ISSN 1045-6333

REINVENTING THE OUTSIDE DIRECTOR: AN AGENDA FOR INSTITUTIONAL INVESTORS

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Discussion Paper No. 93

5/91

Program in Law and Economics
Harvard Law School
Cambridge, MA 02138

The Program in Law and Economics is supported by a grant from the John M. Olin Foundation.

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ABSTRACT

Managerialist rhetoric puts institutional investors between a rock and a hard place. If an institution trades regularly, it is said to be a short-term shareholder with little claim on management's attention. Yet if an institution buys and holds, by indexing its portfolio, it is the wrong kind of long-term shareholder. These twin complaints about indexed investing and short-term trading highlight the fact that we lack a normative model for how shareholders who invest "in the market" should behave toward their portfolio companies. In this article we argue that reform of corporate governance is a sensible strategy for improving the performance of institutional investment portfolios. We propose a strategy for improving corporate governance that need not wait on politically controversial legal or regulatory reform and that is largely within the control of the current institutional investor community to implement. After evaluating current proposals for corporate governance reform and considering the LBO Association and Japanese and German bank centered groups as alternative governance structures, we offer our own agenda for institutional investors: electing to the boards of portfolio companies a minority of professional directors who are not merely independent of management, but are accountable to shareholders. We then explore the legal and political feasibility of our agenda, and conclude that the barriers to collective action by institutional investors are far less imposing than is commonly thought.

REINVENTING THE OUTSIDE DIRECTOR: AN AGENDA FOR INSTITUTIONAL INVESTORS

Ronald J. Gilson and Reinier Kraakman*

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

If an institution trades frequently, it is said to be a short-term shareholder without a stake in the future of the corporation. According to the familiar argument, the short-term shareholder has no more legitimate claim on management's attention than does a holder of options on the company's securities. Neither investor really cares about the corporation. Their only concern, as everyone knows,

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We are grateful to H.B. Atwater, Jr., Victor Brudney, Joseph Grundfest, Howell Jackson, Nell Minow, and Robert Pozen for helpful comments on an earlier draft of this article.

is about the fickle walk of market prices during the brief interval in which they are invested. [1]

Yet, if an institution buys and holds, it fares no better in the standard polemic. Some of the largest institutional investors are long-term investors. For example, the annual turnover rate on the California Public Employees' Retirement System (CalPERS) equity portfolio is approximately 10%, and its average holding period for particular stocks is between six and ten years.[2] Indeed, CalPERS is likely to experience even lower turnover soon, because the proportion of its equity portfolio that is passively managed through indexing is expected to increase from 60% to 85% by 1991.[3] Because CalPERS indexes to avoid trading, it is a long-term investor by definition. Nevertheless, it is the wrong kind of long-term investor in the view of

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

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

J. Lorsch, Pawns or Potentates: The Reality of America's Corporate Boards 46 (1989).

[2] California Public Employees' Retirement System, Why Corporate Governance? 4 (Nov. 7, 1989).

[3] Clark, Why Dale Hanson Won't Go Away, Institutional Investor (April, 1990), p. 80. A recent Financial Executives Institute survey of plans totalling $260 billion in assets reported that 34% of equity investments by the surveyed plans were passively managed by indexing, See Walker, The Increasing Role of Pension Plans in the Capital Market Markets and in Corporate Governance, paper presented at Salomon Brothers Center and Rutgers Center conference on The Fiduciary Responsibilities of Institutional Investors (June 14-15, 1990) (reporting study).

many managers. Consider the remarks of Andrew Sigler, the Chief Executive Officer of Champion International:

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

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

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

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[4]Quoted in The Governor's Task Force on Pension Fund Investment, Our Money's Worth 37 (June, 1989) (New York) ("New York Task Force Report").
[5]Some commentators assert both the short-term and the indexed investor criticisms. See C. Whitehill, A Sound Argument Why the American Law Institute Should Defer Adoption of Part VI of its Corporate Governance Project 10, Vol. 2, No. 2, National Legal Center (May 4, 1990) ("The managers of these

cares only about covariances and not about companies at all, undertakes the ultimate abstraction from the concerns of the traditional property holder.

Puzzlement over appropriate behavior by the indexed investor -- or by any other investor oriented toward the market rather than toward particular companies -- is hardly limited to managers. Recast only slightly, Sigler's complaint states the question that an investor like CalPERS, with almost $50 billion of indexed investments, must inevitably ask itself: How should a passive investor relate to its portfolio companies?

In this article, we offer not only an answer but also something else that is in even shorter supply among academics: a realistic agenda for institutional investors. We propose a strategy for improving corporate governance that need not wait on politically controversial legal or regulatory reform and that is largely within the control of the current instutitional investor community to implement. We begin Part I by briefly restating the familiar but nonetheless centrally important case for a reform of corporate governance as a sensible strategy for improving the performance of institutional investment portfolios. Part II then offers a critical evaluation of current efforts by institutional investors to implement such a strategy: proposals to protect the market for corporate control, to

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[indexed] funds are looking at broad market movements and are not concerned with the performance of individual corporations. The long-term growth of a particular corporation is unimportant compared to the immediate issue of whether the price offered in a takeover is better than the current market price.") Clifford Whitehill is Senior Vice President and General Counsel of General Mills, Inc., and Chairman of the Lawyers Steering Committee of the Corporate Governance Task Force of The Business Roundtable.

establish shareholder advisory committees, and to appoint additional outside directors. With criticism, however, comes the responsibility to be constructive. Part III considers alternative approaches to corporate governance -- the LBO Association and Japanese and German corporate groups -- which returns us to the central role of the outside director. Part IV identifies the limitations of existing proposals for reforming the board of directors. In Part V, we offer our own agenda for institutional investors by discussing how a core of professional directors might be organized and how it would be likely to function in practice. Finally, Part VI explores the political and legal feasibility of our agenda and concludes that the barriers to collective action by institutional investors are far less imposing than is commonly supposed.

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

I. THE INEVITABILITY OF A CORPORATE GOVERNANCE STRATEGY.

The movement of large institutional investors toward indexed investing reflects two different, but complementary, trends. The first is the increased influence of the efficient capital market hypothesis on institutional investors, and especially on pension funds. During the last

20 years, an important body of research has shown that on a risk-adjusted basis, over time and on average, active portfolio management of publicly traded equities does no better than the market. After netting out commission and management fees, active portfolio management often does worse than the market.[6] By contrast, indexing allows investors to obtain the same performance as the market with dramatically lower transaction costs.

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

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[6] See, e.g., W. Sharpe, Investments 453-7 (1978); Jensen, The Performance of Mutual Funds in the Period 1945-64, 23 J. Fin. 389 (1968); Mains, Risk, the Pricing of Capital Assets, and the Evaluation of Investment Portfolios: Comment, 50 J. Bus. 371 (1977). Walker, supra note 3, reports that "from 1950 to 1987, passively managed funds (defined as plans with less than 15% average equity turnover) out-performed the most actively managed fund (defined as plans with over 70% average turnover.)"

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

the market through indexing eliminates the problem by eliminating the need to trade.[8]

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

A corporate governance strategy for passive portfolio managers begins with the insight that efforts to increase investment values must be measured by their effect on the entire portfolio. This can be seen most clearly by analogy to a different kind of indexed investor: the

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[8] See New York Task Force Report, supra note 4, at 37.

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

United States government. The government's proceeds from the corporate income tax resemble the returns on a fully indexed (at least nationally) portfolio of preferred stock with a stated dividend of the marginal tax rates. A strategy to increase the value of this portfolio -- to increase the corporate tax yield -- must promise to improve the performance of the entire economy since the government gains nothing if one company pays more taxes at the cost of decreasing the tax receipts from another company.[10] An institutional investor is in precisely the same position. The surest way to increase the value of an indexed stock portfolio is to increase the value of all of the companies in the portfolio.

