members’ experience and expertise is to provide judgment and to help management. Unlike the example I just gave—the small very active board—most boards have neither the time nor the working knowledge of the corporation to make day-to-day operational determinations.

In addition to general guidance and assistance, there is one particular area where I look to our board for help and guidance: making judgments about our key managers. Our board includes men and women with experience in managing diverse types of enterprises. They are very people-oriented, as is the retail business. Even those members of the board who are not completely immersed in the management of large enterprises are individuals of knowledge and experience, who are sensitive towards people and the issues confronting major enterprises. It is precisely because they have these qualities that we want them exposed to top management, and top management exposed to them. In this way top management enjoys the benefit of the diversity of experiences and judgment of our board members, and our board becomes exposed to our managers, the people who make the key day-to-day business judgments. This exposure on the part of the board has been of invaluable assistance to me since neither the board nor I make the day-to-day decisions, but we both can evaluate together, based upon good first-hand information, the men and women who do make these decisions and become comfortable with their judgment.

It must be remembered that this is one example of how I used and worked with our board. Each corporation has its own practice which it has adapted and developed to suit its own particular needs. In my opinion, there is absolutely nothing wrong with this; flexibility is a virtue of our current corporate scheme. I don’t expect, nor would I want, everyone to do it our way.

Let me briefly turn to the third and final topic I would like to cover today—those factors which I believe could significantly impede the successful development of our corporate governance scheme.

First and foremost is director liability. There should be little or no concern on the part of board members about possible legal liability for decisions made or reviewed by them in good faith relating to business
matters. Ingenuity, innovation, and risk-taking are essential ingredients in the success of any business, and it is undesirable to place legislative restrictions on the decision-making process. Better performance cannot be obtained from directors by increasing their potential liability. Such actions will only have the effect of reducing risk-taking and innovativeness, and causing directors to spend significant amounts of time creating "paper trails" in order to be able to document their diligence.

Not only do I feel that concern for liability should not be permitted to infect the decision-making process, I am also apprehensive that the creation of such restrictions will cause the good people we wish to attract to serve on our boards to defer from such service. My own assessment is that there is an extremely limited pool of talent, which will be significantly reduced if the individuals involved feel that their personal assets would be placed at risk if they join those boards to which they could make significant contributions.

A second factor that can have an extremely adverse effect on the efficient and accountable operation of corporations is litigation. I have had some experience with the effect of litigation on the productivity of corporate management and corporate directors. It is an unbelievable time consuming process in the sense that it diverts significant amounts of time away from the creative process. I cannot think of a single better way to reduce the productivity of American business than by channelling the creative energies of management and the board away from business activities and towards concerns about what must and must not be said at the next deposition, and other similar matters. In addition, and more obviously, the enormous cost of litigation can in no way enhance the corporate interest.

One bright spot in this regard has been the ability of corporations to create Special Litigation Committees to determine whether director litigation should be pursued. I have had only limited experience with the use of such committees, but it seems to me that putting the decision-making process concerning such litigation in the hands of corporate directors is highly desirable. It protects the interests of the corporation, and, at the same time, limits the costs of litigation to the corporation by allowing those who known best to make the cost/benefit calculations concerning the corporation's involvement in a lawsuit. This seems to me to be a logical process.

Seeing that my time is just about up, I would like to come full circle by returning to the quote by Holmes that I opened with—"The life of the law has not been logic; it has been experience." In summary,
I think my experiences teach two fundamental lessons. First, this is not an area for rigid rules and models. Corporations must be free to adapt their governance systems to changing needs and competitive environments. Second, director diligence cannot be maintained by increasing the threat of litigation. Such actions will only decrease corporate productivity and competitiveness, and dissuade good candidates from accepting board positions.

In conclusion, I would like to return to my original theme that our system, as it presently operates, makes it uniquely possible to tap human talent and energies. This is because it is based on faith in the individual and his ability to make sound decisions. However, if we attempt to legislate or regulate out of existence this right to risk failure—which is the other side of the right to experiment—we destroy the system. Let’s be careful.
The Development of the Law of Corporate Governance

The Honorable Ralph K. Winter, Jr.*

In the recent ALI Tentative Drafts there are suggestions for corporate law reform which repeat themes, well rehearsed for almost two generations, criticizing that body of law. The persistence of the criticism has not been rewarded, however, for, with the exception of federal securities legislation, both statutory and case law have generally moved in a direction contrary to that demanded by the critics. This is somewhat surprising, since an allied body of criticism directed at consumer and antitrust law achieved considerable success.

One reason for the failure of the criticism of the law of corporate governance to bring about change has been the critics’ propensity to offer somewhat drastic solutions to very ill-defined problems, the seeming attractiveness of the cure obviating the necessity for a diagnosis. Another reason has been the failure to distinguish between the very different and often inconsistent goals which such change might have. Many critics of existing corporate law simultaneously bandy about terms such as “investor protection,” “shareholder democracy” and “corporate social responsibility,” without hinting that they may be inconsistent even at the slogan level. Others join proposals for increasing the power of shareholders with calls for blatantly anti-investor legislation.

Representatives of the business community, moreover, have not enhanced the intellectual level of the debate. Instead of demanding a better definition of the putative problem or attention to the distinctions among goals of particular reforms, they have sought to determine what concessions might appease the critics. The ensuing debate has resembled a series of guerrilla attacks on changing targets of opportunity while a ponderous defense force seeks peace by offering sacrificial lambs which merely whet the appetite of the attackers.

My former colleague at Yale, Judge Robert Bork, has described a meeting with businessmen on this subject. Quoting Judge Bork:

I remember a talk in which a prominent businessman said that he and his colleagues were concerned that the large American corporation does not possess legitimacy in the eyes

---

*Judge, United States Court of Appeals for the Second Circuit.

(524)
of the rest of society. He asked how they could alter their modes of corporate governance in particular, in order to be accepted into the society as legitimate members. . . I recall having two reactions to his approach. The first was surprise at the triviality of the response suggested. A change in corporate governance . . . will have very little impact, if any, upon the public perception of the corporation and its role in the society. Anti-corporate sentiment is directed to the entire role of business and free enterprise in our lives. Fiddling with corporate governance for no better reason than to defuse hostility and head off punishing "reforms" is like tinkering with a leaky faucet in the hope of averting the Johnstown flood.

My other reaction was surprise at the mood of defeat, of lowered morale, that suffuses meetings to discuss problems of this sort. It is as though a large fraction of the community of business leaders wants to make preemptive concessions, as if they meet not to plan a fight against wrongheaded movement but to discuss how best to negotiate the terms of surrender.

The response of businessmen to the wave of criticism of the existing body of corporate law has actually legitimized the assumption that it is deficient. This legitimization has come about as a consequence of the critics' realization that the presence of business representatives on a group studying corporate law reform will lead neither to an informative debate nor to serious resistance to calls for legal change. Thus, Professor Wechsler's somewhat defensive foreword to the ALI Tentative Draft I emphasized that business representatives joined the calls for change, as though that fact is a suitable substitute for an empirical demonstration of actual deficiencies in the body of corporate law.

In aid of clarifying the issues to some degree, I would suggest that discussion of change in the law of corporate governance distinguish between proposals designed to further social and political goals and those designed to enhance the efficiency of the capital markets.

The regulation of corporate governance in the name of social or political goals raises issues having to do with notions of concentration of political power and with the role of government relative to the private sector—issues which relate to basic notions about freedom in a democratic society. Some argue that business corporations are centers of power which ought to be subject to public control. Others argue that such measures will increase the concentration of power in govern-
ment. This discussion should not proceed upon the assumption that professors of corporate law and members of the business community are primary sources of wisdom. Where such basic normative choices are at stake, expertise in the legal doctrines of corporate governance is a most dispensable qualification. Moreover, it is an even greater error to look to representatives of the business community as reliable defenders of capitalism and free markets. This is so partly for reasons described above and partly because members of the business community have particularized interests of their own to defend, e.g., they frequently favor protectionist legislation impeding corporate takeovers, and ought not be expected to mount a principled defense of either democratic capitalism or competition in particular controversies. This aspect of the debate, therefore, must be expanded to include the larger community and ought not be regarded as an issue of law reform.

Let me turn now to another goal behind the change in the law of corporate governance—regulation enhancing the efficiency of capital markets. Although this is a less complex debate which involves the relative role of market forces and legal rules, it too has been carried on in a state of some confusion. This is partly because much of the most insistent criticism of the relation of corporate management to shareholders has come from persons who appear, on other issues, to exhibit an outspoken anti-investor viewpoint, and not from the investment community itself. Moreover, discussion of proposed changes on both sides of the debate appears at times to be little more than rank speculation. Consider, for example, the controversy surrounding the ALI Tentative Draft as to the duty of care owed by officers and directors to the corporation and the effect of the so-called business judgment rule. Looking at the debate alone, one can hardly be sure that the time-honored rules benefit shareholders less than the changes proposed. As to whether a problem exists, there certainly has been precious little protest from the investment community about the business judgment rule. The great bulk of agitation has come from one group of academics, largely professors of law. Even that discussion, however, entails little more than an occasional reference to the Penn Central bankruptcy, unadorned by a showing that a different legal rule would have led to a different business outcome. At bottom, the seeming laxity of existing rules is taken as evidence itself of the need for change.

There are, of course, counterarguments. Any change in the duty of care may be costly to shareholders generally, for it may create incentives for overcautious corporate decisions. Some business opportunities offer potentially great profits at the risk of substantial losses, while alternatives offer less risk with potentially lower gains. The undiver-
sified shareholder may prefer the latter, less risky, but also potentially less profitable, course. In the case of the diversified shareholder, however, the seemingly more risky alternative may well be the best choice, since great losses in some cases will be offset by even greater gains in others. Given mutual funds and similar forms of diversified investment, the law need not give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A duty of care which deters the choice of seemingly riskier alternatives thus may not be in the interests of shareholders generally. Since corporate management has a larger stake in the survival of a particular corporation than does a diversified shareholder—indeed, since management’s viewpoint is closer to that of the undiversified shareholder, its self-interest may cause it to be too cautious so far as shareholders generally are concerned. If that is so, any change in the law tending to penalize seemingly risky decisions may cause net losses to shareholders generally.

I do not set out this analysis to persuade anyone of its merits but simply to demonstrate the difficulty of focusing upon the seriousness of the supposed problem and of discerning the correct solution. In truth, both sides are simply speculating.

And this brings me to my principal argument, which is that speculation is not necessary to the development of the law of corporate governance so far as the efficiency of capital markets is concerned. There is a process by which legal rules optimizing relationships between corporate management and shareholders can be discerned. Historically, states have competed to attract corporate charters for revenue purposes and this competition has been the single greatest influence on the development of the law of corporate governance. I have articulated elsewhere and continue to believe that this competition among states leads to optimal rules governing the relationship of shareholders to corporations.

Corporations must attract capital from a vast range of competing offers, and any state which rigs its corporate code against investors will drive debt and equity capital away. If Delaware, for example, permits corporate management to ignore the interests of shareholders and other states do not, then earnings of Delaware corporations will be less than earnings of comparable corporations chartered in other states. Shares in Delaware corporations will trade at lower prices. A corporation with lower earnings will be at a disadvantage in raising both debt and equity capital and will be at a disadvantage in the product market. The decline of share price will increase chances of a takeover replacing management. Corporations must, therefore, seek legal systems
more attractive to capital, and states desiring corporate charters will
try to provide legal systems that optimize the shareholder-corporation
relationship.

It is thus not in the interest of either Delaware corporate manage-
ment or the Delaware treasury for corporations chartered there to be
at a disadvantage in raising debt or equity capital in relation to
corporations chartered in other states. Management must induce in-
vestors to choose freely their firm’s stock or bonds instead of, among
other things, stocks and bonds in companies incorporated in other states
or other countries, bank accounts, certificates of deposit, partnerships,
individual proprietorships, joint ventures, real estate or present con-
sumption. A corporation’s ability to compete effectively in pro-
duct markets is related to its ability to raise capital, and management’s
tenure in office is related to the price of its stock. Management has
a powerful incentive to keep the price of stock high enough to prevent
takeovers, a result obtained by making the corporation an attractive
investment.

This analysis is not dependent upon consumers of securities or
lenders understanding the intricacies of corporate law or knowing of
the alleged permissiveness of the Delaware code. A simple comparison
of earnings of various corporations, for example, will affect the price
of Delaware stocks. Moreover, institutional investors—not to mention
investment counselors—cannot be unaware of such critical facts. Their
role in the capital market is so critical that their knowledge alone will
sharply affect share price and the interest rate available to a corporate
borrower. If Delaware were really leading a “race for the bottom,”
as has so frequently been alleged, we would have seen debentures with
restrictions as to the state of incorporation long ago. I would submit,
rather, that the race is to the top.

So long as we are assured that the states continue to compete
for chartering business, the need to undertake a study of the law of
corporate governance is minimal or non-existent, and there is grave
doubt about the need for extensive reform. In short, the law of corporate
governance has failed to change in response to its critics largely because
such changes do not benefit the parties it governs. To change rules,
such as the duty of care and the business judgment rule, simply because
of the claims of a small group of law professors is to ignore the quite
reliable forces which have shaped the law in the first place.

