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Should a Duty to the Corporation Be Imposed on Institutional Shareholders?

By Roberta S. Karmel*

I. INTRODUCTION

The common law principle that directors owe a primary duty to their corporation and a secondary duty to the shareholders of that corporation has been gradually eroded by the federal securities laws so that directors are charged with owing duties to shareholders, with the corporation and other corporate constituents relegated to a lower status.¹ Further, the shareholder primacy model has become the dominant model in scholarship theories with regard to the firm, although other models have been proposed and debated.² Under the shareholder primacy model, shareholders are considered the “owners” of the corporation and therefore given rights at the expense of other corporation constituents.³ In reality, shareholders have a property interest in their shares, not in the corporation’s assets. Further, they have no access to the corporation’s assets and no right to direct or control the disposition of those assets.⁴ The notion that shareholders are

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1. See *infra* text accompanying notes 17–34.

2. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 *Nw. U. L. REV.* 547, 563 (2003).

3. See Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, *N.Y. TIMES MAG.*, Sept. 13, 1970, at 32–33, 122–26, available at <http://www.reputationinstitute.com/sections/rank/friedman.html> (last visited Oct. 10, 2004); American Federation of Labor & Congress of Industrial Organizations, Letter of Comment on SEC proposal S7-19-03, available at <http://www.sec.gov/rules/proposed/s71903/aflcio121903.htm> (Dec. 19, 2003) [hereinafter AFL/CIO Comment Letter].

4. Shareholders generally cannot control dividend policy or share repurchases. See *Klang v. Smith's Food & Drug Ctrs., Inc.*, 702 A.2d 150, 157 (Del. 1997); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971); *Dodge v. Ford Motor Co.*, 170 N.W. 668, 682 (Mich. 1919). Neither can shareholders control a liquidation of corporate assets. See *Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85, 86 (1880). For some academic criticisms of the idea that shareholders are owners of the corporation, see Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 *IOWA L. REV.* 1, 4 (2002); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 *S. CAL. L. REV.* 1189, 1191–95 (2002).

“owners” sometimes expresses the notion that they are the residual claimants on the corporation’s assets. This concept also is flawed.⁵

Modern institutional investors do not necessarily behave like owners of corporate property. Although some institutions supply patient capital to corporations and hold shares for the long term, many institutions are short-term traders or invest in the equity markets through passive index funds.⁶ Nevertheless, the shareholder primacy norm has been strengthened and reinforced by the Sarbanes-Oxley Act of 2002.⁷ In the wake of recent corporate scandals, institutions have been demanding more rights, for example, more rights with respect to the nomination of corporate directors. In view of these demands, this Article will inquire as to whether large shareholders should obtain any such rights without also acquiring duties to the corporations in which they invest, and to other shareholders.

Shareholders do not generally owe any duties to one another or the corporations in which they own shares. There are two exceptions to this proposition. Controlling shareholders owe fiduciary duties to minority shareholders, although the theoretical basis for this exception is not entirely clear.⁸ Some courts have imposed fiduciary duties upon shareholders in close corporations akin to the duties partners owe to one another.⁹ Can either of these theories be extended to fit the role of institutional investors in a large public corporation, or is the role of the institutional investor different? Institutional shareholders are not investing their own capital, but the capital of others to whom they owe fiduciary duties. There is a potential and sometimes an actual conflict between the beneficiaries of an institutional investor and the shareholders and other constituents of corporations in which they invest. On the other hand, institutions have a duty to invest assets of their beneficiaries prudently and such prudence may benefit the financial structures and operations of portfolio companies.¹⁰

In the 1980s and 1990s, equity came to trump all other corporate constituencies. Further, institutional investors became much more heavily invested in

5. Stout, *supra* note 4, at 1192–95.

6. THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE: FINDINGS AND RECOMMENDATIONS 25–28 (Jan. 9, 2003), available at http://www.conference-board.org/PDF_free/756.pdf [hereinafter CONFERENCE BOARD COMMISSION RECOMMENDATIONS]. This Commission was composed of an impressive group of business leaders, institutional investors, and former government officials, including Peter G. Peterson (chair), John W. Snow, John H. Biggs, John C. Bogle, Charles A. Bowsher, Arthur Levitt, Jr., and Paul A. Volker. See also Yuka Hayashi, *Small-Cap Exchange-Traded Funds Find Success*, WALL ST. J., Mar. 13, 2002, at B13D; Yuka Hayashi & Christine Bird, *Institutional Investors Take to the Sidelines*, WALL ST. J., Feb. 12, 2002, at C17; Insider, *Insight: Business Managers and the City; A Blot on the Cityscape*, ACCOUNTANCY AGE, Jan. 22, 2004, at 18.

7. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

8. See, e.g., Zahn v. Transamerica Corp., 162 F.2d 36, 42 (3d Cir. 1947); Kahn v. Tremont Corp., 694 A.2d 422, 428–29 (Del. 1997); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983). My own view is that the duty of controlling shareholders to minority shareholders is based on the ability of a controlling shareholder to elect a majority of the board of directors, so that this duty is merely a variant of the director’s duty of loyalty, adjusted to reach the deep pocket of the controlling shareholder.

9. See, e.g., Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 515 (Mass. 1975). Delaware probably does not recognize such a duty. See Nixon v. Blackwell, 626 A.2d 1366, 1380–81 (Del. 1993).

10. See Gregg v. Transp. Workers of Am. Int’l, 343 F.3d 833, 840–41 (6th Cir. 2003).

equity than had previously been customary.¹¹ They therefore pressured corporate executives to think like shareholders and be compensated in equity and, in addition, pressured corporations to report ever increasing earnings. These pressures in the context of the “irrational exuberance”¹² of a bull market led to financial machinations at many public corporations. When the bull market collapsed, the exposure of serious financial fraud at Enron and other companies led to the passage of Sarbanes-Oxley. Because the mandate of the Securities and Exchange Commission (SEC) is investor protection, however, investors became the beneficiaries of Sarbanes-Oxley rather than objects of further regulation. This Article will argue that Sarbanes-Oxley will not prevent future Enrons as long as it is administered pursuant to a shareholder primacy norm because investors as well as corporate managers and directors need to be appropriately regulated.

The shareholder primacy norm replaced managerialism, but it has been challenged by state corporate constituency statutes and by some competing academic theories, in particular, the nexus of contracts theory, the team production theory, and the director primacy norm.¹³ Although each of these theories has merit, it is unclear whether any of them would lay the foundation for curbing executive abuses for the benefit of the corporation as a whole. If a duty to the business enterprise in which institutions invest was imposed upon institutional shareholders, some of the pathologies which led to the 1990s stock market bubble might be better addressed.

Investors are protected by the federal securities laws in order to encourage capital formation and the efficient allocation of capital in the national economy. Unfortunately, institutional investors and their portfolio managers do not appear to have done an adequate job of analyzing corporate earnings and balance sheets in the 1990s despite the disclosures required by the federal securities laws. Although the errant behavior of corporate managers and their advisors should not be excused, institutional investors should also bear some of the blame for the 1990s stock market bubble and its inevitable collapse. Some of their questionable investment practices can be corrected by focusing on the fiduciary duties they owe to their own beneficiaries, but certain obligations to the corporations in which they invest and the shareholders of those corporations could also be considered.