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

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

institutional investor should seek a corporate governance system that, by improving the monitoring of management in general, can improve the performance, of all companies.

II. EVALUATING CURRENT CORPORATE GOVERNANCE STRATEGIES.

Given their economic interest in corporate governance, it is hardly surprising that institutional investors, and particularly public pension funds,[11] have become increasingly active in the governance of their portfolio companies. To date, their efforts have taken three general directions, all of which were reflected in the recent proxy fight for control of the Lockheed Corporation. The first has been to protect the market for corporate control by seeking to block or dismantle takeover defenses erected by portfolio companies without shareholder approval. For example, precatory shareholder proposals urged Lockheed's board of directors to redeem the company's shareholder rights plan and to cause the company to opt out of the Delaware anti-takeover statute. The second direction, pioneered by CalPERS, urges the creation of shareholder advisory committees. Such a committee was one of the reforms offered to institutional investors by Lockheed's management. Finally, the most aggressive direction pursued by institutional investors has been to seek direct input into the selection of outside directors. In the Lockheed case, this approach was apparent

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[11] Corporate governance activism is not limited to public pension funds. Fidelity Investments, the nation's largest mutual fund organization, has removed investment limitations on 63 of its mutual funds so as to enable the funds to purchase more than 10% of a portfolio company's stock, join in a proxy fight against incumbent management, or seek the sale of a company. In particular, Fidelity's general counsel has urged restricting the duration of poison pills. See Investor Responsibility Research Center, 6 Corporate Governance Bulletin 153 (Nov./Dec. 1989).

in management's reported commitment to allow institutional investors to influence the selection of three outside directors.[12]

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

A. Protecting the Market for Corporate Control.

Institutional investors first entered the world of corporate governance in a response to efforts by portfolio companies to insulate themselves from the market for corporate control. Some four years ago, institutional investors began to offer precatory resolutions urging that directors either redeem poison pill plans, or submit them for shareholders' approval, or subject them to sunset provisions.[13] In the current proxy season, resolutions of this sort have been placed on the ballot at 35 companies.[14] In addition, institutions now offer a much wider range of proposals to limit defensive tactics, including proposals to require shareholder approval before more than 10 percent of a company's stock can be placed with a white squire, proposals to cause the company to opt out of Delaware's anti-takeover law, proposals to

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[12] See White, CalPERS' Chief Wields Big Stick for Institutional Shareholders, Wall St. J., April 3, 1990, p. C1, col. 4. This typology is incomplete. A fourth category, directed at voting procedures, can also be identified. Typical of this cluster are proposals for confidential shareholder voting, present on the ballots of at least 49 companies this proxy season. See Investor Responsibility Research Center, 6 Corporate Governance Bulletin 146-7 (Nov./Dec. 1989).

[13] The results of these efforts are summarized in R. Gilson & R. Kraakman, 1989 Supplement to Gilson's The Law and Finance of Corporate Acquisitions 120-24.

[14] 6 Corporate Governance Bulletin at 148-9.

prohibit greenmail payments, and proposals to require shareholder approval of golden parachutes.[15]

Institutional investors were first drawn into the corporate governance arena by management efforts to escape the market for corporate control for good reason: Few other issues highlight so starkly the relation between the value of an indexed portfolio and principles of corporate governance. Although critics dismiss the engagement of institutional investors with control issues as a childishly short-term demand for large premiums today when independent companies would bring even larger returns tomorrow,[16] the relationship between takeovers and passively managed portfolios is far more complicated than this for two reasons. First, a takeover typically cannot benefit an indexed portfolio directly unless it increases the combined value of the acquiring and target companies. But second, and more important, the chief effect of takeovers on the value of indexed portfolios is indirect:

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[15] Id.

[16] The criticism can be formulated as an empirically testable statement: Shareholders in target companies that defeat hostile tender offers and remain independent do better, in present value terms, than they would have had the offer been accepted. So stated, the evidence is clear that, on average, target shareholders loose significantly when offers are defeated and the company is not subsequently acquired by an alternative bidder. See, e.g., Bradley, Desai & Kim, The Rationale Behind Interim Tender Offers, 11 J. Fin. Econ. 183 (1983); Ruback, Do Target Shareholders Lose in Unsuccessful Control Contests?, in Corporate Takeovers: Causes and Consequences 137 (A. Auerbach ed. 1988); Pound, Takeover Defeats Hurt Stockholders: A Reply to the Kidder Peabody Study, Midland Corp. Fin. J., Summer, 1986, at 33. While the data resolves the charge that a favorable orientation to premium tender offers reflects a short-term orientation, it would resolve whether takeovers are good for an indexed investor only in a quite artificial circumstance: when the investor held a portfolio of only target companies. In the more realistic setting when the portfolio includes target and bidding companies, takeovers are desirable only if they result in a net gain taking into account the impact on both targets and bidders, a point considered TAN 17-18 infra.

the mere potential of a hostile offer is likely to improve the management of a portfolio company.

To see the first point, remember that an investor holding the market will have a weighted position in both the acquiring company and the target company. Such an investor cannot benefit if the premium paid for a target company's stock simply transfers wealth from the shareholders of the acquiring company to those of the target. To benefit an indexed investor, a transaction must increase the combined value of the acquiring and the target companies' stock. Fortunately, the empirical evidence indicates that hostile takeovers do yield a combined benefit. Although the shareholders of bidder companies earn normal returns or even small losses in takeovers,[17] target company shareholders make substantial gains, which leave net positive gains on average for indexed portfolios as a result of hostile takeovers.[18]

This direct increase in value, however, is not the most important effect of takeovers on indexed portfolios. Hostile takeovers also influence the stock value of the majority of portfolio companies that are neither targets nor bidders only indirectly by altering the

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[17]For surveys of the empirical literature see Jarrell, Brickley & Netter, The Market for Corporate Control: The Empirical Evidence Since 1980, 2 J. Econ. Pers. 49 (1988); Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5 (1983); Jarrell & Paulson, The Return to Acquiring Firms in Tender Offers: Evidence from Three Decades, 18 Fin. Mgmt. 12 (Autumn, 1989).

[18]For the most recent study, see Lang, Stulz & Walking, Management Performance, Tobin's *q* and the Gains from Successful Tender Offers, 24 J. Fin. Econ. 137 (1989). Earlier studies are summarized in Jarrell, Brickley & Netter, supra note 17, and Jensen & Ruback, supra note 17. Where the bidder is privately held, as in many recent LBO transactions, a wealth transfer from bidder to target will increase the value of the institutional investor's portfolio unless the investor also has invested in the LBO sponsor's investment vehicles.

behavior of their managements. As Alfred Rappaport recently observed in the Harvard Business Review, "[i]t is impossible to overstate how deeply the market for corporate control has changed the attitudes and practices of U.S. managers. ... [That market] represents the most effective check on management autonomy ever devised."[19] For example, consider the impact of hostile takeovers on conglomerate organizations. Given that the conglomeration strategy of the 60's and 70's has had a "dismal" track record (in the words of Professor Michael Porter[20]), it is hardly surprising that many hostile takeovers during the 1980's aimed at breaking up conglomerate corporations that had accumulated unrelated businesses during the 60's and 70's.[21] Even so, break-up takeovers affected only a small

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[19]A. Rappaport, The Staying Power of the Public Corporation, 68 Harv. Bus. Rev. 96, 100 (Jan./Feb. 1990).

