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REFLECTIONS ON THE STATE OF CORPORATE GOVERNANCE

*Bevis Longstreth**

To judge from the wealth of recent writings and symposia on the subject, corporate governance, and in particular, the role of the institutional investor therein, has become the new "hot" topic among academics (Richard M. Buxbaum, Ronald J. Gilson and Reinier Kraakman, Louis Lowenstein, George W. Dent, Jr.), lawyers (Martin Lipton, Steven A. Rosenblum and A.A. Sommer, Jr.), businessmen (Elmer Johnson) and institutional investors (CalPERS).

Most commentators attribute this renewed interest in corporate governance to the takeover battles of the 1980s. Certainly there is a connection between the two. In the struggle for corporate control that dominated the corporate landscape throughout that decade, tremendous resources were devoted to both offense and defense in what became for many of those involved a highly personalized matter of corporate life and death. Indeed, the vocabulary, now so well known, underscored the life threatening aspect of these encounters: "poison pills," "shark repellents," "golden parachutes," "PAC man defenses."

One excess begat another.

The growth in hostile takeover bids, sometimes using coercive two-tier offers, sometimes pitting a notorious corporate raider bent on bust-up against a well-regarded management, sometimes using very high leverage through the use of junk bonds, thereby endangering the future health of the target, encouraged a vigorous response on behalf of management. Management's counterattack led to a number of developments:

1. Delaware and other states approved the elimination of liability for breach of the duty of care.

2. At least twenty-nine states adopted second generation antitakeover laws, designed to avoid direct conflict with the Wil-

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liams Act by regulating corporate rights and powers typically defined by state law, thereby skirting the 1982 *Edgar v. MITE Corp.*¹ decision, where the Supreme Court invalidated an Illinois anti-takeover law on Commerce Clause grounds.

3. Poison pills were widely approved by the courts, despite the perception that they had adverse effects on shareholders, as evidenced by directors' unwillingness to seek shareholder approval. Over 1,200 corporations adopted poison pills without consulting shareholders.

4. Beyond these changes, and far more significant in their ability to lessen market forces as a check on management, were (1) the application of the business judgment rule to takeover situations, and (2) the emergence of state laws permitting directors to consider nonshareholder constituencies as a basis for taking action.

The effectiveness of management's counterattack is suggested by the steady decline over the past decade in the percentage of tender offers that were hostile, from a high of 43% in 1982 to 21% in 1989 and a low of 10% in 1990 (through November).

In response to these developments a few institutional investors, most prominently CalPERS, the largest publicly funded retirement system in the country with assets of \$55 billion, sought to use their voting power to dissuade managements from adopting defensive measures that tended to make their corporations bid-proof. CalPERS also sought to gain management acceptance of the "shareholder advisory committee" idea, this being a committee representing a corporation's largest shareholders, formed to meet regularly with management to receive and react to management's reports on its performance. CalPERS succeeded in the case of Lockheed, where management agreed to a shareholders advisory committee in order to win institutional support in its proxy contest with Harold Simmons.

This was roughly the state of play when the junk bond market died, and with it, the takeover era. Unfortunately, the corporate battlegrounds on which the takeover wars were fought remain strewn with the implements of war—the excesses of the eighties. The detritus of these wars may well affect corporate

¹ 457 U.S. 624 (1982).

performance for some time to come. This may help to explain why now, with the subduing effects on the marketplace of a global recession, comes a torrent of writing about corporate governance and the institutional investor.

A common belief underlying much of this writing is that corporations will function better if shareholders are given enhanced voice.

Professors Louis Lowenstein and George Dent would turn over the nominating machinery for directors to shareholders. Professor Lowenstein proposes to give shareholders the exclusive right to nominate one-fifth to one-quarter of the board. Professor Dent would go much further, giving the corporation's ten to twenty largest shareholders exclusive access to the proxy machinery at corporate expense.

Professors Ronald Gilson and Reinier Kraakman seek to create a group of "professional directors," selected by a clearinghouse and approved by enough institutional investors to assure election, either through a proxy fight or by the cooperation of an intimidated management. They suggest that about 25 percent of the board be so elected.

CalPERS would have corporations create the shareholder advisory committees earlier described.

And Marty Lipton and Steve Rosenblum propose a quinquennial system for election of directors, accompanied by a number of other very important changes that make their proposal thoroughly remarkable. (More about this later.)

Let's back up. What's all the shouting about: Is our corporate governance system broken? And if it is broken, how so and what needs to be done?

The orthodox view of corporate purpose is to maximize profits for shareholders, with directors being elected, and management being appointed, to serve the interests of shareholders with care, undivided loyalty and in compliance with law.