Part II of this Article will discuss the shareholder primacy norm and its contribution to Enron and other scandals that emerged with the bursting of the stock market bubble. The shareholder nomination controversy will be the subject of Part III. Part IV will discuss other constituency statutes, the team production theory, and other competitors to the shareholder primacy norm. Part V will pro-

11. In part, this shift from more conservative investments such as bonds to equities has occurred because of the acceptance of modern portfolio theory that encourages diversification, and the argument that over time equities have a better return and are no more volatile than bonds. See Henry T. C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 832–37 (2000).

12. This phrase was coined by Alan Greenspan. See Chairman Alan Greenspan, Remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research (Dec. 5, 1996), available at <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>.

13. See *infra* text accompanying notes 99–125.

pose that obligations to the corporate enterprise, as well as rights, be imposed upon institutional shareholders and that managers and directors be required to consider the corporation as an enterprise as well as stockholders in making business decisions.

II. EQUITY BECOMES KING

In the United Kingdom, courts generally recognize the principle that directors owe fiduciary duties to their companies and not to individual shareholders.¹⁴ The reason is that the fiduciary duties owed to a corporation arise from the legal relationship between directors and their corporations, whereas any fiduciary duties owed by directors to shareholders arise only in special circumstances where directors are treated as having assumed a responsibility to act on behalf of, or for the benefit of, shareholders.¹⁵ In such special relationships, and only in such special situations, directors may owe individual shareholders duties of trust, confidence, and loyalty.¹⁶ Otherwise, the duty of directors runs to the corporation as a whole.¹⁷ This doctrine was reaffirmed in the context of a contest for control in *Dawson International v. Coats Patton*,¹⁸ in which the court stated: “[i]t was a basic and well established principle of company law that the legal personalities of the company and its shareholders were distinct. The fiduciary duty of directors was owed to the company, although its exercise involved balancing disparate interests including those of the company’s employees and members.”¹⁹ The court therefore declined to hold that fiduciary duties of directors run directly to the shareholders in the context of the sale of an enterprise.²⁰

This English view was imported into the United States by way of state law. In *Goodwin v. Agassiz*,²¹ the Massachusetts Supreme Court refused to recognize the legitimacy of a shareholder action for insider trading.²² The court rejected the argument that directors occupy the position of trustee toward individual stockholders, citing to “an imposing weight of authority in other jurisdictions” and pointing out that there was no legal privity between directors and stockholders.²³ This view was subject to an important exception, however, commonly known as the “special facts” exception.²⁴ Such cases usually involved situations where there

14. This rule was enunciated in *Percival v. Wright*, [1902] 2 Ch. 421, 425–26 (1902) (holding that directors do not hold a fiduciary position as trustees for individual shareholders). See also *Great E. Ry. Co. v. Turner*, [1872–73] L.R. 8 Ch. 149, 152 (1871) (stating “[t]he directors are the mere trustees or agents of the company—trustees of the company’s money and property—agents in the transactions which they enter into on behalf of the company.”).

15. *Peskin v. Anderson* [2001] B.C.C. 874 (C.A. 2000), available at No. A3/2000/0429/6326, 2000 WL 1841707 (Dec. 14, 2000).

16. *Peskin*, 2000 WL 1841707, at 6.

17. *Id.* at 5.

18. 1988 S.L.T. 854 (O.H. 1988).

19. *Id.* at 859.

20. *Id.* at 860–61.

21. 186 N.E. 659 (Mass. 1933).

22. *Id.* at 661–62. See also *Smith v. Herd*, 53 Mass. 371, 384 (1847).

23. *Goodwin*, 186 N.E. at 660.

24. See *Strong v. Repide*, 213 U.S. 419, 431 (1909).

was face-to-face contact between a director and a shareholder, as opposed to transactions over a public securities exchange, and where a director had peculiar knowledge not available to a shareholder.²⁵ This “special facts” exception also was a part of English law.²⁶

The idea that directors do not owe fiduciary duties directly to shareholders was challenged by the adoption of the federal securities laws in the 1930s. The Securities Act of 1933 (“Securities Act”)²⁷ and the Securities Exchange Act of 1934 (“Exchange Act”)²⁸ were based on a philosophy of full disclosure and were intended to protect the public “with the least possible interference to honest business.”²⁹ The Securities Act imposed duties on corporations to make full disclosure about their financial condition and affairs when raising capital from the public, and made directors liable for false or misleading statements in prospectuses.³⁰ Listed companies were required to file annual and periodic reports³¹ and shareholders of public companies were given rights to information and certain other rights under the proxy rules prior to voting for directors.³² Because the mandate given to the SEC in the securities laws was investor protection, shareholders became a protected class under federal law and in a variety of contexts the federal courts gave shareholders direct rights against officers and directors.³³ Further, in amendments to the Exchange Act over the years, the SEC acquired the power to discipline corporate officers and directors.³⁴

Nevertheless, the SEC role with respect to corporate governance was limited. In cases involving both breaches of fiduciary duty and control contests, the Su-

25. *Id.* at 431–33.

26. See Allen v. Hyatt, 30 T.L.R. 444, 445 (1914). See also *Peskin v. Anderson* [2001] B.C.C. 874 (C.A. 2000), available at No. A3/2000/0429/6326, 2000 WL 1841707 (Dec. 14, 2000), at 5–6.

27. 15 U.S.C. §§ 77a–77z (2000).

28. *Id.* §§ 78a–78mm.

29. *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1294 (2d Cir. 1973) (citing ROOSEVELT MESSAGE TO CONGRESS RECOMMENDING PASSAGE OF SECURITIES ACT, H.R. REP. NO. 85, 73d Cong., 1st Sess. 5, 9–10 (1933)).

30. 15 U.S.C. § 77k.

31. Initially, section 12 of the Exchange Act applied only to listed companies. In 1964, all public companies with a sufficient number of shareholders and amount of assets became subject to Exchange Act registration and required to file annual and periodic reports pursuant to section 13. Pub. L. 88-467 § 13, 78 Stat. 564, 569 (1964).

32. 15 U.S.C. § 78n.

33. Implied rights of actions were first recognized by the federal courts under section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946), and then approved by the Supreme Court in *Superintendent of Insurance of the State of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). A private right of action under section 14(a) of the Exchange Act, 15 U.S.C. § 78n(a), was recognized by the Supreme Court in *J. I. Case Co. v. Borak*, 377 U.S. 426, 430–31 (1964). This recognition of purchasers and sellers of securities and shareholders as protected federal classes, coupled with the federal class action, gave a powerful impetus to the shareholder primacy model of corporate governance.

34. In 1984, the SEC obtained the power to name officers, directors, and other corporate officials as “causes” of false or misleading filings pursuant to section 15(c) of the Exchange Act. See generally William R. McLucas & Laurie Romanowich, *SEC Enforcement Proceedings Under Section 15(c)(4) of the Securities Exchange Act of 1934*, 41 Bus. Law. 145 (1985). In 1990, the SEC obtained the power to bar or suspend officers and directors in court cases. Pub. L. No. 101-429, § 101(e), 104 Stat. 931, 933 (1990). In Sarbanes-Oxley, the SEC obtained the power to levy such bars administratively. Pub. L. No. 107-204, § 1105(a), 116 Stat. 745, 809 (2002) (amending 15 U.S.C. § 78u-3).

preme Court voiced the view that Congress had not meant to federalize corporate governance when it passed the federal securities laws.³⁵ Further, the SEC was rebuffed in its efforts to impose a voting rights rule on public companies in the 1980s because it lacked authority to interfere with internal corporate affairs.³⁶ Accordingly, although the federal securities laws were based on a shareholder primacy norm, the SEC was able to affect corporate governance only at the margins, and the articulation of director fiduciary duties was generally left to state law.