One final word: my skepticism about the need for a study is not
diminished by the fact that the ALI draft even seems to fail to recognize
that it is adopting the highly controversial viewpoint of one school
of academic thought. Indeed, the ALI draft has appeared at a time when there is more challenge than ever before in the academic world to this viewpoint. Every student editor of a law journal today knows that there is a large body of reputable academic opinion in major law schools which holds a radically different view. So far as I can tell in the materials available to me, this school of thought, which now has influence in academia, in the profession and in the courts, is astonishingly unrepresented in the ALI project.¹ The fact that the viewpoint excluded is the only one which opposes on principled grounds both changes in the business judgment rule and legal impediments to takeovers may well explain this omission. It is not up to me to suggest to a private organization like the American Law Institute how to structure its inquiries, but if it desires the credibility which attends a true canvass of views, then it should consider restructuring the project in terms of documenting the problems creating the need for a study, defining the goals of the proposed solutions, and ensuring the representativeness of the participants.

1. This statement is as delivered. Professor Kaplan later rebuked me for not recognizing that of the four Reporters, ten Consultants and forty-five Advisers, one Adviser was in fact associated with the modern school of thought. I stand corrected.
THE LIMITS OF THE MARKET AS A DISCIPLINE IN CORPORATE GOVERNANCE

Edward S. Herman*

Debate on the contribution of the market to assuring efficient and properly responsive management rests on differences in interpretations of history, in differing views on relevant theory, and different appraisals of the actual working of the market mechanism. I want to discuss briefly some facets of these matters from a semi-managerialist perspective. After a brief review of the historical context and background of Berle and Means’ Modern Corporation and Private Property, I will discuss their analysis, the formulation of the issues of corporate control and governance that follow from managerialist models, and the inferences that can be drawn from them. They provide a rival interpretation of facts, so that they lead easily into a consideration of contemporary merger facts from alternative perspectives.

I. BACKGROUND OF BERLE AND MEANS

One of the things that has given Berle and Means enduring value is that their analysis was rooted in a very close observation of institutions and history. They wrote in the wake of a second great merger movement, the growth of the large corporation to a commanding position in the economy, and the democratization of the public market for securities. These matters are central in their book, published in 1932, and they spent a great deal of space documenting the small stockholdings of management and the great dispersion of public holdings, as institutional facts bearing heavily on power and control in the corporation. That the managements of these large organizations had a great deal of power, and were not reliably devoted servants of the public stockholders, was also part of the common experience of informed observers of the 1920’s and earlier. This was an age of an extreme hard-sell of securities, and of promotional corporations, most notably in the utility field but spreading beyond utilities, with the assistance of many large investment and banking houses. There was gross exploitation of an uninformed market in the late 1920s of such

*Professor of Finance, Wharton School, University of Pennsylvania, and author of Corporate Control, Corporate Power (1981).

1. A. BERLE & G. MEANS, Modern Corporation and Private Property (1932).
scope as to contribute to systemic instability. This was a period in which shareholder disenfranchisement by the use of non-voting shares, shares with multiple voting power, and the rather audacious use of "management shares" (shares that had a vote, issued along with publicly-owned shares that had no vote) was widespread. There was also a period in which there was a sharp increase in the use of option warrants and management contracts which represented serious seizures of prospective market gain and income from public shareholders by top insiders and bankers. A vast quantity of securities was issued in the late 1920s. Corporate pyramids were built that were designed primarily to sell securities, with no underlying real economic function.

Furthermore, disclosure conditions in the 1920s were not compatible with rational decision-making by shareholders and potential investors. The majority of firms in the late 1920s did not make available annual, let alone quarterly, net income figures. Managers tended to look upon shareholders who were openly inquisitive about developments in "their" corporation as audaciously intrusive outsiders. There was also a tremendous amount of manipulative activity in securities markets, including many pools established by investment bankers and by individual corporations, or with the cooperation of the selling firms, frequently accompanied by deliberate misrepresentation. Main Street and Wall Street by William Z. Ripley, published in 1927, has two chapters on disclosure conditions and the treatment by public corporations of their own stockholders in the 1920s that still make quite dramatic reading.

It is often argued that information is not needed by ordinary shareholders if an efficient market has already digested it. But minimally available information was also not available to market professionals on any kind of consistent basis in 1925. The low quality and the erratic information flow encouraged the promotional conditions that prevailed and contributed to the destabilizing tendencies in the securities markets of the late 1920s. I believe that there is also pretty solid evidence that security markets in the pre-SEC era were less efficient in a technical economic sense than they were after 1933. This was part of the Berle-Means background; one with which they were familiar and which shaped their view of corporate governance.

2. See W. Ripley, Main Street and Wall Street 161 (1927).
3. See generally id.
4. The variances and standard deviations of residuals of market returns on stocks fell markedly between the pre-and post-SEC periods. See M. Blume, The Assess-
Berle and Means were also familiar with the pre-World War I background of a still "freer" market. I think it is impossible to read, with any diligence, about managerial behavior in the years from, say, 1875 to 1915, without being impressed by the fact that, along with some of the most constructive builders of U.S. history, there was a very considerable set of raiders who had a substantial negative efficiency impact on the system, and who were quite important quantitatively. Alongside a Harriman and a Hill in the railroad business were a Gould and a Drew, and numerous others whose financial speculations caused serious damage to the railroad business. The raider threat was so great at the end of the nineteenth century that Harriman, who had achieved a monument of constructiveness in developing the Union Pacific Railroad, felt so insecure in the years around 1898 to 1902 that he went to great pains to get a lot of friends and associates to build up holdings of thirty or forty percent of the stock of Union Pacific, in order to preclude a raid. Even a book sympathetic to Jay Gould, by my late colleague Julius Grodinsky, makes it clear that, in the bulk of the cases where Jay Gould took control (and he took control of a great many, quite important companies), neither the shareholders nor social efficiency were likely beneficiaries. And in the culture of those times, the laws of fraud, as well as the market, were ineffectual as control devices.

II. THE MANAGERIALIST FRAMEWORK

Thus, in building a model of corporate control in which strategic position was important and management discretion was real, Berle and Means were starting from what seemed an obvious and conspicuous reality. There was the reality of the experience of fairly widespread abuse of fiduciary powers, and there was the reality of management power based on strategic position. Berle and Means as analysts worked with a simple "structural" model, in which power is based on position in an organization and the functions and the relationships that arise out of that position. The position yields power partly by default, by virtue of the familiar diffusion of ownership, the transactions costs

of active ownership, control of the proxy machinery by the manage-
ment, and the like. But, positively, management has substantial power 
for very solid, substantive reasons. They have special skills, knowledge, 
and command over knowledge, and they possess immediate operational 
authority over resources and people within the organization. Thus their 
position gives them a dependency structure that conveys power, and 
they have an interest in building up that power base further to assure 
their own security and command.

Most modern analyses of the internal power structures of the large 
corporations have found the top insiders to be the power and decision-
making center, with the outside directors usually serving in an ad-
visory role. This is based on the factors just mentioned—command 
over resources, special skills, plus the tendency of the top insiders to 
build up a congenial board. Also, board traditions in the United States 
make outsiders invited guests, not policy makers. They have fiduciary 
and advisory duties and responsibilities, but normally they behave 
passively and reactively. There is considerable variation in the level 
of activity and power of outside directors, but this general pattern of 
power is well-accepted as a fact in the corporate world. Such a version 
of corporate control is consistently reported in Conference Board studies 
of the structures of boards and the evolution of board power.5

Managerialists start with these basic structural facts and proceed 
from there in elaborating on the complexities of insider and outside 
power relations. Managerialists also pay a great deal of attention to 
the constraints and limits on the managers that stem from the invest-
ment community directly through the board, and indirectly through 
banker/broker inquiries, peer group pressures, and market forces. They 
also give varying degrees of weight to pressures within the organiza-
tion in promotion and goal-setting that tend to make for a profit ori-
entation. Thus, in my own informal managerial model (which I spell 
out in Corporate Control, Corporate Power),6 I end up with a weight to 
these constraint factors that leaves the managers pretty close to profit-
maximizers, but with a growth bias. Still, a central feature of 
managerialism is that it roots power in the large corporation first in 
structure. Structure includes the corporate organization itself and the 
power arrangements within it, as well as the pattern of stock owner-

5. See J. Bacon & J. Brown, Corporate Directorship Practices: Role, 
Selection and Legal Status of the Board (1975), and The Board of Directors:
New Challenges, New Directions, Conference Board (1971).
ship and modalities which allow ownership to influence corporate ends and behavior. The power attainable by strategic position is thought to be real and capable of expansion and exploitation, even if it is constrained.

III. The Agency Model

How does the agency model deal with the power arising out of strategic position? In part, it resorts to conjectural history, postulating a gathering under an oak tree, possibly back in the seventeenth century, when the shareholders and the other factors of production agreed to a contract with a coordinating and monitoring agent.7 This agent contract would be designed to make the agent work undeviatingly for the stockholder masses, which he then does. This contract is sometimes invoked to prove managerial devotion to the shareholder interest. Thus, one of my distinguished confreres has stated in relation to the question of the adequacy of disclosure in the 1920s, "[I]f management believed that the marginal revenue to the stockholders as a group would exceed the marginal cost of preparing and supplying the information, they would disclose their financial and other data."8 This could not be based on observation; it must have flowed from the conjectural-historic contract that was assumed to be applicable.

Besides the contract, the agency model also postulates an intensity of competition that drives managers and board members to a wage-marginal product equilibrium.9 Thus, an intervening institutional mechanism is irrelevant; it apparently is for Judge Winter, too, on similar grounds of the efficacy of a different competitive mechanism. But, I find this profoundly unrealistic, and it leaves us with a model that is supposed to be pertinent to corporate governance, without governors. It's a Hamlet without a prince. Of course, there is a further instrument influencing corporate governance in the "market for corporate control," to which I shall return. However, we are again offered a very indirect and crude instrument. This neglect of serious and direct analysis of the actual governors and governance processes and the power of strategic position seems a grievous omission to managerialists.

There is explicit recognition in agency and efficient market analyses that the actual governors play a definite role in the special case of takeovers, where managers try to fend off offers that would appear advantageous to the shareholders, resorting even to scorched corporate assets policies. Although these defensive tactics are objected to with some indignation, agency model adherents fail to draw inferences that bear on the realities of corporate governance. One inference would be that the agents of the target firms are not functioning as true agents, suggesting a serious slippage between the cup of the agency contract and the lip of managerial behavior. A question quickly follows: if the agents are not true agents on the one side of the transaction, why should we assume optimizing behavior on the other side?

IV. Managerialism and Takeovers

What conclusions follow from the managerialist theory? I must treat this, I’m afraid, with distressing brevity. Managerialist theory is diverse, and I don’t really speak for all the managerialists. But certainly, a main stress of managerial models is that management power will tend to bend the corporation toward an emphasis on growth, with less emphasis on rate of return on shareholder investment and maximization of present value of the corporation in the interests of the shareholders. Instead of paying out dividends or buying back corporate stock with large cash flows, managers will tend to keep the money within their control by reinvesting, even at low rates, in existing activities, or by buying out other companies. This will, of course, always be rationalized as in the interest of diversification. In the managerial view, this bias is based on both the tie-in of managerial income, power, prestige and security to corporate size, as well as on organizational imperatives to which the management is relatively sensitive. Managerial theory also suggests a managerial bent towards expense preference, other forms of income diversion into the pockets of the managers and possible misuse of inside information.

One problem with testing such hypotheses is that they are associated, not so much with pure management control, as with separation of ownership and control. Minority owners who control might want to take out income and expenses as much as non-owning managers. Many forms which such insider abuses may take have been contained by law and associated practice since the 1920s. I will, therefore, focus particularly on the hypothesis of growth per se. This hypothesis poses an alternative explanation of takeovers, to that of the market for corporate control as enhancer of efficiency and protector of the shareholder interest.
In the market-for-corporate-control model, poorly managed or sorely abused firms will be undervalued and their shares will be a target of better managed firms. In managerial models, management-controlled firms will tend to buy irrespective of their own managerial skills, and with less sure interest in badly managed and unprofitable firms. These contrasting hypotheses suggest a number of possible tests that ultimately turn on the weight managerial firms place on growth, as compared to rate of return on stockholder investment, in deciding between payout, retention and acquisitions.

There are a great many studies that have sought to compare manager and owner-controlled firms. A majority have found that companies that are managerially-controlled have lower rates of return on investment than owner-controlled companies. We may infer an excessive retention rate from this low rate of return associated with managerial control. Grabowski and Mueller have also made a strong case that owners of mature, large companies would prefer a larger payout than they were receiving. William McEachern has found that the incentive structures established under management control are less closely geared to stockholder return than in cases of externally controlled, owner-dominated firms.

Another major issue is whether merger activity has involved well-managed firms as acquirers and badly-managed firms as targets. In some cases this is clearly so, but the exceptions are numerous and the implications are troublesome regarding efficiency effects and the view that the market for corporate control is a "shadow" mode of governance. Many large companies have deliberately embarked on buying programs which focus on well-managed and profitable targets. The conglomerate movement of the 1960s was frequently characterized by low-earnings-rate companies buying more profitable companies. On quality of management—"pruning dead wood"—logic, this was perverse. Some poorly managed companies have actually become buyers as the route out of industry difficulties, some of them partly of their own making. There is a lot of evidence on this, but I just call your attention in passing to the U.S. Steel acquisition of Marathon. The market having fixed the price on Marathon at about $60 a share, U.S.