[20]Porter, From Competitive Strategy to Corporate Strategy, 65 Harv. Bus. Rev. 43 (May-June 1987). Professor Porter investigated the aftermath of the diversification efforts of 33 large U.S. companies. Where the company entered an unrelated line of business by acquisition prior to 1975, 74.4% of the acquisitions were subsequently divested. Where the entry was by start-up, the new business was subsequently divested 40.9% of the time. Finally, when the entry was by joint venture, the acquisition was subsequently divested 48.9% of the time. Id. at 50-51 (Exhibit III. Porter's findings were recently confirmed by a study of 271 large acquisitions occurring between 1972 and 1982. When the target company's businesses were unrelated to those of the acquirer, over 60 percent of the acquisitions had been divested by 1989. K. Kaplan & M. Weisbach, Acquisitions and Diversification: What is Divested and How Much Does the Market Anticipate?, Working paper No. 90-02, Managerial Economics Research Center, Simon Graduate School of Business, University of Rochester (March, 1990).

[21]R. Mork, A. Schliefer & R. Vishny, Do Managerial Objectives Drive Bad Acquisitions?, 45 J. Fin. 31, 47 (1990), offer empirical evidence "that the source of bust-up gains in the 1980s is the reversal of the unrelated diversification of the 1960s and the 1970s. Hostile bust-up takeovers simply undo past conglomeration." See Bhide, The Causes and Consequences of Hostile Takeovers, 2 J. Appl. Corp. Fin. 36, 52-55 (1989) (Real source of gains in hostile takeovers lies in splitting up diversified companies); S. Bhagat, A. Shleifer & R. Vishny, Hostile Takeovers in the 1980's: The Return to Corporate Specialization in Brookings Papers on Economic Activity 1 (1990) (same).

number of conglomerates directly. Arguably, the chief impact of these takeovers on the value of indexed portfolios was not direct but indirect: It encouraged a much larger number of companies to ward off hostile offers by restructuring voluntarily. Thus, one study reported that in 1985 alone, 23% of the nation's 850 largest corporations experienced an "operational restructuring," which usually involves the sale or spin off of a division.[22]

Given the contribution of hostile takeovers to portfolio values during the 1980's, institutional investors were quite right to target defensive tactics for their initial foray into the corpororate governance debate. In plotting future strategy, however, it is equally clear that other areas of corporate governance have assumed greater promise of improving portfolio performance. First, the hostile takeover is an expensive and inexact tool for monitoring managers that is better suited for correcting mistakes than preventing them. A corporate governance mechanism that might have blunted the conglomeration wave in the first place would have been far more efficient -- if it had been in place during the 1960's and 1970's -- than a decade of deal-making to reverse the damage.[23] Second, and even more to the point, the future of hostile takeovers is now in doubt. The problem is the

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[22]See Buzzotta, A Quiet Revolution in the Work Place, N.Y.Times, Sept. 4, 1985, Sec.A, p.27.

[23]To be sure, the threat of a hostile takeover has a general deterrence effect, as we saw in connection with bust-up takeovers. But that effect seems far better suited to reversing decisions that the market has already determined were a mistake, than to determining in the first place whether proposed action is a mistake. Thus, the general deterrent effect of hostile takeovers certainly accelerated the process of deconglomerization, but there is good reason for skepticism concerning whether hostile takeovers, had they been on the scene at that time, would have significantly deterred the original conglomerate movement.

combination of the collapse of the junk bond market and management's extraordinary political success in persuading state legislatures to overrule shareholders by making any change in control very costly without management's approval. For example, the recent Pennsylvania legislation -- admittedly the worst of the bunch -- not only discourages hostile tender offers with the threat of a disgorgement remedy if the offer proves unsuccessful, but it extends this same threat to shareholders who seek to displace management through a proxy context as well.[24]

Thus, institutional investors can no longer rely on the market for corporate control to remedy defects in the corporate governance system. Instead, other improvements in the corporate governance system will be necessary to protect takeovers from political action in the future.[25]

B. Shareholder Advisory Committees.

A second approach to reforming corporate governance advanced by institutional investors -- the shareholder advisory committee -- seems designed to compensate for some of the failings of the market

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[24]Subchapter H of Chapter 25, Pa. C.S., effective April 27, 1990. Pressure by institutional investors is credited with causing a number of large Pennsylvania corporations -- including Westinghouse Electric Corporation, the H. J. Heinz Company, Allegheny Ludlum, Mellon Bank and The Sun Company -- to opt out of all or a part of the Pennsylvania legislation. See Wayne, Many Companies in Pennsylvania Reject State's Takeover Protection, N.Y. Times, July 20, 1990, p. A1, Col. 1. Massachusetts recently displayed a similarly cooperative attitude toward management by enacting, virtually overnight, a statutory requirement of staggered boards of directors, in response to the efforts of a local corporation to defeat a hostile takeover. See Ingrassia & Hilder, Norton Wins a Round Against BTR Bid as Massachusetts Law Makers Clear Bill, Wall St. J., April 18, 1990, at A4, col. 2.

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

for corporate control. As advocated by CalPERS and recently adopted by Lockheed's management to win institutional votes in its proxy contest with Harold Simmons, this strategy calls for the establishment of an advisory committee representing a company's largest shareholders, which are typically its institutional investors.[26] Such a committee is supposed to receive management's reports on the company's progress and convey shareholders' concerns to management. This exchange, the argument goes, presents a textured alternative to the limited choice that a takeover allows between the raider and the status quo. Moreover, an advisory committee might be able to resolve problems at an early stage, before they became serious enough to invite a takeover.

Notwithstanding these claims, we believe that the advisory committee is likely to prove an ineffectual tool for reform. Its only real virtue is "moderation" from the perspective of corporate management: It is, in fact, so moderate that it would merely formalize existing management-shareholder exchanges for many companies. But precisely because the advisory structure proposes a kind of "shadow board," while not contesting the composition of the "real board," it is doomed to failure. Such a shadow board would suffer all of the structural shortcomings that critics have identified in actual boards of directors, while exercising none of an actual board's power. If boards of directors today meet too infrequently and have too little information

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[26] CalPERS recently withdrew its shareholder proposal to establish a shareholder advisory committee at Occidental Petroleum Corp. when the company agreed to have four directors, including at least two independent directors, meet twice yearly with CalPERS officials to discuss the company's business plans. White, Occidental Agrees to Slate Meetings with CalPERS Fund, Wall St. J., March 22, 1990, p. A6, col. 5.

to monitor management effectively except during occasional crises,[27] an advisory committee would presumably meet even less frequently and receive even less information from management. Similarly, if the outside directors of public corporations, who are largely senior executives of other public corporations, lack the time for real monitoring,[28] shareholder representatives assigned to numerous portfolio companies would presumably lack not only the time but also the expertise of the executive outsiders.

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

C. Reforming the Board: The Role of Outside Directors

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

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[27] Among more recent, albeit sympathetic critics, see J. Lorsch, supra note 1, at 84-88; Johnson, An Insider's Call for Outside Direction, 68 Harv. Bus. Rev. 46 (March/April 1990) (former executive vice-president and director of General Motors).

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

of New York University to the Texaco board. Similarly, Lockheed recently agreed to allow institutional investors to influence the selection of three board members as a means of gaining support in a proxy fight initiated by Harold Simmons.[29]

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

Nonetheless, institutional investors are undoubtedly correct to focus on the boardroom. In the corporate governance debate, all arguments ultimately converge on the role of the board of directors in general, and on the role of outside directors in particular. Ever since Berle and Means first articulated the separation of ownership and management, commentators have searched for the corporate equivalent of the Holy Grail: a mechanism to bridge the separation by holding managers truly accountable for their performance. At this

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

point in the search, one solution to the accountability problem has attained the status of conventional wisdom. Whether one asks the Business Roundtable[30], the Conference Board,[31] the American Bar Association[32] or the American Law Institute,[33] the answer to the question of who monitors management is the same: independent outside directors elected by the shareholders. And it is important to understand how pervasive an institution the outside director has become: As of 1987, 74% of the directors of publicly held companies were not company employees.[34]

The justification for relying on outside directors as a monitoring mechanism is straightforward. Because such directors are "independent" -- that is, they do not have a personal financial stake in maintaining management in office -- they can act as shareholder surrogates to assure that the company is run in the long term best interests of its owners. From the outset, however, this analysis has begged a nagging ambiguity: Who will monitor the monitors?[35]

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[30]The Business Roundtable, Corporate Governance and American Competitiveness (March, 1990); Statement of Position Concerning the Role of Corporate Directors of the Business Roundtable, 33 Bus. Law. 2083 (1978).