During the merger and acquisition boom of the 1980s, some theorists advocated a shareholder primacy model for corporate boards, urging that directors remain completely passive when a tender offer for a corporation was made so that the shareholders could determine the outcome of a control contest without any interference from directors.³⁷ The states did not accept this formulation. In Delaware, where over half of all public companies are incorporated, the courts developed the doctrine that when directors perceive that a tender offer is a threat to the corporation, they may take defensive measures that are reasonable in relation to the threat posed.³⁸ There are two exceptions to this rule. If a company is up for sale, directors are obligated to obtain the highest price available for the benefit of shareholders.³⁹ In this situation, the interests of shareholders can trump the interests of the corporation as a whole because the corporation is doomed to disappear. The second exception to the ability of directors to frustrate a takeover is that they are prohibited from interfering with shareholder voting rights.⁴⁰ In some cases involving control contests, a shareholder primacy norm was espoused. For example, in cases where bondholders were disadvantaged by tender offers, the courts upheld shareholder interests over the interests of creditors.⁴¹ As a general matter, however, the courts allowed interests of the corporation and its non-shareholder constituencies to be considered.⁴² Also, most of the states passed other constituency statutes permitting, or in some cases mandating, that directors take into account the interests of constituencies other than shareholders in re-

35. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 86 (1987); *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 11–12 (1985); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479–80 (1977).

36. *Bus. Roundtable v. SEC*, 905 F.2d 406, 413–14 (D.C. Cir. 1990).

37. See generally Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 *YALE L.J.* 698 (1982). It is interesting that this is the rule in the United Kingdom, not by reason of company law, but rather by reason of the Takeover Code, which prohibits “frustrating action” by directors once a tender offer for their company is initiated. See Simmons & Simmons, *The Panel on Takeovers and Mergers in the City Code*, City Code on Takeovers and Mergers General Principle 7, available at http://www.simmons-simmons.com/display_home/takeover/samples/Takeover_Panel.ppt (last visited Oct. 14, 2004). Thus, the same tension between a duty to the corporation as a whole and a duty to shareholders that is seen in the United States between state and federal law also can be observed between company law and securities law in the United Kingdom.

38. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985).

39. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

40. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 662–63 (Del. Ch. 1988).

41. See *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F.Supp. 1504, 1524 (S.D.N.Y. 1989); *Hartford Fire Ins. Co. v. Federated Dep’t Stores, Inc.*, 723 F.Supp. 976, 990 (S.D.N.Y. 1989).

42. See, e.g., *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1989).

sponding to hostile tender offers.⁴³ In trying to reconcile the conflicts of interest involved, the best the courts could do was to stress that:

It is basic to our law that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. In discharging this function, the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders. This unremitting obligation extends equally to board conduct in a sale of corporate control.⁴⁴

In the 1990s, the shareholder primacy norm spawned widespread abuse and illegal behavior by public corporations, their investment bankers, and their advisors. As expressed by Professor Coffee,

the blunt truth is that recent accounting scandals and the broader phenomenon of earnings management are by-products of a system of corporate governance that has indeed made corporate managers more accountable to the market. Yet sensitivity to the market can be a mixed blessing, particularly when the market becomes euphoric and uncritical.⁴⁵

The abuses by Enron and its ilk in the corporate world will not be repeated here. Neither will the abuses by research analysts, underwriters, auditors, and other gatekeepers. What all of these scandals had in common of relevance to this Article is the distortion of financial reporting and disclosure. According to a study by the General Accounting Office, approximately ten percent of publicly traded companies restated their financial statements between 1997 and 2001.⁴⁶ Blame for this sorry state of affairs can be assigned to many culprits, but this Article will argue that institutional investors should be included among the culprits for two reasons. First, they did a poor job of analyzing corporate finances and prospects, or at the very least acquiesced in unrealistic valuations.⁴⁷ Second, in aggressively pursuing a shareholder primacy norm, they encouraged earnings manipulations and excessive executive compensation schemes.

Institutional investors account for over half the ownership and seventy-five percent of the trading in equities listed on the New York Stock Exchange, Inc. ("NYSE").⁴⁸ Institutions were heavily invested in the high flyers of the 1990s that collapsed. In the case of Enron, it can be argued that much of what led to the

43. See generally Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992).

44. *Mills Acquisition Co. v. MacMillan*, 559 A.2d 1261, 1280 (Del. 1988) (internal citations omitted).

45. John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 271 (2004).

46. REPORT TO THE CHAIRMAN, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, U.S. SENATE, U.S. GENERAL ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES AND REMAINING CHALLENGES 15 (2002) (GAO-03-138), available at <http://www.gao.gov/new.items/d03138.pdf>.

47. Coffee, *supra* note 45, at 274-75.

48. James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?* 80 WASH. U. L.Q. 855, 855 n.4 (2002).

corporation's collapse was discernable from its SEC filings,⁴⁹ yet at the peak of the market, sixty percent of Enron stock was held by large institutional investors.⁵⁰ The assets of institutional investors generally are managed by outside fund managers who are primarily motivated to perform better than other managers on a quarterly basis. This pressure leads to herd behavior.⁵¹ It also leads to a trading mentality that is at odds with the model of shareholders as owners.⁵²

The idea that managerial and director interests should be aligned with shareholder interests, an idea fostered by institutional investors, led to the popularity of stock options as a form of executive compensation and a shocking deterioration of controls with regard to executive compensation. Because executive compensation needs to be defended only as reasonable rather than fair to the corporation,⁵³ it is generally established by reference to marketplace standards.⁵⁴ Because the bull market gave such exaggerated values to stock options and other equity compensation, the market for executive compensation was completely distorted. It has been argued that shareholders did not adequately constrain executive compensation that was set by managers with little outside control.⁵⁵ Indeed, it can be argued that institutional investors assisted in raising executive compensation to historically high levels.⁵⁶ State courts generally declined to interfere with exorbitant compensation schemes until after the bursting of the stock market bubble and the enactment of Sarbanes-Oxley.⁵⁷ Congress and the SEC only exacerbated the situation. Congress prevented the Financial Accounting Standards Board from insisting that stock options be expensed.⁵⁸ The SEC rolled back a rule that had required shareholders to approve stock option plans.⁵⁹

49. See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1299–1332 (2002); Anthony H. Catanach, Jr. & Shelley Rhoades-Catanach, *Enron: A Financial Reporting Failure?*, 48 VILL. L. REV. 1057, 1074–76 (2003) (noting pre-existing accounting problems at Enron were largely ignored by the financial community).

50. Paul M. Healy & Krishna Palepu, *Governance and Intermediation Problems in Capital Markets: Evidence from the Fall of Enron*, Harvard NOM Research Paper No. 02-27, 22 (Aug. 2002). Further, Calpers and some other pension funds were invested in Enron's special purpose entities. See Richard A. Oppel, Jr., *Employees' Retirement Plan is a Victim as Enron Tumbles*, N.Y. TIMES, Nov. 23, 2001, at A1.