Steel bought it shortly thereafter at $106. With a record of only modest success in the steel business to which it had been addressing itself for many years, U.S. Steel was explicitly unwilling to claim that it was going to manage the oil business better.

Another key empirical question bearing on these contrasting hypotheses is how well acquiring companies do after they buy other firms. This is going to be discussed at length in many other speeches and panels, but I will give a brief summary of my own conclusions. If we examine the large literature that traces back into the 1920s (featuring a famous study by Arthur Dewing) and 1930s (Shaw Livermore), to the present, most investigators conclude that, from the standpoint of the welfare of the stockholders of the acquiring company, acquisitions either damage them or are neutral in effect. The uniform benefactors in mergers are the shareholders who sell out, especially if they make an early and graceful exit from any security package which they may have acquired. In general, shareholders of the acquiring firms would be better off if the management had acquired company stock, or if the management had set up a trustee-managed random portfolio for the benefit of the shareholder aggregate. A study of British experience published in 1981 by Levine and Aaronovitch concluded that the evidence points to mergers "as strategic decisions not involving immediate economic or financial gains." One aspect of such strategic thinking is the desire to become large.

Systematic "mistakes" *ex post facto*, where the buying stockholders regularly fail to benefit, suggest the predominance of managerial strategic and power interests in acquisitions. I admit that this subject remains debatable, with numerous points of great controversy, some of which I am neglecting (we're going to get a large dose of discussion of this subsequently).

My net conclusion, nevertheless, is that the managerial model has somewhat broader explanatory value than an optimizing model stressing efficient and inefficient management. It is still true that the undervalued firms and poor managers are in jeopardy and that there

---

is a discipline arising out of this fact. But so are good managers in jeopardy, increasingly so, and the market may allow ordinary or even weaker managers of firms with large resources to stay in business by extending their sway over performers sometimes better than themselves. In the context of the rise of a very active market for corporate control, this has a number of potentially serious, negative ramifications. One would be the erosion of a small company base in the system without any redeeming efficiency offset. Others would be increased management attention to protective strategies, accommodation to an efficient market—for short term earnings gains—and a further attenuation of long-run, long-term payoff, growth strategies. And it implies an unreliable mechanism for assuring pursuit of shareholder welfare.

V. Conclusion

Let me offer a few final conclusions. In my view, corporate standards of behavior and attention to the welfare of the shareholders are substantially greater today than they were in 1925. Some part of the credit for this should be assigned to the market, including the market for corporate control and the pressures of a more efficient securities market. But, part of the credit also goes to a higher standard of fiduciary responsibility accepted and pressed by a substantial fraction of the business community. Serious conflict abuses have always been hurtful to shareholders and to business efficiency. Coping with them has always been difficult because of the division of business opinion, a strong individualistic tradition, and distrust and ineptitude of government regulation. “Best practice” in American business has evolved slowly and painfully, with limited capacity to constrain socially destructive deviance, and spreading very slowly over time. In this context, I strongly recommend to you a book by Thomas Cochran, called The Railroad Leaders, 1840-1890, which describes the rise in standards of business practice in the railroad business, and the conflicts between those who saw conflict as damaging to the efficiency interests of the roads and the outsiders and raiders who were violating these principles, and who strongly resisted tacit and legal protections of shareholders and the public.

The events of the 1920s and 1930s created a political and moral climate in which an intricate set of business, cultural, and governmental regulatory factors were able to impose more compellingly what were, in many cases, ad hoc and informal business ideas of best practice. The elements in this new environment were enforced disclosure, legal constraints on insider trading, proxy access, the SEC as an institution, shareholder derivative suits, and a great deal of publicity.
Now much of this was unpleasant to the business community, but I contend that it tended to institutionalize and reinforce business’ best practice. I would also contend that the totality of these reforms worked in part through their sensitizing of boards of directors, and this was important in improving standards of corporate governance. It not only supplemented but helped to strengthen behavior patterns consistent with an efficient market. In this respect I agree with Mr. Siebert’s statements. He has argued that imposing rigid regulation would be bad, because businessmen were already evolving best practice. I think he misses a very important point, however, which is that it has been the whole climate of opinion, not just autonomous business practice, that has contributed to the process of evolution of standards. Government regulation was part of that process.

Let me conclude with a quote from the great historian R. H. Tawney in *Religion and the Rise of Capitalism*: “If the medieval moralist was often too naive in expecting sound practice as a result of lofty principles alone, he was at least free from that not unfashionable form of credulity which expects it from their absence or from their opposite.”
MANAGERS’ DISCRETION AND INVESTORS’ WELFARE:
THEORIES AND EVIDENCE

FRANK H. EASTERBROOK*

For the last fifty years, public discussion of corporations and public policy toward corporations have been dominated by the vision of Adolph Berle and Gardiner Means. Berle and Means portrayed managers as out of control. Berle and Means attributed this to the “separation of ownership and control”—another term for a division of labor in which some people specialize in risk-bearing through investment, while others specialize in management. When thousands of people hold investment interests in a firm, none has much incentive to oversee the managers. Each investor, rightly thinking that his efforts can do little, will be passive. The investors are scattered, uncoordinated, and helpless. They have ownership without control; the managers have control without ownership.

Berle and Means also thought that corporations were growing in size and influence. Their great size would give them power over consumers; they could charge “administered prices” without regard to competitive forces. The managers, responsible to no one, could exploit investors and consumers alike.

Berle and Means welcomed the emerging class of managerial technocrats. They saw specialist managers as a way of making corporations more efficient producers. They therefore proposed not control of managers by investors, but control of corporations by government. In the Berle and Means vision, technocratic managers would run the firms, making goods and services in ever-increasing quantities. Investors would be paid enough to keep them satisfied. Public regulators would direct corporate policy in the interest of society as a whole.

The goal of public control animated many of those who wrote and adopted the Securities Act of 1933 and the Securities Exchange Act of 1934. William O. Douglas worked to obtain for the SEC the power to make important decisions for the firms. Those who agreed

* Lee and Brena Freeman Professor of Law, University of Chicago. I thank Walter J. Blum, Dennis W. Carlton, Daniel R. Fischel, Geoffrey Miller, and Roberta Romano for helpful comments on an earlier draft. This article is part of a larger project, tentatively entitled The Economic Structure of Corporate Law, on which Daniel R. Fischel and I are working.

with Berle and Means stopped with half-a-loaf during the New Deal, however. The principal securities acts required disclosure yet avoided substantive regulation. The regulatory agencies were confined to overseeing particular industries, such as transportation and communications, rather than corporations in general.

Even the incomplete victories of the Berle and Means approach have come under pressure. Regulation is increasingly seen as the consequence of interest-group politics, in which the regulated firms themselves obtain regulation in order to forestall competition. A wave of deregulation in transportation, communications, and even the securities exchanges has led to new entry, lower prices, and pressure for still more deregulation.

The Berle and Means vision nevertheless lingers in the rhetoric of regulators, academics, and even corporate officials. All continue to emphasize the helplessness of investors in the face of managers. This is the underpinning of the ALI’s proposals on corporate governance.2

Although the ALI’s drafters do not set out their premises, their proposals and arguments seem to rest on the Berle and Means diagnosis of helplessness. They believe that managers have seized control, that investors are powerless, and that other forms of control (such as competitive product markets, competition among managers, and competition for corporate control) have failed.3 Nonetheless, they do not propose the Berle and Means cure of public control. They recommend instead that control be transferred from managers to “independent” directors, who will be a majority of the board and will review compensation and all significant dealings between managers and the firms. They view independent directors as a cure for “market failure.” They also recommend that some kinds of transactions be banned outright and that managers and investors alike be prohibited from adopting

2. The ALI has authorized the drafting of the Principles of Corporate Governance: Analysis and Recommendations, but the drafts to date are proposals of the Chief Reporter and his staff. Only a few have been discussed by the Institute, and none has been finally adopted. I refer to them as “the ALI’s proposals” with the recognition that this shorthand is not accurate.

3. See Principles of Corporate Governance: Analysis and Recommendations (Tent. Draft No. 2) at 54, 74-76 (1983). The draft not only fails to set out a clear approach but also appears to draw on contradictory premises. See Romano, Metapolitics and Corporate Law Reform, 36 Stan. L. Rev. 923, 956-63 (1984); Weiss, Economic Analysis, Corporate Law, and the ALI Corporate Governance Project, 70 Cornell L. Rev. 1 (1984). Things are clearer in the recent work of Melvin Eisenberg, now the Chief Reporter of the project. See Eisenberg, The Modernization of Corporate Law: An Essay for Bill Cary, 37 U. MIAMI L. Rev. 187 (1983), which is filled with unsupported assertions that managers and state law exploit investors and does not cite, let alone discuss, any contrary data and theory.
contracts at variance with the terms laid down in the ALI's model code.

The ALI's proposals remove control from self-interested managers, ignorant (and passive) investors, and bureaucrats dominated by interest groups. They place it in the hands of disinterested directors and disinterested judges. The drafters evidently hope that these two disinterested groups will achieve the benefits of knowledgeable management without the taint of self-interest.

There is a curious flavor to the Berle and Means vision. They (and the ALI's drafters) see the world as if everyone awakened one morning to find himself a manager or an investor. The veil of ignorance was suddenly parted. The manager stepped out and exalted: 'Aha! No one can stop me!' The investor gasped: 'Woe is me, I'm powerless. Only the ALI can save me now!'

This vision omits dynamic elements vital to an appreciation of corporate organization. Managers and investors do not wake up in this way. They assume their roles with knowledge of the consequences. Investors part with their money willingly, putting dollars in equities instead of debt, T-Bills, land, or gold because they believe the returns of equities are more attractive. Managers obtain their positions after much trouble and toil, competing against others who desire the same posts. There are no third-party effects; all interested people participate in the process, so the correct incentives are in play. Corporations are born small and grow. They must attract customers and investors by promising and delivering what those people value. Corporations that do not do so will not survive. When Berle and Means observe that firms are very large in relation to single investors, they observe the product of success in satisfying investors and customers.

My purpose in this paper is to identify some of the dynamic elements that the Berle-Means-ALI vision leaves out. I discuss some of the ways in which competition over the course of years and decades induces managers to act in the interests of investors, even if each investor is powerless.

A warning. None of the competitive devices is costless or perfect. Indeed, all are quite costly, and all together leave room for occasional fraud and managerial slack. We live in an imperfect world. There is bound to be some divergence between investors' interests and managers' actions. The ALI's proposals rest on the view that if markets have costs and imperfections, then we need legal rules to overcome them. This is a non-sequitur. The observation that there are costs requires us to ask further questions. How large is the divergence? Can it be reduced by new legal rules without incurring costs that exceed the benefits? These are empirical questions, and I offer some evidence that bears on them. The evidence is not conclusive, but it is powerfully
suggestive. It supports the conclusion that markets operating under current legal rules (such as prohibitions against fraud and general fiduciary duties) have been quite successful in aligning the interests of investors and managers.

Existing rules, enforced by private suits and the criminal law, are important in inducing managers to take care of investors' interests. Contractual promises of faithful service would be worth much less in the absence of these rules. But they are not the only safeguards, or even necessarily the most important ones. I discuss below three market mechanisms that also induce managers to act in the interest of investors. The first is the managers' desire to raise money, which they must do if they are to have anything to manage. To raise money, they must promise to control themselves and to act as honest agents of investors. The second mechanism is the market for the firm's stock and products. Managers must continue to run the firm well to avoid failing in these markets. If they fail, they soon will lose their jobs (or chunks of their compensation). Even managers with assurance of tenure must succeed in these markets to have funds they can appropriate. The third market is the one in "corporate control." Managerial teams monitor each other, and they wage proxy fights and tender offers if performance declines.

I. THE MARKET FOR CAPITAL: COMPETITION TO ATTRACT INVESTORS

A. Theory

I have sketched the Berle and Means theory above. Their approach starts with an assumption that managers act in their own interest rather than in that of investors, adds the fact that investors are too widely scattered to control managers, and concludes that managers' discretion is effectively unchecked (or at least "inadequately" checked). Having obtained control, managers will misuse their position. The investors need help.

A different theoretical tradition asks just how it is that managers came to control such resources. Berle and Means were not the first to notice that scattered investors can't control managers. The investors

4. The outstanding contribution is Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976). But this tradition is at least as old as that of Berle and Means. See Coase, The Nature of the Firm, 4 Economica (n.s.) 386 (1937). Other important contributions include
knew so, too. Indeed, the costs of divergence of interest ("agency costs of management") are common knowledge.

If the investors knew that the managers would have excessive discretion, why did they give their money to these managers in the first place? If managers promise to return but a pittance, the investors will not put up very much money. The investors simply pay less for the paper the firms issue. There is therefore a limitation on managers' efforts to enrich themselves at investors' expense. Managers may do their best to take advantage of investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart. It is almost as if there were an invisible hand.