[31]The Conference Board, Corporate Directorship Practices: Role, Selection and Legal Status of the Board (1973).

[32]Committee on Corporate Laws, Section of Corporation, Banking & Bus. Law, American Bar Ass'n, Corporate Director's Guidebook, 33 Bus.Law. 1595 (1978).

[33]See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations §3.03 (Tentative Draft No., 1, 1982).

[34]See J. Lorsch, supra note 1, at 17.

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

> "Oh, the jobs people work at!
> Out west, near Hawtch-Hawtch,
> there's a Hatch-Hawtcher-Bee-Watcher.
> His job is to watch ...
> is to keep both his eyes on the lazy town bee.
> A bee that is watched will work harder, you see.
> Well ... he watched and he watched.

Thus far, there has been no analytically satisfying answer to this question, although two unsuccessful answers have been proffered that appeal to the preconceptions of two very different participants in the corporate governance debate. The managerialist explanation for why outside directors can be trusted to monitor effectively rests on noblesse oblige: The personal character of prominent individuals, with professional and social ties to the business community, assures that they will discharge their duties without any need for additional monitoring. In stark contrast, some academic economists have proposed a quite different reason for trusting outside directors to monitor management faithfully: The market will punish them if they fail. Eugene Fama has stated the argument most explicitly: "In a state of advanced evolution of the external markets that buttress the corporate firm, the outside directors are in their turn disciplined by the market for their services which prices them according to their performance as referrees."[36]

But, in spite of his watch,
the bee didn't work any harder. Not mawtch.
So then somebody said,
'Our old bee-watching man
just isn't bee-watching as hard as he can.
He ought to be watched by *another* hawtch-hawtcher.
The thing that we need is a Bee-Watcher-Watcher.'
WELL ...
The Bee-Watcher-Watcher watched the Bee-Watcher.
He didn't watch well. So another Hatch-Hawtcher
had to come in as a Watch-Watcher-Wacher.
And today all the Hawtchers who live in Hawtch-Hawtch
are watching on Watch-Watcher-Watchering-Watch,
Watch-Watching the Watcher who's watching that bee.
You're not a Hawtch-Hawtcher. You're lucky, you see."

T. Geissel (Dr. Suess), Did I Ever Tell You How Lucky You Are? 26-29 (1973)(emphasis in the original).

[36] Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288, 294 (1980). Some interested observers apparently believe both the noblesse oblige and the market for directors stories. In commenting on the provisions of the

Unfortunately, neither of these explanations for why outside directors would discharge their functions effectively is very persuasive. Although a sterling personal character and financial independence from management are necessary conditions for effective monitoring, they are hardly sufficient. First, even financially independent outside directors depend on management for their tenure as directors, since no one doubts that management selects its own outside directors. Thus, directors who wish to retain their positions are not independent of management. Second, most outside directors share management's ideological disposition toward the single issue most central to their monitoring responsibilities: That is, how intensely outside directors should monitor management.[37] Some 63 percent of the outside directors of public companies are chief executive officers of other public companies.[38] These directors are unlikely to monitor more energetically than they believe they should be monitored by their own boards. Third, outside directors are not socially independent. As Victor Brudney put it, "[n]o definition of independence yet offered precludes an independent director from being a social friend of, or a

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American Law Institute's Corporate Governance Project dealing with transactions in control, prominent takeover lawyer Martin Lipton writes: "The structure of the modern public corporation has many means of aligning the interests of managers and shareholders .... An executive must answer to a board of independent directors, who face their own social and economic pressures to ensure that the corporation they direct is successful." Memorandum from Martin Lipton to the Chief Reporter for Principles of Corporate Governance: Analysis and Recommendations, Comments on Tentative Draft No. 10 (May 4, 1990).

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

[38]J. Lorsch, supra note 1, at 19.

member of the same clubs, associations, or charitable efforts as, the persons whose [performance] he is asked to assess."[39] Finally, in addition to these economic, ideological, and social obstacles to monitoring, outside directors typically lack an affirmative incentive to monitor effectively. The corporation cannot simply pay outside directors a large sum to induce careful monitoring because the prospect of a large payment would itself undercut their financial independence. Yet, any serious effort to monitor inevitably imposes large personal costs. As many commentators have pointed out, outside directors lack time, expertise, staff and information to challenge management, while management controls not only these resources but also has a direct and powerful incentive to direct corporate policy without interference.[40]

Belief that a market for outside directors will supply the missing incentive for independent directors is no less a myth than directorial noblesse oblige. This argument reflects what might be called the "perfect market" or, more lightly, the "can opener" fallacy. The major premise of this fallacious syllogism is that a perfect market generates the right incentives for everyone; the minor premise is that such a market exists, and the conclusion, in our case, is that directors have the

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[39] Brudney, The Independent Director -- Heavenly City or Potemkin Village, 95 Harv. L.Rev. 597, 613 (1982). Elmer Johnson, formerly executive vice-president and director of General Motors, has made a similar comment comment more recently. Johnson, supra note 27, at 47 ("club ethos among members of the board").

[40] Professor Lorsch argues persuasively that outside directors can function effectively in time of crisis -- when events demand that outside directors invest the required amounts of time and the crisis itself shifts control of staff and other corporate resources from management to outside directors. J. Lorsch, supra note 1, at 97-141. In this case, the exception proves to be no more than an exception. A governance system that can operate only in response to crisis has the unfortunate effect of assuring that crises in fact occur.

right incentives to monitor. So stated, the argument's fallacy is apparent: It assumes that the market for directors operates effectively, let alone perfectly.[41] Yet, there is simply no evidence that anything like an effective market for outside directors exists at all.[42]

This, then, is where the problem stands. On the one hand, the board of directors is the only existent device for monitoring managers.

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[41] The "can opener" reference comes from a standard economist joke (which lawyers collect as a defense to the lawyer jokes economists direct at them). The story begins with three survivors of a ship wreck marooned on a desert island: a chemist, a physicist and an economist. Their only source of food was a can of vegetables that they had no apparent way to open. The chemist offered the first suggestion. Looking around the beach, he observed that the chemicals in the sand, when combined with various of the minerals in nearby rocks and placed on the can's lid, would eat through the lid if heated to the proper temperature. The problem was that the sun would not generate sufficient heat to initiate the reaction and they had no matches. The physicist took the next turn. Finding a hefty rock, she told her companions that if they propelled the rock into the air with enough force and with the proper trajectory it would land on the can and break through the lid. The problem was that none of them could throw the rock sufficiently high to give it the necessary velocity. The chemist and physicist then turned to the economist, who had been smugly watching their efforts. When angrily asked for his solution to their food problem, the economist responded that his discipline provided a ready answer to their plight: "Simply assume a can opener!"