51. Healy & Palepu, *supra* note 50, at 26–27. See, e.g., David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 465–66 (1990).

52. See CONFERENCE BOARD COMMISSION RECOMMENDATIONS, *supra* note 6, at 33–34.

53. See *Lewis v. Vogelstein*, 699 A.2d 327, 337 (Del. Ch. 1997); *Haber v. Bell*, 465 A.2d 353, 359 (Del. Ch. 1983).

54. See *Freedman v. Barrow*, 427 F. Supp. 1129, 1136 (S.D.N.Y. 1976); *Hall v. John S. Isaacs & Sons Farms, Inc.*, 146 A.2d 602, 610–12 (Del. Ch. 1958), *aff'd in part*, 163 A.2d 288 (Del. 1960). See generally Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?* 8 J. CORP. L. 231, 270 (1983).

55. See generally Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

56. Coffee, *supra* note 45, at 274–75. See, e.g., Amy L. Goodman, *The Fuss Over Executive Compensation*, INSIGHTS, Jan. 1992, at 2.

57. See and compare *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998), *rev'd sub nom.*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000), *remanded to In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003). Whether the Delaware courts will become more proactive in controlling excessive executive compensation remains to be seen.

58. See Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, COLUM. BUS. L. REV. 35, 98 (2003).

59. Prior to 1996, corporations were required to obtain shareholder approval for executive stock

Equity-based compensation focused directors and managements on stock market prices instead of other traditional metrics used in bonus plans. Pressures by institutional investors for ever higher quarterly earnings made matters worse. The temptation to manage earnings became too great for many corporations, and issuers were not reined in by their auditors, their investment bankers, or other advisors. Investors and financial intermediaries were enthralled by equity and equity was king. Traditional valuations for stocks were discarded as technologically obsolescent.

The Sarbanes-Oxley Act, passed to restore investor confidence after the collapse of the stock market in 2000–01, is based on a shareholder primacy model and envisions a board of directors independent from management and accountable instead to stockholders. The statute gives the SEC new powers to regulate corporate governance that could be used to replace the balancing permitted directors of shareholders and other constituents under state law. Audit committees and other committees are set up as potential adversaries of management.⁶⁰ Prior indirect regulation of CEOs and CFOs is replaced by some direct regulation.⁶¹ Executive compensation is subject to some SEC regulation.⁶² The SEC's regulation of auditors is greatly strengthened and, by making auditors accountable to audit committees, the power of management to influence accountants is limited. In the case of corporate counsel, the power of management is also diminished. Whether this weakening of the authority of the CEO will turn out to be a development for good or ill is not the subject of this Article. What is significant is that areas of the law that previously were handled by the states are now matters of federal regulation for the benefit of investors and not other constituents. Further, the institutional investors that bear some responsibility for the problems that led to the adoption of Sarbanes-Oxley became subject to no new regulation. Rather, they are the beneficiaries of this legislation. The extent to which this turn of events has emboldened institutional investors can be shown by the controversy over shareholder nominations.

III. SHAREHOLDER NOMINATIONS

Institutional investors include government pension funds, labor unions, corporate pension funds, mutual funds, insurance companies, and bank trust departments. In 1998, institutions held more than sixty percent of the voting shares of major U.S. corporations, due in great part to the growth of pension funds for

option plans in order to exempt the exercise of such options and the subsequent sale of shares from short-swing profit restrictions of section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b) (2000). In 1996, the SEC promulgated Rule 16b-3 under the Exchange Act, 17 C.F.R. § 240.16b-3, eliminating the necessity of a shareholder approval for the purposes of section 16(b) exemption. *See Securities Exchange Act Release No. 37,260, 61 Fed. Reg. 30,376, 30,377–78 (June 14, 1996)*. Delaware and New York were quick to follow by amending their laws so as to obviate the need for such a vote. *See DEL. CODE ANN. tit. 8, § 157(b)–(c) (2003); N.Y. BUS. CORP. L. § 505(d) (2003)*.

60. 15 U.S.C. § 78j-1 (2002).

61. *Id.* §§ 7241, 78u-3.

62. *Id.* §§ 7243, 7244, 78m, 78u-3.

employees and retirees of major corporations and governmental units.⁶³ At the end of the third quarter of 2002, U.S. institutions held 49.8 percent of all U.S. equities, with pension funds holding 21.5 percent.⁶⁴ The percentage of institutional participation in stock market activity has also increased. Large block transactions (10,000 or more shares) are a gauge of institutional trading. In 1978, block trades represented 22.9 percent of reported volume on the NYSE.⁶⁵ By 1988, large block transactions represented 51.1 percent of NYSE volume.⁶⁶ By 2003, the percentage of large block transactions fell to thirty-seven percent, most likely as a result of the influx of retail investors during the late 1990s bull market and changing trading strategies of institutional investors.⁶⁷

Pension funds control the largest block of U.S. institutional assets, although their percentage share of total assets has been giving way to mutual funds. In 1998, pension funds held forty-eight percent of all equity assets held by institutions.⁶⁸ Because public pension funds devote an increasing amount of their assets to equities, they are the most activist on corporate governance matters and have increasing clout.⁶⁹ This activism has been expressed through increased pressure on management for corporate governance reforms and lobbying for federal and state legislation and rulemaking.⁷⁰ In the wake of the financial scandals that exploded with Enron, some politically motivated institutions with very large holdings, in particular state comptrollers and treasurers managing government pension funds, campaigned for shareholder nominations to be included on management's proxy statement.⁷¹ The SEC responded by proposing such a rule.⁷²

There is nothing to prevent any shareholder from nominating a director in opposition to a director nominated by a current board, but this can be a costly endeavor.⁷³ Shareholders who desire to use management's proxy want a cheaper way to put forward candidates in opposition to candidates selected by a corporation's current board. A group of state pension fund managers from New York, California, and elsewhere, as self-declared "representatives of shareholders," advocated broad shareholder access to the company's proxy card on the ground that

63. Warren F. Grienberger, *Institutional Investor and Corporate Governance* 25, 27 (PLI Corp. Law & Practice Course, Handbook Series No. B0-006E, 1999), available at WL 1093 PLI/Corp 25.

64. See NYSE Data, *Fact Book: Interactive Viewer*, at http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=2673&category=12 (last visited Oct. 25, 2004).

65. See *id.* at http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=1203&category=3 (last visited Oct. 25, 2004).

66. See *id.* at http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=802&category=3 (last visited Oct. 25, 2004).

67. See *id.* at http://www.nysedata.com/factbook/viewer_edition.asp?mode=table&key=240&category=3 (last visited Oct. 25, 2004).

68. Symposium, *The Institutional Investor's Goals for Corporate Law in the Twenty-First Century*, 25 DEL. J. CORP. L. 35, 38 (2000).

69. *Id.* at 38-39.

70. Grienberger, *supra* note 63, at 28-29.

71. Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784, 60,786 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

72. *Id.* at 60,787. At the time of this writing, a final rule had not been passed. It is possible it will differ in minor respects or substantially from the proposed rule.