The corporation and its securities are products to as great an extent as the sewing machines or other items the firm produces. Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of firm, governance structure, and securities people value. The founders of the firm will find it profitable to promise the governance structure that is most beneficial to investors, net of the costs of maintaining the structure. Managers who seek resources to control will have to promise more returns to investors. Those who promise the highest returns, and make the promises binding, hence believable, will obtain the largest investments.

The first question facing managers is what promises to make, and the second is how to induce investors to believe the promises. Empty promises are worthless. Answering the first question depends on finding ways to reduce the effects of divergent interests; answering the second depends on finding legal and automatic enforcement devices.

---

The more automatic the enforcement, the more investors will believe the promises.

What promises will the managers make to induce investors to hand over more money? It should be plain that no one set of promises is suited for all firms at all times. No one thinks that the governance structure used for a small business will work well for Exxon. The "best" structure cannot be derived from theory; it must be developed by experience. We should be deeply skeptical of claims that any one structure or class of structures is best. But we can see the sorts of promises that are likely to emerge in the competition for investments.

Some promises may entail submitting to scrutiny in advance of action. The managers may set up prior monitoring. Outside directors may watch inside ones; inside directors may watch other managers; managers may hire detectives to watch the employees. At other times, though, prior monitoring may be too costly in relation to its benefits, and the most desirable methods of control will rest on deterrence, on letting people act as they wish but penalizing certain conduct. Fiduciary obligations and derivative litigation are forms of subsequent settling-up that are among these effective protections of the agency relation. Still other methods operate automatically. Managers enjoy hefty salaries and perquisites of office; the threat of losing these can induce managers to act in investors' interest.

Managers select the state of incorporation. States offer different menus of devices (from voting by shareholders to fiduciary rules to derivative litigation) for the protection of investors. The managers who pick the state of incorporation that is most desirable from the perspective of investors will attract the most money. The states that select the best combination of rules will attract the most corporate investment (and therefore increase tax collections). So states compete to offer, and managers compete to use, beneficial sets of legal rules. These include not only rules about governance structures but also fiduciary rules and prohibitions of fraud.

Managers select when to go public. Less experienced managers start with their own money or with venture capital, which comes with extensive strings. The venture capitalists control the operation of the firm with some care. Only after the managerial team and structure have matured will the firm issue public securities.

Managers make promises in the articles of incorporation and the securities they issue when they go public. The debt investors will receive exceptionally detailed promises in indentures. These promises will concern the riskiness of the firm's operations, the extent to which earnings may be paid out, and the domain of managerial discretion. These promises benefit equity investors as well as debt investors. The equity
investors usually receive votes rather than explicit promises. These voting rules make it possible for the investors to replace the managers. (Those who believe that managers have unchecked control should ask themselves why the organizers of a firm ever issue equity claims that enable the investors to replace the managers.) The managers also promise, explicitly or otherwise, to abide by the standards of “fair dealing” embedded in the fiduciary rules of state law. Sometimes they make additional promises.

To sum up: self-interested managers, just like other investors, are driven to find the devices most likely to reduce agency costs. If they do not, they pay in lower prices for corporate paper. Any one firm may deviate from the optimal measures. Over tens of years and thousands of firms, though, tendencies emerge. The firms and managers that make the choices investors prefer will prosper relative to others. Because the choices do not impose costs on strangers to the contracts, what is optimal for the firms and investors is optimal for society. We can learn a great deal simply by observing which devices are widely used and which are not.

It is important to distinguish between isolated transactions and governance structures. There are high costs of operating capital and managerial markets, just as there are high costs of other methods of dealing with the agency relation. It is inevitable that a substantial amount of undesirable slack or self-dealing will escape punishment by markets. The question is not whether this occurs, but whether the costs of this shirking can be reduced by mechanisms that are not themselves more costly. We accept some costly conduct because the costs of the remedy are even greater. We also use deterrence (say, the threat of punishment for fraud) rather than other forms of legal control when deterrence is the most economical method of handling a problem.

Markets that let particular episodes of wrongdoing slide by, or legal systems that use deterrence rather than structural change to handle the costs of management, are likely very effective in making judgments about optimal governance structures. Governance structures are open and notorious, unlike the conduct they seek to control. Costs of obtaining information about a firm’s governance are low. Firms and teams of managers can compete with each other over time to design governance structures and to build in penalties for malfeasance. There is no substantial impediment to the operation of the competitive process at the level of structure. Contractual promises and fiduciary rules arise as a result of these considerations.

5. For an analysis of why voting rules are as they are, see Easterbrook & Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395 (1983).
B. Evidence

It is not easy to test the divergent theories presented above. Testing depends on finding differing predictions about observable things, and these are rarer than one might think. Suppose Berle and Means are right, and managers will not implement the governance structures that are most beneficial to investors but instead select rules that make shirking and appropriation of investors’ funds easy. This implies that securities in firms sell for less than they would fetch if managers made enforceable promises to act in investors’ interests. Yet how could we detect this?

We cannot measure this gap by comparing one firm against another, because each firm is a unique bundle of assets, prospects, and managers. We also cannot compare the price of, say, Apple Computer stock under optimal governance structures with its actual price. We cannot even compare the consequences to investors of putting money into the hands of exploiting managers versus the consequences of entrusting money to “better” managers (or managerial teams that have established better governance structures). Because no group of managers has power in the market for capital assets, the investors would do equally well entrusting money to either group. They would just pay less in the first instance for the stock of the firms that had inferior structures.

One type of inquiry that might help to differentiate the theories is whether firms adopt “investor protection” policies in the absence of legal compulsion to do so. There is substantial evidence along these lines.

Firms voluntarily arrange with debt investors to restrict managers’ discretion. The promises in indentures—most of them wholly contractual—are extensive. Firms voluntarily issue equity securities with voting rights attached, even though these rights allow the investors to evict managers. Firms could confine voting securities to the managers themselves, issuing only nonvoting stock to outside investors, but they do not. They vote on many issues, such as the level of executive compensation, on which the decision of the board would be binding even without shareholders’ approval. Firms place “disinterested” directors on their boards in large numbers, although no law requires this.

6. The New York Stock Exchange declines to list the securities of firms with nonvoting common stock. This is a wholly private arrangement. No rule requires it, and other exchanges (such as the American) do not have the same requirement.
These directors, and others invited onto the board by managers, frequently out their former patrons and bring in new managers because they conclude that the existing ones are no longer best for the firm.

Long before federal law required annual audits by independent accountants, every firm listed on the New York Stock Exchange had such annual reviews. Indeed, auditing has existed for as long as firms have existed.7 Similarly, firms made extensive disclosures to investors well before state and federal law required such disclosures. To a substantial degree, federal law simply codified the accepted disclosure practice of the established investment banks and underwriters.8 Today, despite the many rules requiring disclosure of particular facts, two thirds of large corporations' disclosure expenditures are incurred to supply information in excess of that required by law.9

All of this evidence suggests that managers do not need legal commands to induce them to establish governance structures that serve investors' interests. Nonetheless, the evidence is rather impressionistic. How much independent auditing is the "right" amount in the investors' interest? Was the amount of disclosure before 1934 the "right" amount, or is it "right" now? (Maybe neither is optimal.) How can we know whether firms are acting to assist investors or to stave off further legal regulation?

Evidence from the stock market provides a cleaner test. Firms can increase the price of their stock by selecting articles of incorporation and other "constitutional" rules beneficial to investors. Although we cannot observe the effects of these provisions directly at the time

---


8. This is one reason, among many others, why the apparently promising approach of seeing whether investors have done "better" after the securities acts does not reveal whether managers act optimally in investors' interests without legal compulsion. See Easterbrook & Fischel, Mandatory Disclosure, supra note 4, at 707-14, for a summary of the evidence developed in such comparisons and an assessment of why the data are not illuminating.

firms first go public, we can observe the effects of changes. One important "constitutional" choice is the state of incorporation. State law provides many of the rules by which the firm operates day to day. Most of these are just "fallback" rules that govern when the articles are silent; a few are mandatory. State law also includes the fiduciary principle, a guarantee of honest and "fair" dealing when firms do not spell out in the articles exactly how certain transactions will be handled. Both the statutory and fiduciary rules vary slightly from state to state, so the place of incorporation will influence investors' welfare.

For several decades, Delaware's law has afforded managers the greatest discretion. The statutory law allows almost unlimited alteration of rules in the articles and bylaws, which managers control. And the Delaware fiduciary principle allows most forms of self-dealing transactions, so long as the terms approximate those that might be reached in arms' length bargaining. In Delaware managers may pursue "corporate opportunities" after obtaining the board's consent, and they may engage in mergers, going-private transactions, and other deals that squeeze out public shareholders at prices set largely by the managers. These and other features of Delaware law led scholars in the Berle and Means tradition to conclude that Delaware had won a "race for the bottom."\textsuperscript{10} By enhancing managers' discretion, they argued, Delaware had sacrificed investors' interests.

This is a wonderfully testable proposition. Delaware law increases managers' discretion. If the Berle and Means hypothesis is correct, firms that move their place of incorporation to Delaware do poorly for their investors. Lower expected earnings will lead to lower prices in the stock market.\textsuperscript{11} If, on the other hand, markets constrain managers to act in investors' interest, then a move to Delaware would be neutral or even lead to an increase in the price of stock.

\textsuperscript{10} See Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663 (1974). The flexibility and managerial discretion to which Cary objected continue to characterize Delaware law. On the statutory side, see, e.g., Del. Code Ann. tit. 8, § 141 (board may delegate), § 144 (standards of self-dealing conduct), § 228 (majority may act without meeting), § 251 (limits on shareholders' role in mergers), § 262 (limits on appraisal remedy). On the judicial side, see, e.g., Aronson v. Lewis, 473 A.2d 805 (Del. Sup. 1984) (strong business judgment rule protects discretionary decisions unless director is on both sides of transaction); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. Sup. 1983) (approving freezeout mergers in principle, limiting judicial inquiry, and holding appraisal remedy exclusive in absence of fraud); Field v. Allyn, 457 A.2d 1089 (Del. Ch. 1983) (approving leveraged buyout; applying "equal dignity principle" to allow managers to choose the least-restricted way to conduct any transaction).

\textsuperscript{11} The price of stock depends on investors' evaluation of their future returns.
Peter Dodd and Richard Leftwich looked at what happened to the investors in the 140 firms listed on the New York Stock Exchange that had moved their place of incorporation to Delaware between 1927 and 1977. They found these firms were doing better than expected before the move (that is, their stocks were rising compared with portfolios of similar stocks), that the price of their stock rose still further in the month the move was announced, and that the price continued to rise after the move. The total unexpected gain was about 2.9% in the eighty days surrounding the move, 11.65% over a longer period. The verdict of investors: an increase in managers' discretion was beneficial, not detrimental. This is a substantial challenge to the Berle and Means hypothesis, substantial support for the hypothesis that markets induce managers to act in investors' interest.

This does not mean that more discretion is always better. It means, rather, that the existence of choice, of ability to elect a high-discretion system, is beneficial. For many firms at many times, it is advantageous to hem in managers' discretion. One need only think of close corporations to see why and to see restrictions in practice. The existence of different ownership structures also implies the utility of different legal

Reduce the expected returns, holding other things constant, and the price of stock will fall. Increase the returns and it will rise. All of the stock market research reported below uses this principle. It holds constant other changes in the economy and particular industries by identifying the difference between how a firm's stock does on a day when there is "news" and how it would have been expected to do—given its past volatility and relation to the rest of the market—had there been no news specific to the firm. See Schwert, Using Financial Data to Measure Effects of Regulation, 24 J. L. & Econ. 121 (1981), and Brown & Warner, Using Daily Stock Returns: The Case of Event Studies, 14 J. Fin. Econ. 1 (1985), for an explanation of the method.

This approach does not depend on stock prices being efficient in the sense that they correctly reflect all information about each firm. It rests, rather, on the assumption that the degree of accuracy does not change radically over short periods. Thus if the price of stock rises 1% relative to expectations, and the new price is not "more accurate" than the old, it is appropriate to conclude that the increase reflects "good news" worth approximately 1% of the equity in the firm. Because prices of stock are substantially influenced, if not determined, by the professional investors who have prompt access to news and who control pools of capital that they can shift rapidly from one stock to another, it is unlikely that any bit of information about a firm (or category of firms) could cause a sudden change in the extent to which prices reflect real values. Thus the implications laid out in the following text are adequately supported by the methodology. See also R. Brealey, An Introduction to Risk and Return from Common Stocks (2d ed. 1983), [hereinafter cited as R. Brealey] for information on the methodology and its reliability.

structures, so that managers and investors can choose the legal structure best suited to their needs. One recent study showed that both "loose" and "strict" laws can be advantageous for different kinds of firms, and that firms migrate to the states whose legal structures are best adapted to the firms' ownership structure.13

It is possible to examine the effects of adding discretion-increasing rules to articles of incorporation. Financial economists are performing such studies in increasing numbers. So far the results are mixed, as we should expect in light of the fact that more discretion is not always better. Some studies find gains for investors. But studies of "shark repellent" amendments to charters—that is, provisions giving managers greater discretion to defeat tender offers—come to conflicting conclusions.14 It seems safe to say that studies will find examples of some managerial conduct harmful to shareholders. This is not surprising. As I said above, markets do not perfectly align the interests of managers and investors. Nonetheless, the findings to date have two aspects. They suggest (a) that the provisions in the articles at the time the firm issued stock were valued by the investors, and (b) that the

13. See Baysinger & Butler, The Role of Corporate Law in the Theory of the Firm, in 28 J. L. & Econ. 179 (1985) (showing that firms with scattered shareholders select and gain from incorporating in "liberal" states, while the more concentrated the investments the more likely a firm is to select and gain from incorporation in a "strict" state). For other confirming evidence on the benefits of competition among jurisdictions see Butler, Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges, 14 J. Legal Studies 129 (1985); R. Romano, Some Pieces of the Incorporation Puzzle (draft Nov. 1984).