[42] Steven Kaplan and David Reishus provide data that they believe "suggest that top mangers face an external labor market as described by Fama." S. Kaplan & D. Reishus, Outside Directors and Corporate Performance 2-3 (mimeo, Feb. 1990) (forthcoming, J.Fin. Econ.). They studied what happened to outside directors who also were senior executive officers of other companies when their own companies performed poorly, as measured by a 25 percent dividend cut in the prior 12 months. The data show that only approximately one such senior executive in 6 actually loses an outside directorship in the three years following announcement of the dividend reduction in the executive's own company. Thus, the authors conclude that although "perceived managerial ability matters in the external labor market, it may not matter a great deal. Top executives of the poorer performers are not significantly more likely than better performers to lose outside directorships they already have." Id. at 17. Rather than evidence of the existence of market constraints on outside director performance, the data suggest to us that such market as may exist is quite ineffective. Gilson, Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Ownership and Control When Firms Default, paper presented at conference on The Structure and Governance of Enterprise, Harvard Business School, March 29, 1990 (March, 1990), reports similar data.

On the other hand, both more[43] and less[44] sympathetic observers of boards of directors have now come to acknowledge what should have been obvious all along: the traditional corporate solution of introducing outside directors to bridge the separation between ownership and control has dramatic limitations.

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

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

The domestic alternative to the traditional corporate governance structure of the public corporation is what Michael Jensen dubs the "LBO Association."[45] This structure bridges the separation of ownership and management by eliminating public shareholders, typically through a leveraged management buyout. Three groups compose the LBO Association: a sponsoring partnership, which controls at least 20 percent of the equity and monitors the company's management; the company's

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43 See, e.g., J. Lorsch, supra note 1; Johnson, supra note 27.

44 See Brudney, supra note 39.

45 Jensen, Eclipse of the Public Corporation, 67 Harv. Bus. Rev. 61 (Sept./Oct. 1989).

managers, who also own a substantial equity stake that may be financed with personal, full recourse loans; and the institutional investors, who provide the balance of the debt and equity necessary for the acquisition. Separation of ownership and management is minimized because both the managers and the monitors are major equity holders, with interests that closely track those of the passive investors in the company. Indeed, the highly leveraged sponsor and management groups stand to gain or lose proportionately even more when the company performs well or poorly than do the passive investors. In addition, the company's large debt load is an important control device in its own right: It allows the managers of the Association little room for mistakes before the passive investor can take remedial actions that are facilitated by the terms of the debt contract.[46]

As described by Jensen, the LBO Association contains a useful lesson for institutional investors: A professional monitor that is suitably motivated, such as an LBO sponsor, can be an invaluable means of bridging the separation of ownership and control. Nevertheless, the LBO structure in its entirety is unsuitable for institutional investors because it "solves" the governance problem largely by eliminating it through the wholesale substitution of debt for equity and the introduction of overwhelming financial incentives. The LBO recipe not only prescribes withdrawal from the direct market, but it also requires a massive reassignment of equity values to insiders. In addition, the LBO capital structure is simply inappropriate, on

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

Jensen's own description, for large numbers of public corporations that require the cash flow flexibility to fund R&D or to compete in growing markets.[47] Indeed, notwithstanding Jensen's forceful account of its virtues, the LBO Association may be a temporary organizational form even in its natural habitat of stable industries.[48]

By contrast, a second radical alternative -- the typical governance structures of Japanese and German corporations -- initially appears to be more compatible with the orientation of American institutional investors toward the public market, even though it is more remote from a cultural or legal perspective. Jensen notes that an LBO Association behaves much like a Japanese *keiretsu*, a business grouping in which a company's main bank is also a major shareholder and a dominant influence on management.[49] Mark Roe describes a similar phenomenon in Germany, where three banks control more than 40 percent of outstanding stock (for example, 28 percent of Daimler-Benz

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[47] See Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 Va. L.Rev. 807 (1987) (comparing characteristics consistent with leveraged buyout with those consistent with dual class recapitalizations); Lehn, Netter & Poulsen, Consolidating Corporate Control: The Choice Between Dual-Class Recapitalizations and Leveraged Buyouts (mimeo, 1990, forthcoming, J. Fin. Econ.) (empirical test of Gilson hypothesis).
[48] See S. Bhagat, A. Shleifer, and R. Vishney, Hostile Takeovers in the 1980's: The Return to Corporate Specialization, in Brookings Papers on Economic Activity -- Microeconomics 1, 3 (1990) (describing the MBO as a "transitory arrangement used to allocate assets to corporations managing similar assets.").
[49] Jensen, supra note 45, at 73. S. Prowse, Institutional Investment Patterns and Corporate Financial Behavior in the U.S. and Japan 5-6, Table 2, Paper presented at a conference on the Structure and Governance of Equity, Harvard Business School (Nov., 1989), reports that, on average, a Japanese company's largest debtholder owned 6.2% of the company's equity; that the 5 largest debtholders owned 18.2% of equity; and that of 133 sample companies, the largest debtholder was also the largest shareholder in 57 companies and in an additional 67 companies, the largest shareholder and largest debtholder were members of the same Keiretsu. The parallel to an LBO Association is not perfect, however. Companies within the same Keiretsu typically have supplier as well as financial links.

is held by a single bank).[50] As with the LBO Association, the model of bank ownership -- or any similar structure of active expert monitoring by an influential shareholder -- also contains a lesson for institutional investors: The governance problem can be solved without abandoning the public market if a single shareholder with sufficient voting power and expertise emerges to become a representative monitor.

Again, however, what might be termed the "banker model" remains largely inapposite to the circumstances of the American institutional investor. Like the LBO model, the banker model unifies, rather than bridges, ownership and control. It combines massive equity ownership with the expertise of in-house professionals who, in this case, are banking professionals skilled in monitoring by their primary occupation.[51] Pension funds and other passive American institutions lack a comparably skilled pool of employees. Moreover, even if American institutions possessed the requisite expertise, the

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[50] M. Roe, Legal Restraints on Ownership and Control of Public Companies 32 (Mimeo, Feb. 1990)(forthcoming, J. Fin. Econ.); see Lowenstein & Millstein, The American Corporation and the Institutional Investor: Are There Lessons from Abroad?, 3 Col. Bus. L.Rev. 739, 747 (1988) ("On one end of the spectrum is the German experience, where there is a substantial concentration of voting rights in a relatively small number of large banks. It is through the exercise of those voting rights that the large banks directly influence the selection of corporate executives and managing boards and indirectly influence all fundamental business decisions."); Cable, Capital Market Information and Industrial Performance: The Role of West German Banks, 95 Econ. J. 118, 129 (1985) ("West German banks provide industry with substantial long-term finance, have extensive control over shareholders' voting rights and are widely represented on company boards.").

[51] Hoshi, Kashyap & Scharfstein, The Role of Banks in Reducing the Costs of Financial Distress in Japan, paper presented at conference on The Structure and Governance of Enterprise, Harvard Business School, March, 1990 (Feb., 1990); Aoki, Toward an Economic Model of the Japanese Firm, 27 J. Econ. Lit. 1, 14-20 (1989); and Sheard, The Main Bank System in Corporate Monitoring and Control in Japan, 11 J. Econ. Behav. & Org. 399 (1989), analyze the monitoring role of Japanese "main" banks, particularly in the setting of a group company's financial distress.

obstacles to importing the banker model to the United States would remain formidable. Not only are there legal barriers to active share ownership by financial intermediaries in the United States but, equally important, there are deeply-rooted political barriers. As Roe concludes in his historical analysis of these obstacles, American "[c]orporate history can be seen as an effort to find substitutes for the direct monitoring [of management] that politics disallowed."[52]

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

As this brief review suggests, the range of existing solutions to the problem of corporate governance leaves institutional investors with a dilemma. On the one hand, the reform strategies that they now pursue -- limiting anti-takeover defenses, establishing advisory committees, and attempting to install traditional outside directors -- are too limited. In particular, outside directors tend to be far more independent of a company's shareholders than of its managers. On the other hand, the radical changes that might solve the governance problem -- that is, the LBO Association and banker models -- clash with the existing role and basic identity of institutional investors, and with traditional political values and social norms. These models call for combining high-powered expertise with concentrated equity

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[52]Roe, supra note 50, at 35. Of course, what institution substitutes for what depends on your perspective. While Roe characterizes takeovers as a substitute for the banker model in the United States, Sheard characterizes the banker model in Japan as a "substitute for the missing takeover market in Japan." Sheard, supra note 51, at 399. More specifically, "the main bank performs a role that closely parallels in its effect the external takeover market: in particular in bringing about the displacement of ineffectual management and reorganization of corporate assets to improve efficiency." Id. at 409.

ownership in ways that American institutions neither wish to, nor are able to, undertake on their own. The challenge for institutional investors, then, is to weld the existing governance structure of public companies, including the board of directors, with the existing ownership structure of public companies, so as to create a new structure that duplicates the monitoring capabilities of the LBO and banker models.