73. CONFERENCE BOARD COMMISSION RECOMMENDATIONS, *supra* note 6, at 24-25.

“[c]ompetition for board seats and the accountability that contested elections impose will raise standards for those who serve as directors.”⁷⁴ The American Federation of Labor and Congress of Industrial Organizations urged shareholder nominations as “necessary to restore genuine accountability to a boardroom culture that for too long has been characterized by cozy relationships and a resulting unwillingness to challenge management.”⁷⁵ By contrast, the Business Roundtable attacked the SEC proposals as “sweeping, harmful changes in corporate governance practices” which would give undue leverage to special interest groups and generate expense for corporations “to ensure that each of their directors’ primary loyalty is to the company and *all* shareholders.”⁷⁶ The politically charged atmosphere in which the SEC’s proposals were floated may obscure the complicated and difficult issues raised by the pending regulation and the elevation of the shareholder primacy norm in director elections.

The SEC’s proposed rule would create a mechanism whereby director nominees of long-term security holders, or groups of long-term security holders, with significant holdings, could be included in company proxy materials where there are indications that the proxy process has been ineffective or that security holders are dissatisfied with that process.⁷⁷ The proposal would be applicable to all companies subject to the proxy rules and once applicable, shareholder access would apply for two years.⁷⁸ The names of shareholder nominees proposed through this mechanism may be submitted by a shareholder or group who has beneficially owned at least 5 percent of shares outstanding for at least two years who express their intent to hold the shares through the annual meeting.⁷⁹ Any shareholder or group nominating a candidate must be eligible to report beneficial ownership on Exchange Act Schedule 13G and have filed such a schedule.⁸⁰ The candidacy or election of board nominees must not violate controlling state law, federal law, or the rules of any applicable national securities exchange or association.⁸¹ Further, the nominee must satisfy the objective independence criteria of the listing standard

74. Letter from Alan G. Hevesi, Comptroller, State of New York, to William Donaldson, Chairman, SEC (Oct. 1, 2003), available at <http://www.osc.state.ny.us/press/releases/oct03/proxyletter.pdf>. See also Alison Carpenter, AFSCME, CalPERS Seek Investor Access to Nomination Process, 35 Sec. Reg. & L. Rep. (BNA) 1599 (Sept. 29, 2003).

75. AFL/CIO Comment Letter, *supra* note 3.

76. Letter from Henry A. McKinnell, Chairman, Business Roundtable, to Jonathan G. Katz, Secretary, SEC (Dec. 22, 2003) (emphasis in original), available at <http://www.sec.gov/rules/proposed/s71903/br122203.htm>.

77. Security Holder Director Nominations, 68 Fed. Reg. at 60,784.

78. Two circumstances would trigger shareholder access: the receipt of more than 35 percent “with-hold” votes of any director; or a shareholder proposal to activate the shareholder access process proposed by a shareholder or group who have held at least one percent of outstanding shares for one year and received a majority of shareholder votes cast. *Id.* at 60,789–90. The maximum number of nominees that may be proposed is as follows: one nominee if the board has eight or fewer directors; two nominees if the board has between nine and nineteen directors; three nominees if the board has twenty or more directors. *Id.* at 60,797. If a company receives nominees in excess of the applicable numbers, those nominees from a shareholder or group with the largest share ownership would be selected as nominees. *Id.* at 60,798.

79. *Id.* at 60,794.

80. *Id.*

81. *Id.* at 60,795.

applicable to the issuer and have no specified relationships with the nominating shareholder or group or agreements with the issuer regarding the nomination.⁸²

For some time, companies have been required to disclose in their proxy statements whether they have a standing nominating committee, and if so, to describe its members, functions and processes, including whether the committee considers shareholder recommendations for board nominees.⁸³ Under the SEC's new disclosure rules,⁸⁴ beginning January 1, 2004, companies are required to provide further information about a board's processes for director selection, its consideration of candidates recommended by shareholders, and the procedure by which shareholders may submit candidates for consideration to the board.⁸⁵ If a company does not have a nominating committee, it must state why it does not.⁸⁶ If a company does have a nominating committee, it will have to make the charter of the nominating committee available on its website or as an attachment to its proxy statement at least once every three years.⁸⁷ Information regarding the independence of nominating committee members must be set forth.⁸⁸ Among other new required disclosures are statements as to whether the nominating committee has a policy regarding shareholder nominees and, if the nominating committee has received a nomination from a shareholder or a group of shareholders who beneficially owns more than five percent of the company's voting common shares, a statement as to whether the nominating committee chose to nominate such a candidate.⁸⁹ Further, issuers must describe any minimum director qualifications sought by its nominating committee, the process by which its nominating committee identifies and evaluates nominees, and the source for the recommendation of any nominees, such as a security holder, a non-management director, an executive officer, or a third party search firm.⁹⁰

The SEC's rule proposal on shareholder nominations goes beyond disclosure and has been very controversial because it raises a variety of legal and policy

82. The SEC's shareholder access proposals were preceded by the publication of a staff report on shareholder access to proxies, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,938, at 87,869 (July 15, 2003) and new disclosure requirements with regard to board nominating committees. Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors, Exchange Act Release 48,301, 68 Fed. Reg. 48,724, 48,724 (proposed Aug. 14, 2003) (to be codified at 17 C.F.R. pt. 240); Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors; Republication, Exchange Act Release 48,825, 68 Fed. Reg. 69,204 (Nov. 28, 2003) (republication Dec. 11, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 270, and 274).

83. Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, 68 Fed. Reg. at 48,725.

84. Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Republication, 68 Fed. Reg. at 69,204.

85. *Id.* at 69,205.

86. *Id.* at 69,205-06.

87. *Id.* at 69,206.

88. *Id.*

89. *Id.* at 69,207.

90. *Id.* at 69,206-07.

questions, most of which are beyond the scope of this Article.⁹¹ The policy question of relevance here is whether activist institutional shareholders should be permitted access to management's proxy when these shareholders do not represent anyone but themselves and do not have any duties to either the corporation or other shareholders. Underlying all of the rhetoric in the letters of comment on the SEC proposal is a serious policy issue of the legitimacy of certain institutional shareholders to initiate changes in the board of directors or corporate governance. Why should a corporation be managed for the benefit of some institutional investors rather than all of its shareholders?

Some commenters have recognized this issue, if only indirectly. There was considerable debate on the length of time a shareholder should own stock in a corporation before being eligible for making a shareholder nomination.⁹² In addition, there was a suggestion that a nominating shareholder should be required to represent its intent to hold the securities not only until the date of the election of directors, but thereafter for the duration of the nominee's term as a director if the nominee is elected.⁹³ Further, the shareholder should continue to hold the requisite stake in the corporation necessary to initiate a shareholder proposal.⁹⁴ One of the proponents of the rule acknowledged the costs and risks to public companies, and their shareholders, including the risk that nominees might seek to represent a limited group of shareholders and suggested that any security holder's nominee be required to certify that, if elected, the nominee would represent the financial interests of all security holders.⁹⁵

The state treasurers, comptrollers, and labor unions that have been the prime movers in urging the SEC forward in the direction of shareholder proxy access declared that shareholders are owners of corporations and should have the right to nominate candidates for directors on the company proxy card.⁹⁶ In an insti-