14. DeAngelo & Rice, Antitakeover Charter Amendments and Stockholder Wealth, 11 J. Fin. Econ. 329 (1983), uses data on daily prices and concludes that announcement of such amendments harms stockholders, although the firms making such changes generally have stocks rising relative to market. This may be interpreted as evidence that such firms are perceived as targets (hence the rise in price) but that the amendments decrease somewhat the value of this chance to investors. Linn & McConnell, An Empirical Investigation of the Impact of "Antitakeover" Amendments on Common Stock Prices, 11 J. Fin. Econ. 361 (1983), uses monthly price data and concludes that the amendments are associated with price increases. The differences in the data make the two studies not contradictory, but they leave unanswered whether increased managerial discretion here helps or harms investors. A study by the SEC released in November 1984 shows that different anti-takeover amendments have different effects, some negative and some positive. One possible conclusion is that managerial discretion to defeat the market for corporate control is harmful to investors. See Part III below.

Bhagat, The Effect of Pre-Empitive Right Amendments on Shareholder Wealth, 12 J. Fin. Econ. 289 (1983), and Bhagat & Brickley, Cumulative Voting: The Value of Minority Shareholder Voting Rights, 27 J.L. & Econ. 339 (1984), find that changes in certain rules (the elimination of preemptive rights and cumulative voting) are associated with declines in the price of stock. These rules are not obviously tied to "managers' discretion" in running the firm; indeed, it is not clear just how preemptive rights and cumulative voting affect managers' conduct.
provisions the managers later selected were less highly valued. The findings confirm that managers initially picked "good" rules and indicate that the later change was undesirable. Perhaps such findings indicate the utility of rules of law that make changes in the articles difficult and scrutinize them carefully. Opportunism by managers seeking to breach the optimal contract provisions written when a firm goes public may be a significant problem.15

It would be nice to have still further studies. Few if any firms include in their constitutional documents any inhibitions on insiders' trading in stock. It is sometimes said that this demonstrates that managers are willing and able to take advantage of investors. If the market were operating properly, the argument runs, managers would have limited their compensation to such publicly approved forms as salary, bonuses and stock options. Henry Manne and others have argued in response that firms do not prohibit such trading by contract because inside trading is beneficial to investors.16 Just to confuse things, I have argued that even if insider trading is harmful to investors, we should not expect to see contracts prohibiting it, because the contracts are too costly to write and enforce.17

These and other controversies about the effectiveness of the market in extracting optimal promises from managers raising capital could be illuminated by further empirical work. Financial economists are designing and executing some of these tests. It is therefore premature to say that the evidence proves or disproves any particular assessment of the effects of managers' discretion.

15. The hardest questions in corporate law concern arrangements that are adopted or changed after the firm is under way and the capital has been raised. Shareholders' approval of changes is likely to be unreliable as an indicator of their interests, because scattered shareholders in publicly-held firms do not have the time, information, or incentives to review all proposed changes. Thus doctrines of corporate law refusing to allow shareholders to ratify waste (except unanimously) are well-founded. Yet the rules for amending the rules are themselves part of the original articles, and it is (or should be) possible to draft limitations on amendment. These most commonly take the form of provisions designating some amendments as transactions from which investors may dissent and demand appraisal. Moreover, amendments to governance structures may spark proxy contests in which investors' attention is focused, and they also may call forth takeover bids. On this reasoning, provisions for governance set out in amendments to the articles should be fully enforced. This is not the place to resolve such difficult issues, if they can be resolved at all.


The evidence does, however, support this more limited claim: Markets induce managers seeking funds to promise investors governance structures that investors value, and the data do not reflect ability on the part of managers to inflict systematic harm on investors by selection of governance rules. An increase in managers' discretion does not automatically lead investors to revise their estimates of return downward. Even so modestly put, the data inflict heavy blows on the Berle-Means-ALI hypothesis.

II. PRODUCT AND STOCK MARKETS: COMPETITION TO GENERATE PROFITS

A. Theory

From the Berle and Means perspective, managers need pay investors just enough to keep the wolf from the door. The rest of the profits they may keep for themselves. They will do this both by receiving excessive salary and by appropriating information from the firm, whether by engaging in inside trading or by allocating corporate opportunities to themselves. They will consume excessive perquisites, which may take the form of needless fringe benefits (corporate jets for personal pleasure) or power over others (arbitrary hirings, firings and decisions regarding what to make and where to make it).

Berle and Means, like the ALI's drafters, portray competition, after the firm is in business as ineffectual to induce managers to act in investors' interests. Disinterested directors, the ALI reasons, will not allow managers to keep the proceeds for themselves. They will compel managers to forego self-dealing and to keep their noses to the grindstones.

No one denies that managers can set up perquisites, act in arbitrary ways, or make inferior decisions. There are plenty of examples of these things. The question is not whether managers have discretion, but

---

18. Harold Demsetz has made a strong argument that managers who are also substantial investors are more likely to take their income in perquisites (fringe benefits and arbitrary authority) than are other managers. Demsetz reasons that the owner-manager can obtain both tax benefits and on-the-job consumption from this strategy. The owner-manager will consume on the job when this is more valuable to him than the consumption at home that could be purchased with equivalent after-tax income. A non owner-manager gets only the consumption value of perquisites, which may be less than the value of money converted to consumption at home. Demsetz, The Structure of Ownership and the Theory of the Firm, 26 J. L. & Econ. 375 (1983) [hereinafter
how much they have, and whether this amount can be reduced by legal rules that are worth the cost. The answers depend on whether “automatic” devices are effective in reducing, although not eliminating, the divergence of interest between investors and managers once the firm is under way. The argument that there are effective “automatic” devices follows.

After they have raised capital, the managers depend on the firms’ profits for their salary and perquisites. Even if the managers’ inside position gives them great ability to take advantage of the investors, they still find it advantageous to run the firms so as generally to maximize profits. Then there is a larger kitty into which they can dip. This may show up in the value of stock holdings and bonuses; in the longer run it controls salary as well.

From this perspective the question is not how to overcome the effects of managers’ self-interest but how to put that self-interest to good use. Self-dealing transactions are one method of curtailing agency costs. To see why, consider the essential contradiction of the agency relation: the principal wants to hire the agent’s dedicated service, yet the agent’s loyalty remains largely to his own interests. To induce the agent to pursue the principal’s interests, the principal must promise the agent a reward for success; yet the reward is itself a reduction in the principal’s return, a cost of the agency relation. The greater the reward for success, the more dedicated the agent to the task and the better the result in pursuit of the principal’s goals; yet the greater the reward, the less desirable the whole arrangement for the principal. There is a delicate balance. Some gains must be apportioned to the agent, some to the principal. Like all balancing efforts, there is no one “right” answer. Which apportionment methods work best—or work least poorly—is determined by observing which lead to success in the market.

The appeal to the agent’s self-interest is an indispensable ingredient in making the agency relation work. The trick in constructing a corporate governance structure is to align the interests of the agents with those of the investors, not to pretend that self-interest is a pestiferous thing to be conquered. In large firms managers hold stock (and are paid in stock options, phantom stock, and bonuses) so that managers’ prosperity depends on the success of the equity investors.

cited as Demsetz]. Certainly many of the customary examples of high-handed management (Henry Ford is a prime example) come from firms in which the manager was owner as well. Nonetheless, it is not necessary to pursue this insight here.
Similarly, the trustee under a bond indenture often is a large bank that independently loans money to the firm. This makes the trustee’s reward depend on the repayment of the firm’s debt, and it also induces the trustee to gather information and superintend the managers.

The promise of advancement within the managerial structure also aligns interests. Those most interested in advancement are the second and third tier of managers. These people not only want to move up but also have the best information about how the higher-ups are doing. They are therefore one logical group of watchdogs in the investors’ interest. The investors gain if they are present on the board of directors, serving in that role. On this logic, a reduction in the number of “inside” directors, to make room for independent directors who have both less information about the firm and less reason to insist that the top managers perform up to standard, would be a step backward.

Some number of disinterested directors could serve a watchdog role too, because these would be particularly effective in monitoring the kinds of conflicts of interests that firms deliberately create in order to improve the incentives of managers. Nothing in this line of argument suggests that there is something “wrong” with outside directors. But the number of such directors that will benefit the firm is an empirical question. Outsiders give the firm an improved ability to monitor conflicts; outsiders cost the firm some of the self-interest that drives directors to find and pursue profitable business ventures. They, too, face an agency cost: diligence versus leisure. Their very disinterestedness makes leisure and carelessness more attractive. The outsiders also know less about the business than the interested directors. If they work substantially full time at the firm to acquire information, they become “inside” directors; if they do not spend substantially full time at the firm, though, they will never know enough to fulfill their monitoring functions. You can’t run General Motors on ten hours a month.

This analysis suggests that, although there are functions for independent directors (which is why firms voluntarily have them), the functions are quite limited. The less-knowledgeable, non-interested directors may serve as passive evaluators of the performance of managers, and they may be able to initiate changes in the managerial team if performance falls off or the interest-alignment devices malfunction. It is unlikely, though, that outside directors could make investors

---

better off by reviewing most transactions in advance; their distance from the firm and their lack of interest ensures that they will not know enough to make discriminating choices.

There are other forms of control that do not appeal to the self-interest of managers. Professional investors continuously monitor ongoing firms, because they (or the funds they represent) have large sums at stake. When their assessment of the managers’ dedication and performance falls, the price of the stock falls too. The lower price makes it harder for the firm to raise new capital in competition against other firms with more dedicated managers, and this puts great pressure on managers to improve. The higher the price of capital, the higher the firm’s cost in making and supplying goods. The higher its cost, the less it can sell in competition with other firms that adopt superior management-control devices. It also makes less per sale. Lower profits mean diminished ability to divert benefits (and increased chance of replacement).

Although this chain from lower stock prices to lower sales to new managers seems a bit long, nothing in the economic treatment suggests that the effects occur immediately. The consequences of inferior managerial structures may take years to come home to roost when the performance is only “a little” sub-par. Yet recall that we are examining how markets influence governance structures, not particular acts of managers given the governance structure. The ALI proposes new governance structures, not new managers. The governance structures of firms are the product of decades of evolution under competitive pressure. Market forces that operate “in the long run” are exactly the forces that determine governance structures.

Back to capital markets. Other participants there also act as surrogates for the investors. The stock exchanges flourish when trading volume is high. The willingness of people to trade depends in large measure on their belief that they will get a fair deal. Thus it is in the interest of stock exchanges to establish rules for the protection of investors, and managers who seek to attract money will submit to these rules to obtain the benefit of being listed with other firms similarly constrained. All stock exchanges have significant listing rules and had them before the advent of regulation in 1934. For example, firms listed on the NYSE must obtain the approval of shareholders before issuing new stock exceeding 18% of the value of outstanding stock, and all stock must have voting rights; listed firms also must make certain timely disclosures and have audit committees.

The investment banks and underwriters through which firms issue
stock seek to maintain their own reputations. Accordingly, they make
careful inspections of managerial quality and the accuracy of representa-
tions before they sell the firm’s stock to the public. To obtain the
endorsement of these firms, managers must make believable pledges
to act in the investors’ interests.

Competition in product markets has a similar effect. When
managers’ performance falls off, the firm’s profits also fall off. Other
firms, with more capable managers, will make the sales and the pro-
fits. This has two consequences. One works through the price of stock
and the monitoring of market professionals. A drop in the price of
stock implies higher cost of capital and still greater difficulties in product-
market competition. The other is that when profits drop, managers
simply have less they can divert to themselves. Even the managers
with the greatest discretion over the disposition of the firm’s income
must produce income before they can dispose of it.20

There is, finally, competition for the position of manager. In order
to obtain desirable positions, would-be managers will offer to work
for the competitive wage. Those who offer the best deal to the firm
ultimately end up in control, just as those who offer to sell other in-
puts (whether steel or office space) on the most attractive terms end
up as suppliers. Even if the most senior managers are in a position
of complete control, they have no reason to let junior managers skim
off profits. The senior managers therefore place their juniors under
effective controls in order to keep the most for themselves. When the
juniors are promoted, the controls stay in place, and the investors
receive the benefits of the process.