A. Design Criteria.

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

The good news is that half of the battle has already been won: Institutional investors now <u>have</u> the necessary voting power. As a result of the growth of institutional holdings during the 1980's, manageable numbers of institutions already command what would be, if it were voted in a coordinated fashion, a controlling block of stock in many public companies.[53] Moreover, institutional interest in corporate governance demonstrates that these investors have the requisite monitoring incentives. Our earlier effort to offer a

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[53]<u>See</u> TAN 80-83 <u>infra</u>.

normative model of the relationship between the institutional investor and its portfolio companies was not designed to spark institutional interest in corporate governance; it was intended to explain a commitment to reform that is already well-developed.

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

This brings us back full circle to the outside director. An ideal mechanism for delegated monitoring would seem to be the expert director, chosen coooperatively by institutional investors. There is just one hitch: As we have already argued, outside directors today are simply not reliable representatives of shareholder interests. Thus, if the outside director is to power a new monitoring structure, the system of outside directors itself is in need of reform. The question is: What reform is called for?

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

Precisely because the current governance system of outside directors so clearly fails to monitor effectively, numerous commentators have proposed ways to reform the system by eliminating the dependence of outside directors on management.

These proposals typically begin by locating the problem in management's control of the proxy process, and proceed by advocating a more or less extensive expansion of shareholder access to the proxy machinary. For example, Melvin Eisenberg has recommeded permitting shareholders who hold more than 5 percent of a corporation's stock to nominate directors on the corporation's proxy statement.[54] Somewhat more expansively, Louis Lowenstein has urged that shareholders have the exclusive right to nominate one-fifth to one-quarter of the board.[55] At the extreme, George Dent has suggested lodging exclusive access to the proxy machinary in a committee of the corporation's ten or twenty largest shareholders.[56]

From our perspective, all of these proposals share two failings: first, they would merely make outside directors independent of management, rather than dependent on shareholders; and, second, they would require cooperation from one of three unlikely sources to be implemented -- a state legislature, the federal government, or the corporation itself.

The first failing reflects the familiar problem that when shareholdings are dispersed, no one remains to monitor the monitors. Without providing directors an affirmative incentive to monitor, all that can be done is to make directors financially independent from management and, in Peter Drucker's words, to elect "professional directors, men and women of public standing and proven competence

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[54]M. Eisenberg, The Structure of the Corporation 117-20 (1976).
[55]L. Lowenstein, What's Wrong with Wall Street: Short-Term Gain and the Absentee Shareholder 209-210 (1988).
[56]Dent, Toward Unifying Ownership and Control in the Public Corporation, 1989 Wis. L.Rev. 881, 907-8 (1989),

who, as members of the board, can be truly independent of management."[57] As we have seen, however, this is no substitute for giving directors a real incentive to monitor effectively. Moreover, nothing changes if the outside directors are selected by a committee of shareholders rather than by management. When, in connection with its proxy fight with Carl Icahn, Texaco allowed CalPERS to help select one new board member, the nominee who emerged was the president of a major university. Independent of management, perhaps; but dependent on shareholders, hardly (not even if this particular university president happened to have the time and the skills to monitor management of a vertically integrated natural resources company).[58]

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[57] P. Drucker, The Unseen Revolution: How Pension Fund Socialism Came to America 91 (1976).

[58] The problem appears starkly in the recent amendment to the Michigan Business Corporation Act that creates a statutory independent director. Public Acts 1989, No. 121, effective Oct. 1, 1989. Under the statute, either the board of directors or the shareholders can designate a director as "independent" provided that the individual meets standard conflict of interest limits on other relations with the corporation or its executives and has not been a director for more than three years. Once designated independent, a director can be paid special compensation, will have corporate funds available for expenses related to his duties and, most significant, may communicate with shareholders, at the corporation's expense, in any communication the corporation sends to its shareholders. The statute encourages corporations to appoint independent directors by giving special weight to their determinations concerning indemnification, ratification of interested transactions, and terminating derivative litigation.

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

The second failing common to past reform proposals -- that they require too much cooperation from the company or the government -- is a straightforward reflection of the political realities. There seems to be no chance of immediate action to reform the selection of outside directors, either by corporate management or by state legislatures, the SEC, or Congress. To date, corporations have allowed institutional investors to participate in the selection of board members only when, as in the Texaco and Lockheed cases, management needed votes in a hard-fought proxy fight. Nor are prospects more favorable for a regulatory initiative. State legislatures are curtailing, not expanding, shareholder access to the proxy machinary.[59] Although the SEC seemingly has authority under Section 14(a) of the Williams Act to mandate broader access to the proxy machinery, and CalPERS[60] and the United Shareholders Association[61] have urged it do so, none of the Commission's public statements suggest that action is imminent. Finally, there is no reason to expect Congressional action. In the current political climate, Congress is likely to treat access to the proxy machinary as part of the debate over hostile takeovers, and to view expanded access as a pro-raider position. Since Congress has declined to deal directly with the

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[59] See TAN 24 supra.

[60] Letter from Dale M. Hanson, California Public Employees' Retirement System to Linda C. Quinn, Director, Division of Corporate Finance, Securities and Exchange Commission, Nov. 3, 1989.

[61] See 22 BNA Sec. Reg. L. Rep. 464 (1990) (reporting United Shareholder Association request for rule making proceeding).

takeover phenomenon at its height,[62] legislative action is hardly more likely now.

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

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

Thus far we have sketched an aspirational objective for corporate governance reform on behalf of institutional investors: The introduction of outside directors who will actively monitor public corporations, much as LBO sponsors and Japanese and German banks now monitor their client companies. The time has come to propose how such a class of directors might arise and how it might function. To be persuasive, our proposal must meet four criteria. First, it must be <u>feasible</u> to organize at an acceptable cost. Second, it must promise real <u>operational improvements</u> in the monitoring of portfolio companies. Third, it must be <u>politically practical</u> for institutional investors to implement by themselves, without the unlikely

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[62] The only significant Congressional action with respect to acquisitions has been through the tax law. Most important, the Tax Reform Act of 1986, P.L. 99-514, 99th Cong., 2d Sess. (1986), repealed the General Utilities doctrine that allowed a step up in the basis of a target company's depreciable assets without incurring a corporate level tax. Additionally, Internal Revenue Code Section 5881 imposes a penalty tax on the payment of greenmail, Section 4999 imposes a similar tax on excessive golden parachute payments, and Section 275(a)(6) makes the payment of such taxes nondeductible.

assistance of portfolio companies or governmental authorities.[63] And fourth, it must be legally practical under the constraints imposed by prevailing law. In this Part, we sketch a proposal that we believe to organizationally and operationally feasible. In the next Part, we address the proposal's political and legal practicality.