91. Among other things, the proposal raises some serious questions concerning the SEC's authority to adopt such a rule. *See and contrast*, Business Roundtable, *Detailed Comments of Business Roundtable on The "Proposed Election Contest Rules" of the U.S. Securities and Exchange Commission*, at 1–19, available at <http://www.sec.gov/rules/proposed/s71903/brt122203.pdf> [hereinafter Business Roundtable]; Letter from the Faculty of Harvard Law School and Harvard Business School, to Jonathan G. Katz, Secretary, SEC (Dec. 3, 2003), available at <http://www.sec.gov/rules/proposed/s71903/harvard120303.htm>. *See also* Letter from Section of Business Law, American Bar Association, to Jonathan G. Katz, Secretary, SEC (Jan. 7, 2004), available at <http://www.sec.gov/rules/proposed/s71903/aba010704.htm>. There also has been debate about whether a rule permitting shareholder access to management's proxies would be unduly disruptive of normal board functioning. *Id.* at 5–6; Letter from Wachtell, Lipton, Rosen & Katz, to Jonathan G. Katz, Secretary, SEC (Nov. 14, 2003), available at <http://www.sec.gov/rules/proposed/s71903/wachtell111403.htm> [hereinafter Wachtell Letter]; Letter from James P. Hoffa, General President, International Brotherhood of Teamsters, to Jonathan G. Katz, Secretary, SEC (Dec. 22, 2003), available at <http://www.sec.gov/rules/proposed/s71903/s71903-487.pdf> [hereinafter Hoffa Letter].

92. *See* Business Roundtable, *supra* note 91; *see* Wachtell Letter, *supra* note 91; Letter from Peter C. Clapman, Senior Vice President and Chief Counsel, Corporate Governance, Teachers Insurance and Annuity Association of America-College Retirement and Equities Fund, to Jonathan G. Katz, Secretary, SEC (Dec. 17, 2003), at <http://www.sec.gov/rules/proposed/s71903/pclapman121703.htm> [hereinafter Clapman Letter].

93. Wachtell Letter, *supra* note 91, at 6.

94. Business Roundtable, *supra* note 91, at 63.

95. *See* Clapman Letter, *supra* note 92, at 3.

96. Hoffa Letter, *supra* note 91, at 2.

tutional stock market, where pension funds are not investing their own money but the savings of pension fund beneficiaries and where the heads of such pension funds generally delegate investment decision-making to a wide variety of pension fund managers, some of whom are long-term investors but some of whom are short-term traders and many of whom choose indexation as an investment strategy, it is really a legal fiction (however useful) to say that shareholders are owners of a company. Although an investor in a passive index is not indifferent to how the companies in that index fund perform, the institution is not analyzing any of the available information concerning the company prior to making an investment and is not allocating capital in the economy to its best and most efficient use. A short-term trader may have even less interest in company fundamentals.

Contested elections are being advocated by government pension funds and others who may be overly influenced by governmental rather than business models. The notion that corporate suffrage should mimic political suffrage so that there should be contested elections for directors is flawed because corporations are managed for economic gain, not democratic objectives. Although it has been asserted that printing and mailing proxy material is prohibitively expensive, and therefore substantial, long-term shareholders should "have a means to assure that the corporation is being directed and managed [o]n their behalf,"⁹⁷ a large shareholder or group is not necessarily more representative of the interests of the shareholders as a body than management and the board, who have fiduciary duties to all of the shareholders. By contrast, one shareholder or minority group does not have fiduciary duties to other shareholders.

Demands by institutional directors for greater power with respect to corporate governance are unlikely to subside whatever the SEC decides with respect to shareholder nominations. Institutional investor power is being exercised in various shareholder proposals and in other ways.⁹⁸ Probably the most effective lever institutions have is their ability to drive down the price of a company's stock by refusing to invest or selling shares. The SEC's shareholder nomination proposal has touched off such a furor because it involves a power struggle over corporate control. Traditional corporation law teaches that shareholders who have a controlling interest in a corporation have fiduciary duties to other shareholders.

IV. CORPORATE GOVERNANCE MODELS

In the 1930s, the accepted theory of the firm was a managerialist theory, although there was not agreement as to the proper object of a corporation's efforts. In the famous debate between Adolf Berle and E. Merrick Dodd, both assumed that corporate managers exercised free reign.⁹⁹ Dodd argued that the state should

97. CONFERENCE BOARD COMMISSION RECOMMENDATIONS, *supra* note 6, at 25.

98. See Institutional Shareholder Services, *Institutional Shareholder Services Releases Preliminary Proxy Season Review* (June 16, 2004), available at http://www.issproxy.com/pdf/2004_Season_Wrap_Up_061604.pdf; Chip Cummins, *Pension Funds Sue Shell Officials To Force Revamp*, WALL ST. J., June 28, 2004, at A3.

99. E. Merrick Dodd, Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI L. REV. 194, 196-98 (1935).

regulate this absolute control of corporate property exercised by corporate managers not only for the benefit of shareholders, but also for society at large.¹⁰⁰ He viewed corporations as autocratic merchant states that derived their power from the government and therefore had to be brought under government control for the benefit of society at large.¹⁰¹ Berle, on the other hand, viewed corporate officers as representatives and was concerned about making corporate managers more responsive to the economic interest of shareholders.¹⁰² He hypothesized that shareholders had surrendered control of the corporation to management and that such control needed to be returned to shareholders through the enforcement of fiduciary duties owed to them by officers and directors.¹⁰³ The managerialist theory was thus an interesting transition from the view that corporation law was constitutional law because the powers of the corporation came from the state (sometimes called the concession theory)¹⁰⁴ to the view that corporate power derived from shareholders.

The debate between Professors Berle and Dodd in 1931 and 1932 formed part of the backdrop for New Deal reform legislation. The federal securities laws adopted the Berle view and compelled managers who tapped the capital markets to behave like public functionaries and be accountable to investors through the mechanism of full disclosure.¹⁰⁵ But the creation of the SEC as a surrogate for investors was really the beginning of a trend toward a theory of the firm based on shareholder primacy. Although merit regulation was rejected, and corporations were not obligated to demonstrate viable capital structures in order to go public, some control of capital structures was maintained through state blue sky laws and then rules of the National Association of Securities Dealers, Inc. (“NASD”) applicable to underwriters.¹⁰⁶ Today, shareholder primacy is the dominant theory of the firm, although it has some competitors.¹⁰⁷ As a theory of the firm, shareholder primacy rests on two principles—shareholder wealth maximization as the object of corporate endeavor, and the principle of ultimate shareholder control.¹⁰⁸

Although the SEC has always viewed itself as the surrogate for shareholders and investors, regulating and disciplining corporate managers for their sake, a very different theory of the firm—the contractarian or corporation as a nexus of

100. *Id.* at 205–07.

101. *Id.* at 198; E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1161–63 (1932).

102. A. A. Berle, Jr., *For Whom Corporate Managers are Trustees: A Note*, 45 HARV. L. REV. 1365, 1365 (1932).

103. *See id.* at 1367, 1371; A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049–50 (1931).

104. *See* Joan MacLeod Heminway, *Enron’s Tangled Web: Complex Relationships; Unanswered Questions*, 71 U. CIN. L. REV. 1167, 1170–71 (2003). Under this theory, directors are viewed as agents of the state.

105. *See supra* notes 27–28 and accompanying text.