B. Evidence

So much for the theory. What of the evidence? Once more it
is hard to design tests in which the Berle- Means- ALI and investors’-
welfare approaches give significantly different predictions. One can
show, for example, that stock market prices change quickly and
reasonably accurately to reflect available information about firms.21

One possible inference is that the disciplinary mechanism discussed
above (self-centered managers drive down prices, and this in turn

20. For a formal demonstration of how this induces managers to act in
investors’ interests, see Hart, The Market Mechanism as an Incentive Scheme, 14 Bell
J. Econ. 366 (1983).

21. See R. Brealey, supra note 11; J. Lorie & M. Hamilton, The Stock
Market: Theories and Evidence (1973). Reasonably accurate is not perfectly ac-
curate, but here (as in horseshoes) close is good enough. See Gilson & Kraakman,
penalizes the managers for various reasons) is effective. The adherent of the Berle-Means-ALI position could concede the stock price effect, though, without conceding the effect of prices on managers' conduct.\textsuperscript{22} Some other test—outside the stock market—is therefore necessary.

Stock Ownership. One quick and dirty approach is to see whether managers believe they have the power to exploit investors. If managers believe the Berle-Means-ALI hypothesis, they will not invest in the stock of the firms they manage. Why should they pick their own pockets?

It turns out, however, that managers own stock—great quantities of stock. And the larger the firm, the more stock the managers own. Harold Demsetz computed the stock holdings by managers of firms from 1973-82. He found that the managers of the ten largest Fortune 500 firms owned outright an average of $151,621 of their firms' stock.\textsuperscript{23} Managers of middle Fortune 500 firms owned an average of $124,560 of their firms' stock. The managers of the bottom ten in the Fortune 500 owned only $27,134 of their firms' stock on average. The "top" managers of all of these firms own substantially more, often millions of dollars worth. And data show that the value of firms rises when they adopt compensation plans increasing managers' ownership interest.\textsuperscript{24}

It is important to distinguish ownership by value from ownership by percentage. As firm size increases, managers own smaller percentages of all outstanding stock. This is what Berle and Means reported and what Edward Herman confirms is still true.\textsuperscript{25} The divergence in percentage of ownership is the source of the cost of the agency rela-

\textsuperscript{22} Oliver Williamson reports that a decline in profits is associated with a sharp reduction in the consumption of perquisites, such as "excessive" staff, that managers may prefer to compensation and may be able to employ when market discipline is weak. Managerial Discretion and Business Behavior, 53 Am. Econ. Rev. 1032 (1963). This suggests a direct effect of profits on managerial conduct. Other studies find a similar effect as either product market competition or potential competition for corporate control increases. E.g., O'Hara, Property Rights and the Financial Firm, 24 J. L. & Econ. 317 (1981).

\textsuperscript{23} Demsetz, supra note 18, at 388. This is one of the most modest estimates I could find. Edward Herman and even Ralph Nader report larger figures. E. Herman, Corporate Control, Corporate Power 91-95 (1981) [hereinafter referred to as Herman] (holdings averaging $920,000 in 1974-75); R. Nader, M. Green & J. Seligman, Taming the Giant Corporation 116 (1976) (chief executives of largest corporations own average of $1,566,009 of firm's stock).

\textsuperscript{24} Brickley, Bhagat & Lease, The Impact of Long-Range Managerial Compensation Plans on Shareholder Wealth, 11 J. Accr. & Econ. 115 (1985).

\textsuperscript{25} Herman, supra note 23, at 87-93.
tion. Yet for many purposes the absolute quantity of stock ownership may be as important as the percentage of the firm's stock managers hold. Suppose a manager with an annual income of $200,000 and $2 million of wealth holds half of his wealth in the stock of his employer. Then a 10% drop (from $1 million to $900,000) in the market value of his stock is equivalent to a 50% reduction in salary. The stock ownership quickly brings home the consequences of the firm's doing well or poorly. It aligns the manager's interests with those of the stockholders, inducing the manager not only to perform well himself but also to ensure that other managers do likewise. The manager feels the consequences of price changes more quickly than an ordinary stockholder, whose portfolio will be more diversified and who therefore cares more about the market as a whole than about the prospects of a single firm.

Sources of Compensation. Stock ownership is not the only device aligning managers' interests with those of equity investors. Managers also design stock option plans (the right to obtain stock in the future at today's price, creating a "bargain" if the price rises) and phantom stock plans (bonuses paid according to increases in the price of stock). These and other stock-based compensation plans do not show up as stock currently "owned" by the managers, but they have similar effects.

The hypothesis that market forces induce managers to act in investors' interests predicts that a substantial portion of managers' compensation will come through devices based on the price of stock. Managers will get paid only to the extent (other) investors do well. The Berle-Means-ALI hypothesis predicts, to the contrary, that managers' compensation will come in salary, bonuses, perquisites, and other forms that are at least potentially at the expense of investors.

The evidence supports the investors' welfare hypothesis. Wilbur Lewellen reported in 1971 the results of a survey of compensation patterns at 50 of the largest manufacturers, 15 of the largest retailers and 15 small manufacturers, between 1940 and 1963. He separated the managers' compensation into cash-based (salary, loans, pension contributions, and the value of perquisites) and stock-based (dividends, appreciation or depreciation of shares owned, and the value of options). He found that for the top managers of the largest firms, the after-tax value of the stock-based compensation was three to five times the after-tax value of the other compensation.26

Surveys covering more recent years confirm the dependence of total managerial compensation on the performance of the firm's stock. George Benston's survey of the earnings of managers of 29 large conglomerates in 1970-75 shows that stock-based compensation dominated other forms of remuneration. Benston added stock- and cash-based returns. In years when the firms' stock rose 30%, these executives made more than $1 million apiece; in years when the stock fell by that amount, they lost more than $1 million apiece. Other surveys show similar dominance of stock performance in the total compensation package.

Relation Between Performance and Compensation. The Berle-Means-ALI hypothesis and the investors' welfare hypothesis make different predictions about the relation between managers' compensation and the performance of their firms. Berle and Means predict rewards for absolute size, because managers of larger firms have control over more resources (there is more to divert), yet investors' control is diluted. They predict little or no reward for performance, because managers with control can pay themselves no matter what and need not attend to investors' interests. The investors' welfare hypothesis predicts rewards for both size and profit. The reward for size comes about because larger pools of assets call for the supervision of higher-quality managers, and firms must pay for the extra skills they need. The reward for profit serves as the spur for managers to act in investors' interests.

The data strongly support the investors' welfare hypothesis. Managers' compensation depends on both size and profit. There are so many studies of this relation that I report only three of the most recent.

27. Benston, The Self-Serving Management Hypothesis: Some Evidence, 11 J. Acct. & Econ. 67 (1985). The actual figures for years when stocks generally declined: $1,328,000 average loss in 1972; $715,000 average loss in 1971; $710,000 average loss in 1974. For high-growth years: $1,138,000 average gain in 1971; $1,735,000 average gain in 1975. For all years and outcomes, the value of stock changes swamped salaries by a ratio of five to one.

28. See also W. Baumol, Business Behavior, Value, and Growth (1967).

29. A manager does more for investors by taking a $10 billion firm from 6.5% to 6.7% return on investment than by taking a $1 billion firm from 10% to 11% return. Because compensation should be related to the manager's marginal influence on the absolute return, it is necessary to look with caution at studies that estimate average (rather than marginal) profits or examine rates of return on investment.

30. See Jensen & Zimmerman, Management Compensation and the Managerial Labor Market, 11 J. Acct. & Econ. 3 (1985), for an overview. Existing surveys in the legal literature overlook most of these studies, and so they underestimate the power of market
Barry Harris looked at the compensation of managers of 19 firms in the food industry (all in the 250 largest of the Fortune 500) from 1952-72. He found that a 1% increase in sales was associated with a 0.45% increase in executive compensation, and that a 1% increase in accounting profits was associated with a 0.23% increase in executive compensation.³¹ Kevin Murphy looked at the compensation of 366 executives from 57 of the largest manufacturing firms. He found that a 1% increase in revenues was associated with a 0.18% increase in total earnings (salary, bonus, and the value of new stock options), and that a 1% increase in the rate of return on assets was associated with a 0.15% increase in earnings.³² In both studies, reductions in sales, profits, and return on assets brought corresponding reductions in compensation.

The most interesting of the recent studies has been performed by Rick Antle and Abbie Smith. They looked at the three highest-paid executives in 39 large firms between 1947 and 1977. They inquired whether compensation (which they defined as the after-tax value of salary, bonuses, stock options, pension contributions, stock holdings, and some other ingredients) depended on the performance of the firm relative to other firms in the same industry. Many managers can obtain "average" performance, they reasoned; if every firm in an industry is prospering (or failing), there is nothing special for which its managers should be rewarded (or penalized). If, on the other hand, some firms stand out in profit (or loss), the managers should reap the rewards of their success (or failure). They found that about 65% of the variance in total executive compensation can be explained by differences in the firms' return on assets (that is, that compensation strongly depends on performance), and that most of this variance also depends on performance relative to the rest of the industry.³³ This strongly supports the investors' welfare hypothesis.


Many of these studies show little relation between managers' salary and their firms' performance. Some people find this conclusion and infer that the market for managerial services does not work well. It is always necessary to adjust, as the studies I have mentioned do, for other aspects of managers' compensation. A rule restricting the fluctuation of salaries has many attractions to a firm. It provides managers with some income through times thick and thin, while changes in the value of managers' portfolio of holdings provide the incentive for better performance.

Relation Between Performance and Structure of Ownership. The Berle- Means-ALI hypothesis has implications for the effect of the structure of ownership on profits, managerial compensation, and the like. If inability of investors to control managers is deleterious, we would expect that as firms grow and holdings become more widely scattered, the performance of managers would decline, and with it the firm's profits. On this view managers' compensation would rise as the degree of investors' control declined. To the extent these implications depend on effects through the level of profits, they have been tested above and found wanting because compensation depends strongly on profit. It is possible to test them more directly, too.

One way to do this is to construct the relation between size of firm and managerial compensation and to determine whether the concentration of ownership affects the relation. We expect managers' compensation to rise with the size of firms, for reasons already explained. The question, then, is whether the managers of firms without effective investor oversight do better than might be expected from knowing the size of assets alone. George Stigler and Claire Friedland, using data available to (but unused by) Berle and Means, found that they do not. They found that in a regression of salaries on the logarithm of assets, control type (management-controlled, shareholder-controlled, etc.) had no effect. Herman reports a similar conclusion.

Stigler and Friedland also inquired whether the profitability of firms depended on the concentration of control. The utility of 'profit' studies is open to serious question because of the great difficulties in interpreting accounting numbers. Nonetheless, to the extent there are useful profit data, the prediction of the Berle and Means approach

35. Herman, supra note 23, at 112.
is unambiguous: the less control investors have, the more the managers will shirk, divert opportunities, consume perquisites, etc., and thus the lower the profit per unit of investment. Stigler and Friedland examined four sets of data for different industries and different years. In only one of these was there a significant effect of the sort predicted by Berle and Means.36 And when this group of firms was re-evaluated using a slightly different format (using as an independent variable the percentage of shares controlled by the 20 largest investors, rather than a dichotomous owner vs. manager control variable) the effect vanished.

A different source of data suggests that control by managers is not fatal to profits. An extensive literature in antitrust reports findings that larger firms, and those in more highly concentrated industries, consistently obtain profits exceeding those of smaller firms.37 It also turns out that within the concentrated industries, the largest firms consistently earn the largest rates of profit.38 Once more, one may doubt whether these "profitability" studies tell us much of interest. To the extent they do, however, they are at odds with the Berle-Means-ALI approach. Larger firms generally have more widely-scattered holdings. Under the Berle and Means story, they therefore should earn lower profits. In fact, they earn higher profits.

Whether we attribute these profits to innovation and efficient conduct of the business, as some would do, or to oligopoly and monopoly, as other argue, is irrelevant. Both efficiency and monopoly may be the results of managers driven to act in investors' interests. (Those

36. The other three had negative coefficients on the control variable, indicating that management control was associated with smaller profits, but in each the size of this effect was too small to be statistically significant. (That is, it was so small that a statistician would not be confident that it was different from zero). See also Stano, Executive Ownership Interests and Corporate Performance, 42 S. Econ. J. 272 (1975) (reporting a negative, but not statistically significant, relation between degree of control by managers and corporate profitability; also reporting a strongly positive and significant relation between absolute amount of stock held by managers and firm's profitability). For a summary of other work, much of it reporting similar negative but not significant results, see DeAlessi, Private Property and Dispersion of Ownership in Large Corporations, 28 J. Fin. 839 (1973).


who assert that managers disserve investors' interests also frequently argue that managers create monopolies, evade pollution and labor laws, bribe their customers, and otherwise expose themselves to criminal and civil liability, as well as loss of employment and social status, in pursuit of profits. Managers willing to violate the law must perceive themselves under substantial pressure to produce profits.)

III. The Market for Corporate Control: Competition for Position

A. Theory

Berle and Means paint the firm as a static institution. “The managers” have “control” and retain it. The powerless investors must accept the crumbs the managers hand out. One of the dynamic elements Berle and Means omit is competition among teams of managers to have control. It is not written that today's managerial team will be in charge tomorrow; to the contrary, several devices create the possibility of revolutionary change.