A. Introducing Professional Directors.

Our earlier analysis identifying the obstacles to monitoring by traditional outside directors also indicates the characteristics that a new generation of professional directors must have. Outside directors presently lack an incentive to act as ongoing monitors of management performance.[64] Although they are financially independent, they are selected by management and remain socially and ideologically tied to management (recall that 63% of outside directors are chief executive officers who must face their own boards of directors). In addition, outside directors presently lack the time to monitor except during corporate crises,[65] because they are either CEO's themselves or hold equally demanding full-time positions -- indeed, if a director supported himself as a full-time member of the board of a particular corporation, he would no longer be an outside director at all. It follows that a new class of outside directors must have the time and

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63We do not object to cooperation by companies, state legislatures or Congress. Rather, based on history, we simply do not expect it. Consequently, proposals that require it lack the potential to be helpful now.

64To be sure, outside directors do seem to function much more effectively in sharply defined crisis situations. See note 40 supra. In these situations, events -- Lorsch's examples are takeovers and unanticipated executive turnover -- force directors into the monitoring role. The goal, however, is to design a system in which monitoring precedes, and therefore sometimes prevents, the onset of a crisis.

65Again, crises provide the exception, forcing directors to spend vastly more time on the crisis and necessarily resulting in increased information.

skill to monitor energetically on behalf of shareholders; they must have the independence from management to perform their monitoring function without inhibitions or constraints; and they must have the incentive to actually perform this function.

We propose to create directors with these characteristics by designing a novel position (the role of professional outside director) that would exist prior to, and apart from, the election of directors to the boards of particular companies. The key organizational issues are how to design such a position and how institutional investors can act, collectively or individually, to create it.

1. Designing the Position of Professional Director.

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

Now imagine that the new position required a full-time commitment and obligated each expert to serve on the boards of perhaps six portfolio companies. In this case, an expert's annual compensation solely from board memberships easily might exceed $200,000: the aggregate of the board fees, committee fees, and fringe benefits that six large public companies would ordinarily pay to their directors. In all likelihood, this sum alone would attract top-flight business professionals even without additional compensation (although extra pay could be provided if necessary). The talented experts we describe could undoubtedly earn larger incomes in other employment, but they would be hard-pressed to match the intrinsic interest of the professional director's work or the social prestige that multiple directorships would confer.

Once individuals with the requisite skills agreed to serve as professional directors, moreover, they would automatically enjoy the two most essential resources for effective monitoring: a focused mandate and the time to familarize themselves with their companies. Because they would serve as directors full-time, their corporate positions would not be ancillary to their real work. Further, because they would have no other duties, they would have far more time to devote to each of their companies than outside directors now have, and they would have great flexibility to apportion time among their companies as the need arose.[66] For example, during periods of crisis or poor performance, they would be free to concentrate on their neediest companies. Of course, this relative flexibility and specialization would lead professional directors to accept more active roles on their boards than traditional outside directors could afford to

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[66]The average outside director now devotes 14 days a year to each board on which he or she serves, including travel, preparation time, and committee work. Heidrick & Struggles, The Changing Board 9 (1987). Professor Lorsch identifies time constraints as the most pressing issue facing talented businessmen and professionals who are asked to join boards. J. Lorsch, *supra* note 1, at 23. By contrast, a professional director who served on six boards would be able to devote an average of 50 days a year to each board. In addition, the professional director's flexibility to allocate time among companies would further magnify his advantage. Thus, on the dimension of time alone, the resources of professional directors would exceed those of traditional outside directors by an order of magnitude.

take, including perhaps a disproportionate number of important committee assignments. But this is precisely what institutional investors should hope for. Professional directors who are central to the board's operation would be best situated to act as effective monitors.

Yet, as we envision the position of professional director, its most important advantage would be to avoid the incentive problem presented by either a full-time insider directorship or a conventional reform of the role of the outside director. Unlike other plans for full-time directorships, our proposal would not tie directors to particular companies: Our directors would serve full-time only with respect to the combination of companies to which they were elected by institutional investors. Thus, they would remain financially independent of the managements of particular companies.[67] Unlike other plans for adding outside directors, however, our proposal departs from the old model of financial independence to make professional directors financially dependent on their performance, just like the sponsors of LBO's and the shareholder directors of Japanese and German bank-centered corporate groups. If institutional shareholders were dissatisfied with a professional director, they could refuse to reelect him -- not just to one board, but to every board on which he served.[68]

67The continuing support of institutional investors would also secure the independence of professional directors. Presumably institutional investors would be inclined to support such directors in any principled disputes with management, in which case management could remove these directors only at the risk of a proxy fight.

68In addition to the de facto power to discharge professional directors who failed to perform satisfactorily, institutional investors might also experiment with more graduated incentive devices, such as offering directors stock

2. Implementing the New Position.

The professional outside director is a way to breathe life into Eugene Fama's idyllic account of a system of corporate governance secured by an external labor market to monitor the monitors.[69] Yet, the market that we envision would be far more organized than the market postulated by Fama, because the "buyers" in our market (that is, institutional investors) could elect professional directors only by coordinating their voting efforts. Or, put another way, professional directors are a public good for institutional investors. All investors would benefit from the services of these directors; yet no single investor could obtain their services without at least some cooperation from other shareholders. A market for professional directors is possible today only because institutional investors have aggregated shareholdings to the point where their costs of collective action, although still important, have at last reached manageable proportions.

Precisely how much coordination would be required to support professional directors depends on the scope of the market. In many respects, the market might operate most efficiently if it were institutionalized through a permanent and organizationally distinct clearinghouse. For example, institutional investors might collectively finance a nonprofit organization charged with recruiting directors and performing the routine processing and filing tasks that coordinated action among institutional investors would inevitably generate.[70] One

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appreciation rights (SARs). Such incentive plans might be an appropriate area of experimentation once a system of professional directors was in place, although they would present risks at the outset. See note 79 infra.

[69] More bluntly, we might characterize the goal of our proposal as making an honest man out of Eugene Fama. See TAN 36 supra.

[70] See TAN 85-117 infra.

or more of the industry groups and consulting organizations that now promote the collective interests of institutional investors might initiate such a clearinghouse.[71] Indeed, several groups have already introduced data bases that might be useful in the future operations of a directors' clearinghouse.[72]

A centralized organization could enhance the effectiveness of a core of professional directors in several ways. For example, it might negotiate with the managements of individual corporations on behalf of institutional investors and continue to monitor professional directors after they were elected to office. In both these capacities, the clearinghouse would provide an organizational buffer between institutional investors and portfolio companies. Professional directors selected -- and, in the first instance, monitored -- by the clearinghouse would in no sense be "delegates" of particular investors. In fact, institutional investors would have no need even to commit their votes to professional directors in advance. To function effectively, the clearinghouse would merely need to know that institutional investors, out of self-interest, ordinarily _would_ vote for its nominees. And this much it would know, since its nominees would be selected expressly in order to promote shareholder interests.

To be sure, even an established clearinghouse that attempted to elect a critical mass -- following Lowenstein, say one-quarter[73] -- of

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[71] For example, the Council of Institutional Investors ("CII"), the Investor Responsibility Research Center ("IRRC"), the Institutional Shareholder Services ("ISS"), the United Shareholder Association ("USA"), and the Analysis Group, Inc.
[72] A partial list of data bases known to us includes the ISS Director Data Base and the corporate governance and performance indices developed by USA and the Analysis Group.
[73] _See_ TAN 55 _supra_.

the directors of major portfolio companies would face a collective action problem. Some institutional investors would free ride on its services by refusing to fund its activities. Yet, freeriding of this sort would not be fatal. As the recent shareholder rights initiatives suggest, there are also many public-spirited institutions that would support a clearinghouse, even without a formal mechanism for assessing contributions. Modest support for the clearinghouse would signal the commitment of institutional investors to the financial interests of their beneficiaries. In addition, institutions that contributed to the clearinghouse would gain a voice in its selection and monitoring policies, and might also gain access to ancillary services, such as comparative ratings of corporate performance.