106. *See* NASD Conduct Rule 2110, Nat’l Ass’n of Sec. Dealers Manual (CCH) 4111 (2004).

107. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440–41, 447–49 (2001).

108. Bainbridge, *supra* note 2, at 573.

contracts—became quite popular in the early 1990s.¹⁰⁹ Pursuant to this theory, corporate power and managerial authority came from the private sector by way of consensual agreements between various corporate constituents.¹¹⁰ The proponents of this theory believed that the law should facilitate private ordering and government regulators should take a back seat to market forces.¹¹¹

A different political twist was given to the notion that constituents other than shareholders might have some claim on managerial allegiance by the team production theory. The team production theory recognizes that corporate production requires inputs from a number of different groups including creditors, employees, and managers, in addition to shareholders.¹¹² These groups participate in and contribute to corporate success because they expect to be compensated in accordance with their explicit contracts.¹¹³ The team production theory logically followed from the enactment of other constituency statutes that undermined shareholder primacy in takeovers and in some cases more generally.¹¹⁴ The team production theory harkens back to the ideas of Dodd to some extent, because it stresses corporate obligations to non-shareholder constituencies and is hostile to shareholder primacy. One of its proponents has argued that there are three justifications for shareholder primacy and two of them—that shareholders own the corporation, and that shareholders are the sole residual claimants of the corporation—are incorrect from both an economic and legal perspective.¹¹⁵ In her view, the best justification for shareholder primacy is that requiring corporate directors to serve only shareholders is the best way to keep them from imposing excessive agency costs on firms, but this justification is weak.¹¹⁶

A new theory of the firm that has been proposed is director primacy. Under this theory, the power and right to exercise decision-making is vested in the board

109. See William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426–28 (1989). The theory of the corporation as a nexus of contractual relationships was introduced in the 1970s by economists. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976), available at http://papers.ssrn.com/sol3/paper.cfm?ABSTRACT_ID=94043 (last visited Oct. 4, 2004).

110. Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426–28 (1989).

111. *Id.* at 1434–35.

112. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250 (1999).

113. See generally *id.*

114. As of 1999, forty-one states had enacted some form of other constituency statute. Delaware, the state of incorporation for the majority of U.S. public companies, had not. See Ryan J. York, *Visages of Janus: The Heavy Burden of Other Constituency Anti-Takeover Statutes on Shareholders and the Efficient Market for Corporate Control*, 38 WILLAMETTE L. REV. 187, 189–90 (2002). See, e.g., CONN. GEN. STAT. ANN. § 33-756(d) (West 1997); FLA. STAT. ANN. § 607.0830(3) (West 1999); GA. CODE ANN. § 14-2-202(b)(5) (2003); IOWA CODE ANN. § 491.101B (West 1999); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West 1992 & Supp. 2004); NEV. REV. STATE ANN. § 78.138(4) (Michie 1999 & Supp. 2003); N.J. STAT. ANN. § 14A:6-1(2) (West 2003); N.Y. BUS. CORP. LAW § 717(b) (McKinney 2003); OHIO REV. CODE ANN. § 1701.59(E) (Anderson 1999); 15 PA. CONS. STAT. ANN. § 1715 (West 1999); WIS. STAT. ANN. § 180.0827 (West 1992).

115. Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1190–95 (2002).

116. *Id.* at 1199–1201.

of directors.¹¹⁷ The board is viewed as sovereign.¹¹⁸ This theory is an interesting update of the managerialist theory of the firm. The board is recognized as the fulcrum of the firm, mediating between managers and shareholders, as well as other constituencies, but with fiat authority to make decisions.¹¹⁹ This theory would appear to accommodate the increasing emphasis on the importance of independent directors, and although harkening back to managerialism, argues that managers and directors are separate centers of power. Further, shareholder rights to control the firm are “so weak that they scarcely qualify as part of corporate governance.”¹²⁰

To what extent are any of these academic theories accepted by practicing lawyers, judges or business leaders? The American Law Institute’s Corporate Governance Project¹²¹ is based on a shareholder primacy model, in which corporations are run for shareholder gain and an independent board of directors, representing the shareholders, monitors corporate management.¹²² The Delaware courts have given managers and directors considerable freedom to thwart shareholders in takeover situations,¹²³ but have insisted on the importance of shareholder suffrage and held in check managers and directors who have attempted to interfere with shareholder voting rights.¹²⁴ One group of business and political leaders recently described the compact that underlies corporate capitalism as one in which “investors entrust their assets to management while boards of directors oversee management so that the potential for conflict of interest between owners and managers is policed.”¹²⁵

In truth, managerialism probably is more consonant with the realities of the business world than any of the more recent academic theories about the firm. The modern public corporation is a vast bureaucratic organization of great complexity. Although shareholders have the power to vote for directors and, in theory, the directors appoint the managers; both shareholders and directors are part-time participants in the corporation’s affairs. The corporate scandals of recent years have demonstrated that corporate managers, and in particular, CEOs, have great power and insufficient accountability. Without such power, they probably could not manage the modern corporation, which is based on a hierarchical structure. The Sarbanes-Oxley Act is an effort to set up independent directors as a check upon corporate managers. Whether this model will work remains to be seen because boards of directors have long operated by consensus. The shareholder nomination rule proposal is an effort to encourage institutional investors to make

117. See Bainbridge, *supra* note 2, at 559–60.

118. *Id.* at 569.

119. *Id.* at 559–60.

120. *Id.* at 569.

121. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994).

122. See *id.* §§ 2.01, 3.01, 3.02.

123. See, e.g., *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1152–54 (Del. 1989); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958–59 (Del. 1985).

124. See *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 658–63 (Del. Ch. 1988).

125. CONFERENCE BOARD COMMISSION RECOMMENDATIONS, *supra* note 6, at 5.

managers more accountable. The SEC's statutory mandate is to protect investors, and the accountability the SEC is seeking is accountability to shareholders, not some larger public or other constituencies. The problem with giving investors greater power to hold managers accountable, however, is that investors are part of the problem.

V. THE TROUBLE WITH INVESTORS

The Conference Board Commission on Public Trust and Private Enterprise expressed the view that:

a strong focus on the corporation's long-term economic growth and viability is essential to the restoration of trust in public corporations. This focus involves not only the board's and management's long-term strategies and conduct of the business to create lasting value, but also the development of a base of shareowners whose investment is similarly for long-term growth and gain Such a long-term ownership focus provides an impetus to avoid management focused exclusively on short-term gain. The Commission believes that managing for short-term earnings and stock price results has led to many of the behaviors and manipulations that have resulted in the recent corporate crises and loss of investor confidence.¹²⁶

Institutional investors, like other investors, are interested in overall return. Most institutions hire pension fund managers to invest their portfolios and they are judged according to fairly short time frames. In their competition with one another, they seek quarter-to-quarter and year-to-year performance statistics that are better than those of their peers. One of the recommendations of the Conference Board Commission is that "[i]nstitutional investors should establish compensation arrangements for portfolio managers that reward a long-term rather than short-term focus."¹²⁷ The proclivity of institutions to focus on short-term gain for money managers has been demonstrated by the recent mutual fund scandals.¹²⁸

During the 1980s, the pressure for high overall return by institutional investors in U.S. corporations resulted in an unhealthy leveraging of U.S. corporations to meet that demand. Funds were borrowed to pay dividends to shareholders, in the form of ordinary cash distributions, share repurchases, or takeover premiums. The net effect was the opposite of capital formation: it was a liquidation of industry. Furthermore, the transaction costs from this restructuring were huge and siphoned money from industry into investment banking and legal fees.¹²⁹

126. *Id.* at 17.