However much (or little) power investors have in the Berle-Means-ALI world, managers have a great deal more. Each team of managers may use this position to compete for the control of other corporate assets. Indeed, it is useful to think of the process of management as an ongoing competitive struggle among teams of managers to exercise control. The profits to be made in changes of control induce managerial teams to monitor each other, and this monitoring by management may be much more effective than monitoring by passive investors. Those who are best at running firms will enlarge the span of their control; those who falter will be replaced. If the faltering team will not yield by resignation or merger, the potential replacement will use force, such as the hostile tender offer or proxy contest.

The corporate control contest is the direct answer to the agency cost problems inherent in the separation of ownership and control. When the costs of widely scattered ownership become too large—perhaps when managers fail to act in investors’ interest—then the investment interests may be gathered up. The control fight reconcentrates ownership. It makes use of safeguards built into the shares when they were issued; the shares are freely tradable and carry votes that allow their owners to take control. The existing managers recognize that they will be subjected to a control contest if they do not act in investors’ interest; this realization prompts them to behave appropriately whether or not a contest materializes.
B. Evidence

Berle and Means thought that managers were entrenched. They therefore portrayed control contests as of little use. The managers could stave off challenges. Worse, a control contest would just swap one set of managers for another, and on average the new managers would be no better for the investors than the old. If managers are impervious to the influence of the market for corporate control, we should see few contests of any sort and little or no improvement in shareholders' welfare when contests occur. If the investors' welfare hypothesis is correct, we should see distinct wealth increases associated with contests, and laws that decrease the efficacy of control contests should produce decreases in investors' wealth. The data support the investors' welfare hypothesis.39

1. Proxy Contests

Proxy contests for corporate control are associated with substantial gains to investors, on the order of 5-10% of the total value of the equity interest.40 Stock appreciates when the contest is announced and during the duration of the contest. The gains exist whether the insurgents win or lose. This may show that the contest keeps the incumbents on their toes, or it may be associated with the assembly of substantial blocs of stock during the contest. (See the discussion below on bloc assembly.) The data cleanly refute any notion that proxy contests are unimportant or that they give control to "raiders" or "looters" who enrich themselves at the expense of investors.

2. Bloc Assembly

When one person assembles a substantial minority bloc in a firm, he may be able to exercise effective control because other interests are too widely spread to unite against him. It is often said that the owner of 25% of the stock of a large firm has "control." The owner of a smaller bloc may be on his way to control (perhaps against the wishes of existing managers). Berle and Means would predict that the assembly of such control blocs would give managers extra power by making insurrection by the investors that much more difficult. The

39. Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5 (1983), collects and evaluates most of the available evidence. The existence of this fine survey article makes it unnecessary for me to clutter this paper with supporting footnotes.
owners of blocs may divert profits to themselves, gaining more in their roles as insiders than they lose in their roles as investors. The existence of control blocs therefore should be associated with decreases in price. Under the investors' welfare hypothesis, the opposite should occur. The interests of the owner of the bloc are aligned with the interests of other investors; each wants shares to appreciate in price. The bloc's owner therefore acts to increase the firm's profits. The existence of the bloc reduces the agency costs of management.\footnote{41}

Again the data support the investors' welfare hypothesis. Bloc assembly is associated with increases in the price of stock outside the bloc. The larger the bloc, the greater the increase. When firms repurchase existing blocs (thus reducing the concentration of ownership), the price of stock outside the bloc falls by more than the value of the premium paid to the bloc's owner.\footnote{42} Bloc assembly, and its effects on control, therefore appears to be useful in controlling the agency costs of management.

3. Tender Offers and Mergers

Both mergers and successful tender offers leave one team of managers in control of assets formerly managed by two teams. The resulting firm is larger and, by the Berle and Means approach, less subject to effective governance by investors. They would expect such transactions to result in a diminution of wealth. Under the investors' welfare hypothesis, in contrast, mergers and tender offers are the visible consequences of competition among managers for control, and the victors should be the managers who can make best use of the assets. Control changes should be accompanied by increases in the value of the assets.

One way to investigate the effect of control changes is to ask whether firms do better in states that facilitate such changes. In some industries there are significant differences from state to state in the

\footnote{41. A more complete explanation of the dynamics of control contests of all sorts may be found in Easterbrook & Fischel, Corporate Control Transactions, 91 YALE L.J. 698 (1982), which also addresses questions concerning the effects of investors' portfolio diversification.}

amenability of a firm to takeover. Christopher James examined banking, an industry for which the variation is quite pronounced. He found that banks that are not subject to acquisition display substantially more managerial slack than banks that could be taken over. This supports the thesis that the market for corporate control protects investors.

Other evidence, which Richard Ruback discusses in this volume, establishes that transfers of control by merger and tender offer are associated with very large increases in the value of the investments, increases on the order of 30%-50%. The appreciation of the acquired firm’s stock is spectacular, but the combined value of the acquiring and acquired firm also increases substantially, by an average exceeding 10%. Even the stock not acquired in a tender offer appreciates in value, so that one cannot explain the premium as a payoff to some investors in exchange for access to a pool of assets that can be raided or exploited. The investors view the new managers as unambiguously preferable to the old. When a merger proposal or tender offer is withdrawn, on the other hand, the price of stock falls. If no acquisition is completed within two years, all appreciation in value disappears.

The existence of the premium shows that the combination is beneficial to investors. The size of the premium is nonetheless troubling. There are few acquisitions today at premiums in the 1-20% range. This means that when combinations could produce benefits of 20% or less to investors, they are unlikely to occur. The takeover device is not as beneficial to investors as it could be.

One shortcoming is that such control transactions are very costly. The expenses of investment banks, lawyers, and printers, the risks of litigation, and other costs discourage control transactions in search of small gains. Another difficulty is that the Williams Act substantially raised the bidder’s costs and facilitated defensive tactics by targets, which raise the costs still farther. After the Williams Act, state takeover laws, and the advent of defensive tactics, there have been fewer acquisitions than there otherwise would have been, and the value of acquisition programs has substantially declined. Managers seek to

defend against the acquisitions. Those who defend successfully harm investors.\textsuperscript{46} And as it turns out, the managers most likely to defend are those who own the least stock in the firm—a collateral confirmation of the findings of the influence of interest-alignment devices.\textsuperscript{47} Corporate acquisitions therefore must be seen as a safety valve, as a response to substantial shortfalls in performance rather than as an ordinary constraint on managers' conduct. Nonetheless, the existence of this backstop influences the incentives of managers, who desire to reduce the risk of their replacement. In conjunction with the many devices discussed in the preceding sections, the market in acquisitions offers still another way of inducing managers to act in investors' interests.

4. Divestitures and Spinoffs

If the reorganization of management can lead to higher values by combining assets, it also should be able to lead to higher values by breaking up concentrations of assets. Spinoffs may reallocate assets to managerial teams that can make better use of them. The Berle-Means-ALI hypothesis, in contrast, portrays spinoffs as methods by which managers can use inside information to divert opportunities to themselves. This hypothesis predicts lower prices for the public's stock. Once more the evidence supports the position that managers act in investors' interests. When firms spin off assets to investors (creating two firms from one) or sell blocs of assets to third parties, public investors obtain gains of 7\% to 10\% on average.\textsuperscript{48} These gains arise, though, only when the spinoffs and sales are voluntary; transactions needed to comply with regulatory orders produce no gains. The market apparently can discriminate beneficial changes of control from others.

\textsuperscript{46} See Jarrell, The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?, 28 J. L. & Econ. 151 (1985) (data showing that strategies designed to defeat offers reduce wealth of investors); Easterbrook & Jarrell, Do Targets Gain from Defeating Tender Offers?, 59 N.Y.U. L. Rev. 277 (1984) (data showing that firms defeating offers cause substantial losses to investors; summary of other studies to same effect).


5. Leveraged Buyouts

The existing managers of a firm are among the contestants in any struggle for control. Just as there may be beneficial incentives in the threat (or actuality) of an outside takeover, so there may be gains from "inside takeovers"—going private transactions or leveraged buyouts.

Berle and Means would portray these transactions as methods of exploiting investors. The managers extinguish the investors' interests at a price that may not reflect the firm's full value. Because of their privileged position, the managers may hide important information or manipulate the price of the transaction to the investors' disadvantage. The investors' welfare hypothesis is that these transactions may reduce the agency costs of management by turning the managers into owners as well. The new manager-owners receive a greater share of gains at the margin and therefore become more dedicated and effective agents.49 These transactions also may be marked by restructuring of management (one faction prevails over another). The existing managers (or faction or managers) cannot take the firm private unless they pay more than the pre-existing value of the stock. They also face competition from other, outside groups and must offer more in order to obtain control.

Here, too, the evidence refutes the Berle and Means approach. Leveraged buyouts are associated with average premiums of about 30% relative to the prior market price.50 The investors thus receive substantial gains, as large on average as those in mergers or tender offers. The market for these arms' length transactions appears to constrain managers from exploiting their position and ensures that much of the gain is distributed to the original investors.

Perhaps more interesting, the data refute any claim that the managers are exploiting privileged access to information. If informational inequalities are responsible for the premium price, we would expect some of the premium to remain even after a going-private offer

49. These transactions are usually so highly leveraged that the managers will receive little or no return in the early years; the firms profits must be used to retire the debt. If the firm is less profitable than expected, the debtholders will become the new controllers. If the managers make enough to pay off the debt, though, they may become fabulously wealthy (in ten years or so) as the full owners of a profitable firm. This large-stakes wager may be just the thing needed to create the incentives for the managers to maximize the firm's value.

has been withdrawn. The offer would cause some of the information to leak to the market, and it also might set the stage for a competing bid by outsiders. Yet this does not occur. When a going-private offer is withdrawn, the entire premium vanishes. The leveraged buyout must itself be the source of the benefits to investors.

IV. Conclusion

Something caused corporations to grow, some much faster than others. Something caused investors willingly to part with their money. Something led to the terms we see in corporate charters. These "somethings" must generally be good for investors and consumers. The firms under scrutiny are the survivors after all. Those that offered terms less useful for investors and consumers are gone.

Why have the current corporate governance structures survived? The hypothesis that managers design structures in investors' interest has many testable implications. So does the Berle-Means-ALI hypothesis about the relation between managers and investors. To the extent the evidence permits the rendition of a verdict, it is that the Berle-Means-ALI hypothesis may confidently be rejected. Its implications are not true.

It is easier to reject a hypothesis than to confirm one. The available evidence generally supports the investors' welfare hypothesis, but it does not do so on every occasion. A few studies have found categories of activities by managers that appear to harm investors. We therefore must be careful in assessing proposals for legal rules. Some rules may be "market perfecting" in the same sense as antitrust. They may make it easier to detect or penalize shortcomings of managers.

In constructing such rules, though, we must start with the best available data. These data suggest, although they cannot prove, that incentives present in existing markets generally induce managers to act in investors' interests. No proposal for change legitimately may be based on the Berle and Means hypothesis that managers consistently act at the expense of investors. Proposals for new rules should perfect the market by reducing its costs. One example would be rules that reduce the costs of waging contests for corporate control. Methods of writing legal rules that mimic the contracts that investors and managers would strike—if they could write and enforce agreements with no transactions costs—also hold some prospect of benefit. Most of the state law rules and fiduciary doctrines now in force are of this sort: they supply contractual terms subject to variance by such actual bargains as investors and managers find worthwhile.
The data supply no support for market-defeating rules. That is, none of the studies recounted above offers the slightest justification for legal rules that reverse actual contractual decisions or frustrate the making of new ones. The process by which corporate governance has evolved has been a mixture of innovation by states and innovation by firms. Some corporations have found new and better ways to establish governance—whether these ways concern voting or methods of internal organization, such as hierarchical versus multidivisional organization. The firms that have adopted the best structures (sometimes contracting around state law) have prospered. Then states write laws that use existing governance structures as models, as starting points that prevail unless negated by contract. The states’ adoption of the new structures reduces the costs to other firms of adopting and implementing them. States that make the choices most beneficial to investors will attract incorporations.

This evolutionary process goes on continuously. There is no reason to “freeze” it with a uniform set of rules that cannot be altered by contract. Even if the ALI could pick “the best” rules for today’s average corporations, it is unlikely that these rules would be best for all firms or that they would remain “best” for long for the average firm. Investors gain when managers are free to invent new devices and to use them in their pursuit of capital. Those who want to still the power of competition must make a case far more powerful than they have to date.

It is sometimes said that the disagreement between those who want to impose new restraints on corporate governance and those who oppose such restraints is a matter of “faith” or “ideology.” All too often, the question is posed as whether one has “faith in the market.” Putting the question this way implies that the data are weak or their interpretation problematic. That is just not so.

Benefits to investors are not a matter of faith. Protection of investors by markets is not a matter of belief. Competition among managers is not a political creed. No one should have “faith” in the market. We should resort, rather, to evidence about the market. And that evidence suggests the power of competition and existing arrangements in protecting investors.
was in part procedural. Here is the ALI, with its enormous prestige, proposing to convert evolving corporate practice into mandatory, legally enforceable norms in a format—the Restatement—that has come to be accepted over the years as absolutely authoritative. Additionally, perhaps there was apprehension as to what the yet undrafted Part VI, which deals with management’s role in the takeover defense area, would look like when it appeared.