If we favor this orthodoxy—and I do—then we need to try to restore it in those places where it has been, or is threatened to be, removed. For example:

1. A number of states, twenty-nine at last count, that have adopted the multiconstituency idea, by which state corporate laws are revised to redefine a director's fiduciary duty as owed not just to shareholders but, perhaps equally or even to a greater extent, to many other constituencies affected by the corporation

as well. The other constituencies typically mentioned include employees, suppliers, customers, and communities in which the corporation operates. There are various versions of the constituency amendment to state corporate statutes that define the duty of directors. Most laws are permissive. Some expressly seek to alter the orthodox notion that directors exclusively serve the interests of shareholders by elevating the many nonshareholder interests to equal status with shareholders' and according directors wide discretion in weighing among them all. Others, such as one enacted in New York in 1989, are ambiguous on the matter. Some are limited in effect to takeover situations, thus revealing more starkly their thwarting purpose; others apply generally to all actions by directors.

2. In the ALI's embattled Corporate Governance Project, the orthodox corporate objective of "profit maximization" has been softened to "enhancing corporate profit and shareholder gain," and even this softened standard is threatened with severe erosion in the context of hostile takeovers. Section 6.02 of the ALI's *Principles of Corporate Governance*, in its most recent draft version, would substitute for the rule of "corporate profit and shareholder gain" a more flexible standard to govern the action of directors seeking to thwart an unfriendly bid. This standard would permit board action favoring nonshareholder constituencies at the expense of shareholders, so long as the long-term interests of shareholders were not disfavored significantly.²

3. The March 1990 Statement of the Business Roundtable on Corporate Governance and American Competitiveness rejected "profit maximization" in favor of a careful weighing by directors of the interests of all stakeholders (defined to include, in addition to shareholders, a corporation's "employees, customers, suppliers, creditors, the communities where the corporation does business, and society as a whole").³ The Roundtable suggests no tilting in favor of shareholders where conflicting interests arise. "Resolving the potentially differing interests of various stakeholders and the best long-term interest of the corporation and its shareholders involves compromises and

² THE AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS TENTATIVE DRAFT No.10* §6.02 (Apr. 16, 1990).

³ The Business Roundtable, *Corporate Governance and American Competitiveness* 4 (March 1990), reprinted in 46 *BUS. LAW.* 241, 244 (1990).

tradeoffs which often must be made rapidly. It is important that all stakeholder interests be considered but impossible to assure that all will be satisfied because competing claims may be mutually exclusive."⁴

Beyond the need to address these problems, and thus to restore the orthodoxy of profit maximization, there is a question of the ways and means by which the interests of management and directors are aligned with the interests of shareholders. How well does our system of corporate governance work to assure that the orthodox notion of corporate purpose is fulfilled? How effective are the ways and means by which directors and management are held accountable to shareholders? How has this system been affected by the excesses of the eighties? There are two issues here and they are often confused with each other: (1) Is management (the agent) serving itself rather than the corporation and its shareholders (the principal)?—this is a matter of loyalty; and (2) Is management, in seeking to serve the corporation and its shareholders, acting in a stupid or otherwise incompetent way?—this is a matter of care.

The role of directors is to see to it that management discharges its duties of loyalty and care. And, of course, directors are equally subject to those duties. The use of outside directors has become the dominant means by which public corporations seek to assure shareholders that management is fulfilling these duties.

Advocates of enhanced shareholder voice, such as CalPERS and Professors Gilson, Kraakman and Dent, believe that: (1) outside directors nominated by management (or even by a committee of outside directors) are so beholden to management as to be incapable of holding management to account—of monitoring management adequately; (2) the failure of outside directors, so nominated, causes losses to shareholders that could be avoided; and (3) the way to avoid those losses, or, put more positively, to achieve shareholder gains, is to create machinery to assure that institutional investors have their own nominees either on the board or with regularized access to it.

I do not favor these ideas. None of the proposals would deal with the threat to orthodoxy seen in the state constituency laws

⁴ *Id.* at 5, reprinted in 46 BUS. LAW. at 245.

and the tendency that can be observed in the evolving drafts of the ALI's project on corporate governance toward a more diffuse set of corporate objectives.

In addition, the advocates of shareholder voice point to no empirical data suggesting that large institutional shareholders, if given the power to nominate, will produce directors better capable of maximizing shareholder gain than those now holding office. To my knowledge there are no such data. It is a particularly dubious proposition when applied to the government sector, where almost all of the shareholder activism is found. There is nothing about our governmental processes, or those in charge, that should inspire confidence in their ability to improve on the quality of directors now in office among our publicly held corporations. Moreover, those chosen to oversee government pension funds are necessarily going to be influenced by a range of political considerations having little or nothing to do with the goal of maximizing shareholder wealth. Political factors could easily become involved in the selection process.