127. *Id.* at 34.

128. See John Hechinger, *Putnam Says It Will Replace Fund Managers*, WALL ST. J., Oct. 24, 2003, at C1; Tom Lauricella, *Mutual-Fund Scandal Clouds Bottom Lines; 'Dilution' Costs to Shareholders Could Be Large and the Target of Regulators' Recovery Efforts*, WALL ST. J., Oct. 20, 2003, at C1.

129. See BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE* 108, 187, 208, 220–21, 243, 254, 298–99, 317, 336–37, 390, 510 (1990); PAUL R. KRUGMAN, *THE AGE OF DIMINISHED EXPECTATIONS* 154–68 (1990).

In the 1990s, institutions pressured managers and directors to become aligned with stockholders that led to an excessive use of stock options and other equity-based incentives. This encouraged managers to focus on stock market prices instead of other measures of corporate performance. As long as the bull market raged on, everyone was happy, but when the market collapsed, the public's distress led to anger and distrust. The blame for fraudulent financial statements at Enron and many other corporations has been laid upon greedy corporate managers and supine directors. New securities regulation was mandated by Sarbanes-Oxley and the SEC and other prosecutions were undertaken to restore investor confidence; however, the truly difficult questions with respect to the savings and pension losses suffered by Americans were not being asked. That is, why were the holdings of so many institutions and individuals invested in equities rather than in bonds?¹³⁰ And why did investors permit corporate capital structures to become leveraged to such an unhealthy extent?

When the federal securities laws were first enacted, many policy makers believed that full disclosure was not a sufficient federal remedy for the excesses of the 1920s. William O. Douglas argued that industry needed "constructive planning and organization conditioned by the requirements of the public good That in essence means control over access to the market."¹³¹ The United States never embraced this kind of central planning, and given the failures of communism and socialism in other countries, that was probably fortunate. The United States long had faith in the ability of the market to efficiently allocate capital. This meant that investors were expected to analyze the disclosures mandated by the SEC and direct capital to the corporations able to use that capital. Of the many social contracts that were broken in the 1990s, this expectation that investors, and particularly institutional investors, with the money and professionalism to choose good investments, would do so for the benefit of the national economy, failed. The inability or unwillingness of investors to assess relative corporate values and invest their capital efficiently and wisely should give pause to the notion that greater shareholder power is the solution to the problems of the financial markets. Why should shareholders obtain more rights unless they assume greater obligations?

The activist institutional investors have large holdings in corporate equities and are politically influential. There is some evidence, however, that other investors, including other institutional investors, "are not particularly interested in corporate governance issues."¹³² If institutional investors do not solicit their own beneficiaries as to their views, and they certainly do not solicit the views of other investors or owe them any duties, it seems inappropriate for them to obtain rights that are

130. The Pension Benefit Guaranty Corporation recently "decided it ha[d] taken on too much risk" and plans to "reduce stocks to as little as 15 percent of its total investments." See Mary Williams Walsh, *Pension Agency to Cut Its Stock Holdings*, N.Y. TIMES, Jan. 30, 2004, at C3; Randy Clerihue, *PBGC Announces New Investment Policy*, Pension Benefit Guaranty Corporation, available at http://www.pbgc.gov/news/press_releases/2004/pr04_25.htm (Jan. 29, 2004).

131. William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 531 (1934).

132. Grienberger, *supra* note 63, at 36.

not accorded to investors generally. If such rights are accompanied by greater obligations, new difficulties could emerge.

Imposing obligations to a business enterprise or other shareholders upon institutional investors would be a tricky business. Such a duty could include a duty to monitor the soundness and fairness of a corporation's capital structure, but in some situations such a duty could involve a conflict of interest. First and foremost, institutional investors should be concerned about their duties to their own beneficiaries, and if these duties were to come into conflict with a duty to the corporation in which the institution is a shareholder, it is not clear how such a conflict could be resolved.

Although the obligation of institutional investors to invest prudently and then monitor their investments can best be enforced by those who regulate such institutions for the benefit of protected groups, such regulators vary in their concerns and regulatory mandates. Banking regulators are concerned about safety and soundness for the benefit of depositors and insurance regulators are concerned about safeguarding the interests of policyholders.¹³³ The SEC is concerned about mutual fund shareholders and conflicts of interest between funds and their advisors.¹³⁴ The Pension Benefit Guaranty Corporation and the Department of Labor are concerned about the solvency of corporate-defined benefit pension funds in order to safeguard the interests of retirees.¹³⁵

Although none of these regulators have responsibility for the efficient allocation of assets in the national economy, and perhaps such regulation would not be welcomed in a capitalist system, more rigorous enforcement of prudent investor-type principles might have the side benefit of making institutions invest more wisely. In addition, mechanisms to encourage institutional investors to hold securities for the long term might be considered by policy makers. This might particularly be applicable to pension funds and endowment funds that should, in theory, be looking at the long term.

The problems of speculative and short-term trading by institutional investors is not new, but the possible creation of a federal right to nominate directors on management's proxy and thus change existing state law does raise some new issues. If institutions win the right to make shareholder nominations, what duties should they then have to other shareholders? Majority shareholders have duties to exercise due care and deal fairly with minority shareholders because they control the board of directors. If favored institutions begin to nominate and cause the election of directors in opposition to the selection by an existing board, such

133. See Heidi Mandanis Schooner, *The Secrets of Bank Regulation: A Reply to Professor Cohen*, 6 GREEN BAG 389, 389-91 (2003). "Bank regulators, unlike securities regulators, are not . . . 'charged with promoting fair and accurate accounting disclosure.'" *Id.* at 390. See also John Dembeck, *Regulation of Insurance* 119, 122 (PLI Litig. & Admin. Practice Course, Handbook Series No. H0-005F, 1999), available at WL 602 PLI/Lit 119.

134. See Samuel S. Kim, Note, *Mutual Funds: Solving the Shortcomings of the Independent Director Response to Advisory Self-Dealing Through Use of the Undue Influence Standard*, 98 COLUM. L. REV. 474, 483-87 (1998). Concerned with protection of mutual fund shareholders, the SEC might be reluctant to act in any way that may destabilize the mutual fund industry. *Id.* at 499.

135. 29 U.S.C. § 1302 (2002).

institutions should, in appropriate cases, be held to the same kind of duties that are imposed on controlling shareholders. They should undertake to monitor the directors they propose and remain shareholders for the duration of the terms of office of such directors. They should monitor corporate capital structures to prevent unfair recapitalizations. Further, they should be prevented from using any power to nominate directors in conflict of interest situations. In the case of labor union pension funds, this could be treacherous ground because they may be more interested in labor issues than shareholder issues.

The serious abuses of trust by some corporate managers and directors during the late 1990s and into the next century have led to a clamor for reform that seems to now have its own momentum. But perhaps those activist institutions that are demanding greater rights as shareholders should be more cautious. If they obtain some of their wishes, they may find that with new rights come new responsibilities and liabilities.