But beyond this, I believe there is an abiding importance to corporate governance issues, illustrated by the intermittent occurrence of such causes célebres as the Bendix-Martin Marietta scrap. Mr. Agee of Bendix plots to pick off Martin Marietta, whose President structures a doomsday pac-man defense in a breath-taking display of brinkmanship. Both companies, naturally, are attended by the customary swarming complement of lawyers and investment bankers. White knights are produced. A fascinated Wall Street follows the course of events with rapt attention culminating in transfixed horror as each company acquires a major chunk of the other, creating a kind of weird corporate double star with a nearly 3-1 debt-equity ratio. Along the way, four Bendix outside directors quit in dismay at the handling of matters. I don’t mean to imply that these transactions involved misconduct or were not aimed at maximizing shareholder welfare. But that case demonstrates our system at its worst. And for my purposes, it highlights the massive power of a CEO to manipulate his company in ludicrous ways without the check and balance of a powerful board. The shareholders of each company ultimately benefited from the opportunity to sell at least some of their shares at a premium, and discipline of sorts was meted out for any excesses when, after a discreet interval, Allied Corporation let Mr. Agee go. Nevertheless, after a carnival like this, with so much ego and macho on display, bemused onlookers have to wonder whether the whole incident isn’t symptomatic of some pathology in the prevailing system of corporate governance. Given the tremendous economic power of the large public corporation, this is obviously a question of first importance.

It is my thesis that too many CEOs of large public companies have enormous power which they exercise virtually unchecked. Neither their boards, their shareholders, nor their government are in much of a position to thwart them. Directors may resign, as they did at Bendix, but the CEO generally prevails. I submit we need to address this problem and quickly.

My plan, in this talk, is to examine critically the “origin myth”
underlying the ALI and other corporate governance schemes and the prescriptions they offer for redemption from the fallen state we are said to be in. My perspective is that of one who has served as a partner in a law firm, an SEC staff member and president and director of a large public company. So if I seem at times to waffle you'll understand why.

II. Ownership v. Control

The starting point for most thought on corporate governance is the celebrated split between ownership and control, expounded at great length by Berle and Means in the 1930's and more recently by such figures as Ralph Nader. Business grew to the point, so the argument goes, where the owner-managers no longer could supply sufficient capital for further expansion themselves. It became necessary to seek additional capital on a large scale from investors who had neither the skill nor the inclination to be involved in the management of the enterprise. These investors were expected to remain passive—indeed, they wanted to remain passive—leaving control of operations to a class of professional salaried managers. Unfortunately, this specialization of function, however efficient and necessary to economic progress, inevitably creates a divergence of interests between the owners and the managers. This divergence is the corporate governance equivalent of original sin. Managers can no longer realize the full upside or downside potential of their decisions; they become more like creditors, suppliers of a specialized form of labor just like the workers they supervise. At best, management, however well-meaning, will not be able to consistently make the same decisions the shareholders would. At worst, the managers develop an agenda of their own, centering on self-aggrandizement and even self-dealing, arrogating to themselves the perquisites of office with scant thought to the welfare of the shareholders.

Another strain of corporate governance thinking is that of accountability to society at large. The corporation is said to be so important an institution in modern society that it must answer to other constituencies besides its owners, such as employees or the local community. Somewhat inconsistently with the ownership-control reasoning, it is asserted here that management is too concerned with maximizing profit to pay proper heed to these other interests.

The solutions that have been propounded have come in two basic forms. One, favored by Berle and Means themselves, is to increase government intervention in business affairs. This remedy is largely
out of favor today; even proposals for federal chartering of corporations are structural in nature and would not impose substantive rules of conduct. I am firmly convinced that corporate decision-making should be left in responsible private hands. But I would accept greater government intervention if the private attempts to construct a more balanced allocation of power were not successful.

The second basic form of solution—and this is where the ALI proposals fit—is to tinker with the internal mechanisms of corporate governance, primarily by establishing a group of overseers, free of the conflicts dogging management, to help ensure that management acts as the shareholders would, if they were in a position to call the shots. Let there be independent directors, and let them constitute a majority of the board. Let the board thus constituted choose top management, establish programs to oversee the corporation’s compliance with laws, and review and approve major corporate plans, policies and commitments. Let the independent directors be gathered up into committees, a greater one (the audit committee) and two lesser ones (the compensation and nominating committees), each ruling in its own specified sphere, but all designed to assure the shareholders dominion over everything that creepeth on the earth (i.e., management). Some observers have gone so far as to suggest mandatory rotation of outside directors or equipping the board with its own permanent staff. Mercifully, the ALI proposals do not go this far.

The SEC had its own go at this issue in 1978 when I was on the staff, proposing that companies categorize directorship nominees as “management,” “affiliated nonmanagement,” or “independent” and state whether or not they had audit, compensation and nominating committees. Chairman Harold Williams had long been in the forefront of the governance debate, exhorting corporations to permit only a single inside director on their boards. The suspicion was abroad in the land that this proposed disclosure was actually conceived as a friendly arm-twisting towards this goal. In response to the ensuing storm of protest, the SEC asserted blandly that the proposals were intended merely to provide investors with useful information rather than to influence board composition or committee structure, although it acknowledged they might have that “beneficial effect.” The commission ultimately and rightly retreated somewhat, dropping the director labels while converting the definitions into disclosure items.

III. Criticism

I have some difficulties with this corporate governance thinking,
both its diagnosis of the problem and the suggested cure. For one thing, I think the scope of the divergence in interests between owners and managers has been overdrawn. This conflict, of course, is not unique to the modern corporation; it has been around as long as principals have been hiring agents. I think generally we have done a pretty good job of making sure management's interests converge with those of the shareholders. This is most obvious in the area of management compensation, which, studies show, correlates strongly with company performance. Also, many managements hold significant equity interests in their companies, further strengthening the identification between ownership and control. I think the right comparison here is not only in terms of management's percentage ownership, but also the value of the investment in absolute terms. From the negative standpoint, management will always fear that substandard performance will lessen the company's value and create an incentive for someone to take it over. And of course we should not forget that there is a well-developed body of law, prohibiting at least the grosser forms of management misconduct. To my way of thinking, the fact that managers have occasionally even put themselves personally at risk by attempting to increase profits through unlawful methods, e.g., cooking the books or paying bribes, while certainly not to be condoned, is some indication that there is a pretty strong incentive to maximize profits.

One piece of evidence frequently cited for the proposition that management favors its own skin over shareholder interests is the often furious efforts by management to resist hostile takeovers. This as a subject on which I can speak with some familiarity, having helped Columbia successfully fight off such an attempt by Kirk Kerkorian. Professor Daniel Fischel, whose other views on corporate governance I find congenial, belongs to this school of thought. Although other academics dispute the point, he contends that even taking into account instances where management lands a white knight at a better price, efforts to resist takeovers better marginal bidders from making their bids, and thus ultimately decrease shareholder welfare. Undoubtedly, there is an element of ego in many decisions to fight a takeover, just as there is in many decisions to attempt one. Nevertheless, I believe resistance to takeovers is often justified. Even the efficient market hypothesis, except in its strongest and unproven form, allows for the possibility that management may have information about the company not reflected in the stock price.

Although Fischel argues to the contrary, such information need not necessarily be of the Texas Gulf Sulfur one-strike variety. Management may simply feel, based on a thousand different factors together
representing its intimate familiarity with the business, that now is not the time to sell out. Even taking risk premiums and the time value of money into account, this feeling often proves justified. We rejected Kerkorian’s offer of about $25 per share—in MGM stock mind you—and later bought him out at $50 a share when the market was $35. For that we were criticized and sued. But some eighteen months later we sold out to the Coca-Cola Company for $75 per share, half of which was tax-free. Had we not persisted in our battle with Kerkorian, our shareholders would have been severely short-changed.

Certainly, the trend in the case law is to recognize that management’s decision to resist, if taken after following appropriate procedures, should be accorded some presumption of validity. But, as you know, proving a negative is impossible and the resisting management will be accused of fighting only to save their jobs. At any rate, even if resistance to takeover attempts is an example of management depredation, I have not seen anything suggesting that the presence of outside directors on the board makes it any less likely to occur, since most, if not all, of the targets that fought had any such directors. Either they agreed that the offer did not serve the shareholder’s interests, or the idea of independent directors is ineffectual.

As for social accountability, the ALI draft itself points out that in most instances social goals will be consistent with shareholder welfare. In those instances where it is not, I am not convinced that independent directors do any better job of reconciling the two than inside ones; indeed, both groups of directors seem to balance the competing concerns in pretty much the same way. Nor do I think it realistic to expect independent directors to be able to ferret out and control corporate wrongdoing.

But my fundamental problem with these proposals for independent directors is that there is simply no evidence, no data, on what constitutes a good director. Like a good parent, a good director is known by what he or she does, and credentials for either a good parent or a good director can and do vary.

Having criticized this analysis of the problem, let me now address the ALI’s proposed remedies. Others have seen these proposals in a decidedly negative, even sinister light. The Business Roundtable concludes that the ALI model as a whole will likely result in inflexibility, increased cost, unwillingness to take risks, a focus on short-term performance and a shortage of qualified outside directors willing to serve on corporate boards. Professor Fischel finds in the proposals a “hidden agenda”, suggesting that they are a kind of Trojan Horse designed to pack the board with directors who will divert corporate resources to serve goals other than shareholder welfare.
My own views are considerably less apocalyptic. I believe we must bear in mind that the board of directors is an institution that has evolved subject to certain inherent constraints, and no amount of exhortation or tinkering with board or committee structure can overcome that fact. Top management of the large publicly-held corporation is invariably composed of hard-driving, strong-willed people who are intimately familiar with the company. Of necessity it controls the agenda for board meetings and the flow of information to directors. It’s just not in the cards to expect the local clergyman or president of a nearby university (or even business school) to be able to dissuade the CEO from pursuing a course of action he has thought through and decided on. After all, not even the dismayed resignation of four outside directors of Bendix, with the attention of the entire financial community riveted on the situation, dissuaded Mr. Agee. Saddling the board and its committees with a laundry list of specified tasks to be gamely plowed through, and requiring that they be performed with reasonable investigation on pain of personal liability, doesn’t help matters. The outside directors would simply never have enough time or expertise to perform adequately what the ALI model demands of them, and so they won’t really try. Thus, I would expect that adoption of the ALI prescriptions would make very little discernible difference in the way a board actually operates.

This conclusion derives support from an empirical study by Professor Paul MacAvoy of Yale, commissioned by the Business Roundtable. The study concludes that corporations which have already adopted the structural components of the ALI model had no better records of economic or social performance than those which hadn’t. Whether the methodology of this study was statistically valid, others more qualified than I will have to determine, but it does support my view that the ALI recommendations are essentially irrelevant to board performance.

On the basis of both theory and my practical experience, I believe the best directors are clearly owners—those who have substantial equity interests in their companies. A board full of such directors would be ideal, although the ALI model ironically would classify them all as insiders. Such directors transcend the chasm between ownership and control; their interests are naturally aligned with those of the shareholders, and they are sufficiently knowledgeable and expert to be able to make a real difference in the performance of the business. Most importantly, they will surely act as a check on the powers of the CEO. This advantage far outweighs any increased risk of self-dealing attendant on placing such directors on the board.
Failing such directors, and despite all I’ve said, I nevertheless think there is much in the ALI model worth observing, provided we are realistic about the magnitude of the benefits that are likely to result. It is possible, and the ALI draft argues, that because of transaction costs and the like, other incentives to management accountability do not do the whole job, and that there is some residual advantage in having independent directors. The direct costs of the ALI apparatus would be comparatively small. Despite what other commentators have said about the indirect costs—tying the board up, diverting attention to inappropriate social goals—I believe in practice they would prove minimal. The fact that so many corporations have adopted many of the practices the ALI recommends is some indication that the benefits do outweigh the costs, although perhaps an equally probable explanation for this trend lies in the public relations value of doing so. Independent directors and I would opt for a broader definition of this concept than the ALI, with its stringent percentage and dollar amount limitations—probably should constitute a majority of the board, which should include only a few management directors. An audit committee is undoubtedly a good thing, although I think the positively messianic expectations that have been lavished on it are way overblown. The other proposed committees, I believe, are basically window dressing, like the “public policy” committee that has been adopted by some corporations—which is a repository for directors with backgrounds that don’t fit them for anything else.

I believe the board does have a role to play in selecting top management and protecting the shareholder’s interests in non-arm’s length transactions. I also think it must serve as a sounding board for a check on management, particularly in crisis situations where management may temporarily lose its way and may need a swift dose of the reality principle. In order to permit the fullest realization of these functions, it is essential that the board and senior management develop an atmosphere of mutual support and accommodation. A major problem I have with the ALI model is its formal specification of tasks. As I’ve indicated, I think they are unrealistically broad. I’d leave board functions and qualifications for membership much more flexible, recognizing that the most important elements of board activity may occur in informal discussions far from the boardroom. If it plays this role, I believe the board will have made a valuable contribution and given us as much as we have a right to expect.

Perhaps in closing I can repeat to you, with some relevance to the ALI proposals, the quip about Wagner’s music: It sounds better than it really is! To that note, I add my thanks for your attention.