With these concerns in mind, it is somewhat chilling to note the confidence in result that CalPERS expresses in its letter to the SEC seeking changes in the proxy rules to give it and other large like-minded investors an easier means of imposing their view on management, without (please note) the cost, or risk, of acquiring control. The following is an excerpt of a letter, dated November 3, 1989, from Richard H. Koppes, General Counsel to CalPERS, to Linda C. Quinn, Director of the SEC's Division of Corporation Finance, in which comprehensive review of the proxy rules was requested and many proposed changes advanced:

In contrast to shareholders that seek control of a company through confrontation of directors and management and market destabilization, the objective of ongoing institutional shareholders, such as CalPERS, is to join in the dialogue of corporate governance and thereby reduce volatility and increase long term share values. . . .

. . . As discussed above, however, there has developed a class of institutional investors that, by virtue of long term outlook and relative sophistication, is not only able to play a positive role in the governance of public corporations but, as the owner of these corporations, has a right to assert that role.

The very important issue presented by the CalPERS request to the SEC for proxy reform was succinctly stated in the

letter, dated April 27, 1990, from the American Bar Association's Section on Business Law to Linda C. Quinn, commenting on the CalPERS proposal:

The fundamental question thus presented is whether the proxy rules and process require change to accommodate the relatively new and important category of shareholder activity, namely, the desire to influence management and the board of directors without directly seeking control of the entire board through a proxy contest or through a tender offer.

With some exceptions, the present system tends to allow an investor, or group of investors acting in concert, to impose their will on a corporation only after they have committed major resources to the task, either through purchasing voting control or mounting a proxy contest for control of the board. There is a rough correspondence between the power to direct and the capital risks undertaken to achieve that power. The CalPERS goal appears to be aimed at empowerment without the risks that now typically are involved.

But there is another problem. The shareholder voice proposals cluster around the notion that the largest institutional investors, who by dint of indexing hold the market, would collectively exercise a uniform voice in nominating and electing "professional" directors to the boards of all the corporations that make up the market. The risk to entrepreneurship of having this group choose ineffective people is somewhat alarming, especially when one considers the impact that getting it wrong could have across a broad spectrum of publicly traded corporations.

There is strength in a system that allows for a wide variety of corporate governance structures and styles within a legal framework that: (1) defines the corporate objective to be profit maximization; (2) imposes on management and the board the duties of loyalty and care; (3) encourages competition for managers, products and services, and capital; and (4) permits a market for control. Since no one with strong empirical support can point to *the* optimal structure for achieving shareholder gain, it is best to allow for diversity of approach to corporate governance, recognizing that entrepreneurship involves risk taking and that investors can protect themselves from the risks of individual expressions of entrepreneurship, however experimental, through intelligent diversification.

The central problem with our present system of corporate governance has been the loss of confidence on the part of shareholders in the willingness of even outside directors to act in the shareholders' best interest when confronted with a threat to control, either through a hostile takeover bid or a proxy contest. This loss of confidence is sometimes justified, but not because outside directors act improperly. The problem is a structural one: we have allowed state law (and the ALI project) to classify outside directors, voting in such extreme circumstances, as "disinterested," therefore entitling them to the robust protections of the business judgment rule. Much has been written about the ability of outside directors to exercise business judgment unaffected by the possibility that management may be self-interested. William T. Allen, Chancellor of the Delaware Court of Chancery and author of the chancery court's opinion in *Paramount Communications, Inc. v. Time, Inc.*,⁵ reviews the matter with a sensitive hand in his recent essay, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*⁶ Confessing to "skepticism" but not the cynicism of such critics as Peter Drucker and Judges Posner, Kaufman and Cudahy, Chancellor Allen remains open to "the possibility that such committees [of outside directors] can be employed effectively to protect corporate and shareholder interests."⁷

In my view, the business judgment rule was not intended for such titanic occasions in corporate life as arise upon a threat to control, and its use in contests for control has created much mischief. Thus, outside directors came to the assistance of management, supporting corporate and statutory defenses to hostile takeover bids that became harder and harder to reconcile with corporate profit and shareholder gain, notwithstanding their success before state legislatures and the courts. Institutional investors, particularly the large public pension funds, grew increasingly alarmed about the scope and effectiveness of these defenses, and about the apparent success outside directors were having in reconciling their support for management with their duties of loyalty and care. And so they now are seeking a very enhanced shareholder voice in the selection of directors.

⁵ [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. Jul. 26, 1989).

⁶ 45 BUS. LAW 2055 (1990).

⁷ *Id.* at 2056.

If one puts aside the role of directors in changes of control, at the beginning of the eighties there was no problem with our present system of corporate governance so fundamental as to require a major systemic change in the way directors are nominated and elected. No system will deter all of the excesses all of the time. No system can, or should, prevent business failures, which are the inevitable flip side of a competitive environment in which businesses are allowed to succeed. Unfortunately, the excesses of the eighties leave us with a legacy of problems that threaten to change the orthodox view of corporate purpose. The problem with proposals for enhanced shareholder voice is that they would introduce uncertainties into the process by which directors are selected while not dealing directly with the legacy of those excesses from the eighties.

As mentioned earlier, Marty Lipton and Steve Rosenblum propose a new system of corporate governance based on a quinquennial election of directors.⁹ What is intriguing about this proposal is that it would sweep away all of the excesses left untouched by the other proponents for change. Here are the essential elements of the Lipton-Rosenblum proposal:

1. Directors, of whom a majority must be outside, would be elected for five-year terms, subject to earlier removal only for "cause."

2. Nonconsensual takeovers would be prohibited. No shareholder could acquire more than 10 percent of a corporation's stock without board approval.

3. In connection with the quinquennial meeting, a shareholder or group of shareholders with 5 percent or more of the corporation's stock, or stock worth \$5 million or more, would have access to the corporate proxy machinery in support of its candidates for the board on the same basis that the incumbent board enjoys in support of itself.

4. The incumbent board would be required to develop detailed strategic five-year plans and, in connection with each quinquennial meeting, would deliver a detailed report to shareholders as to its actual performance over the past five years compared to its five-year plan and as to its strategic plan for the next five years. An investment banking or similar firm would do

⁹ Lipton & Rosenblum, *A Proposal for a New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

a separate evaluation report to shareholders.

5. All existing impediments to takeovers would be eliminated, including, for example, poison pills, staggered boards, super majority "fair price" provisions, state takeover statutes and nonstockholder constituency laws.

6. The "one share, one vote" provisions of Rule 19c-4 under the Securities Exchange Act would be affirmed.

7. An incentive compensation system, based solely on whether and to what extent the corporation met its five-year goals, would be imposed in place of other types of incentives.

This proposal, taken in its totality, is a breathtaking effort to: (1) affirm the corporate orthodoxy of profit maximization; (2) put teeth in such policing mechanisms as the right of shareholders to elect the board and the duty of the board to monitor management; (3) encourage managers, directors and shareholders to develop a longer term perspective, measured in five-year plans; and (4) facilitate a market for corporate control, albeit periodically, every five years, by sweeping away all of the defensive barriers so carefully constructed by management over the past decade to thwart hostile attempts to gain control.

Some might be surprised to find Mr. Lipton, architect of so many of these defenses, proposing their total abandonment in exchange for a five-year wait on contests for control. Lipton and Rosenblum argue that, under their scheme, "institutional shareholders would have no choice but to take at least a five-year perspective"⁹ and to look to the long-term return on their investment. I confess to being surprised by the Lipton-Rosenblum proposal. But I am delighted too, because what Messrs. Lipton and Rosenblum have put forward is a very creative way to erase the excesses of the eighties in one grand sweep. Moreover, their proposal strengthens the traditional methods by which the interests of managers and directors are aligned with those of shareholders.

I have some doubt that the quinquennial system would, in fact, encourage a long-term outlook on the part of management more effectively than what currently exists. In fact, five years is not very long. And the sharp focus on performance against a five-year plan may deter entrepreneurship unduly by making

⁹ *Id.* at 243.

management too risk averse. However, I am inclined, after one look, to accept the trade-off proposed by the authors. In effect, by barring all defensive maneuvers to defeat a hostile takeover attempt, the authors are espousing the central principle of the English system now administered by the Panel on Takeovers and Mergers, namely that management of a defending company should take no frustrating action without the consent of shareholders.

There are, of course, political problems in achieving the clean sweep being advocated, because matters of state and federal law are implicated. But for purposes of debate, the practical problems of implementation can be put aside.

In their paper, some 142 pages in length, the authors devote exactly half the space to arguments against much of the current thinking by academics in regard to corporate governance and to trying to prove that institutional investors have a short-term focus that has caused short-termism among corporate managers and led to the hostile takeover phenomenon of the eighties. What is remarkable about the conclusions advanced in this, the first half of the paper—conclusions, I believe, that rest more on personal perceptions than on solid findings of fact—is that they prepare one not at all for the quinquennial system put forth in the second half of the paper. The authors' proposal comes as something of a non sequitur. But a non sequitur most welcome! For this small observation in no way diminishes my admiration for the sweep and thrust of the proposal itself. More power to Messrs. Lipton and Rosenblum in carrying forward their ideas. They deserve to be taken very seriously indeed.

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