In the present period before the establishment of a working clearinghouse, however, the collective action problem is obviously more serious. For this reason, we wish to emphasize that formal cooperation among numerous institutional investors would not be necessary to demonstrate the merits of our proposal. A single large investor, such as CalPERS, could easily initiate the market for professional directors on its own, merely by picking a dozen companies to target during the proxy season, announcing its intentions, and enlisting the informal cooperation of other institutional investors along the way.[74] Such a modest effort by one (or a small number) of institutional investors would initially result in

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[74] Again, such a pioneering investor might find it useful to initiate its efforts through one of the organizations that presently advise institutional investors. See note 71 supra. These organizations could not only serve as a buffer between the investor and its portfolio companies, but they would also be likely to have the expertise on hand for the selection of target companies and potential nominees.

a less equitable distribution of costs than a central clearinghouse funded by many investors. Nevertheless, the modest expenditure would be both legally and financially prudent. A small-scale initiative to develop professional directors would promise direct gains, by improving the management of the targeted companies, of a significantly greater magnitude than those that can be expected from institutions' current corporate governance initiatives. But more important, it would lay the organizational foundation for expanding the range of professional directors in subsequent proxy seasons, and would thus contribute indirectly to improving returns from all pdortfolio companies. As large shareholders have always known, freeriding by other investors is no excuse for inaction if even a pro rata fraction of potential gains can justify the cost of decisive measures.

B. Professional Directors as Monitors.

Given that a core of professional directors can be organized, through either a clearinghouse or a single institution's pioneering efforts, the issue shifts to how effective such directors are likely to be. It is not enough for professional directors to have the skills, time, and initial motivation to monitor on behalf of institutional investors. To be successful, professional directors must also have the information to evaluate management performance, and the sustained motivation to discharge the task in the face of tepid cooperation or even outright resistance from management. We believe that professional directors would possess these qualities in signficantly greater measure than outside directors now do.

Consider first the dynamic changes on the boards of portfolio companies that would follow the introduction of professional directors. Recall that we envision the election of a critical mass of professional directors: a proportion large enough to be heard clearly but small enough to clearly leave control with management's nominees. A complement of this size (again, say, 25% of the board) would invite cooperation with management. It could neither displace incumbent managers nor shift corporate policy without the cooperation of management's own nominees to the board. At the same time, however, such a minority block of professional directors would hardly be without beneficial influence.

Paradoxically, one source of such influence arises because portfolio companies would also retain a substantial complement of traditional outside directors. As a practical matter, most boards would divide into three structural groupings after the introduction of professional directors: inside management directors, outside management nominees, and professional directors. Any issue that divided management and the professional directors would thus leave the balance of power with the traditional outside directors. In effect, the traditional outsiders would assume a quasi-adjudicative function -- a role that, unlike the monitoring function, they might be expected to perform capably. Although traditional outsiders may be structurally disposed to favor management, we are convinced that they are also men and women of conscience who would take their fiduciary responsibilities seriously. The irony is that they rarely exercise their judgment today, except during crises, not only because they lack the time and the incentives to do so, but also because board meetings are dominated by a management ethos of forced collegiality and agreement.[75] If, in contrast, professional directors were to accept the onus of posing hard questions and framing strategic alternatives, traditional outside directors would be drawn into real discussions of company policy and might well reject management's views when the evidence warranted. Thus, far from displacing traditional outside directors, the introduction of professional directors would create an institutional matrix in which, for the first time, outside directors could display the independence that their proponents have long claimed on their behalf.

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

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

The more serious charge that management might neutralize the board by withholding information is no more justified in our view. Accounts of boardroom life suggest that many managements _now_ suppress information and discussion with impunity under the existing system of outside directors.[76] By contrast, introducing professional directors with a mandate to challenge unsatisfactory performance would force management to produce information in order to defend its policies. The only way that management could credibly respond to the hard questions and the alternative strategies of professional directors would be to share more information, not less. In addition, management would have little incentive to distort information because the consequence of losing credibility with a board that included a minority of professional directors would be much more serious than it is today.

Beyond information supplied by management, moreover, professional directors nominated by an organized clearinghouse or other intermediary could, like directors selected by Japanese or German banks, also tap information from sources outside the firm. They would have the time to conduct independent research. They could press the board to employ outside experts when the circumstances warranted. Indeed, the directors' clearinghouse or other nominating organization could, at relatively little cost, supply directors with routine outside information, such as comparative ranking of corporate performance or the reports of respected securities analysts. At the very least, outside information introduced

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[76] _See, e.g._, J. Lorsch, _supra_ note 1, at 75-96.

by professional directors could help to structure the board's agenda by eliciting comment and explanation from management. Somewhat more optimistically, it could also make the flow of information in the boardroom a two-way street for the traditional outside directors, and perhaps for management as well.

Given that our professional directors could command the information and influence necessary to monitor successfully, the remaining operational issue is whether they could sustain the motivation to monitor energetically. We have already stressed that professional directors would be <u>financially dependent</u> on shareholders under our proposal: Institutional investors would not reelect directors who failed to perform satisfactorily or, more realistically, the organizational intermediary or clearinghouse would not re-submit these directors for nomination in the first instance. Thus, the ultimate incentive for professional directors to sustain their efforts on behalf of shareholders would be the prospect that they might otherwise -- in blunt language -- be fired.

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

There are, however, several reasons why the secondary monitoring of professional directors is much less troublesome for our proposal than it might initially seem. First, institutional investors need not perform the monitoring function themselves. Regardless how institutional investors organize and fund the recruitment of professional directors, an organizational intermediary would be likely to make the actual selection of director nominees and would also be well-situated to assume the monitoring function.[77] Second, although board deliberations are secret, there are objective indices of improved corporate governance that could be monitored at little cost. For example, one of these indices, which is germane to all portfolio companies, is the structure of management's compensation package. Recent research reveals a strikingly low correlation between the comepensation of top managers and the economic performance of their companies.[78] An important issue that one might expect professional directors to press on virtually every board is the alignment of management pay with company performance and shareholder interests. Similarly, other indices of good management for specific industries or categories of companies could doubtlessly be constructed at little cost. Third, although no agency could review the participation of professional directors in particular board deliberations, sustained bad management would not remain a boardroom secret forever. Dramatic business mistakes would come to light in the business press, in which case professional directors could expect to be called upon to explain what efforts they had made to avert disaster.

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

[78]See Jensen & Murphy, Performance Pay and Top-Management Incentives, 98 J. Pol. Econ. 225 (1990). Professors Jensen and Murphy summarize their results and elaborate their implications in CEO Incentives -- It's Not How Much You Pay, But How, Harv. Bus. Rev., May-June 1990, at 138.

But the final, and most important, reason why we are not troubled by limitations on the ability of institutional investors to monitor professional directors is that discharge would serve as an incentive of last resort for these directors. We would expect very few directors to be fired because very few talented experts would accept the post of shareholder advocate without the stomach and the ambition to do the job effectively. After all, the experts who chose to become professional directors would have sacrificed other, more remunerative jobs to enter a position with great autonomy and a clear institutional mandate. Their reputations would be on the line. The immediate quality of their contributions would be known, if not always to institutional investors, then at least to their fellow board members -- including their fellow professional directors -- in six public corporations. In these circumstances, the informal incentives to press shareholder interests, even in the face of resistance, would be extremely powerful.[79]

This completes our sketch of how a core of professional directors can command the motivation, information, and influence to serve as effective monitors on behalf of institutional shareholders. We do not suggest that our proposal is a panglossian cure for all that

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[79]The intrinsic idealism of the position and the likely power of reputational incentives for professional directors are among the reasons why we hesitate to propose monetary incentives that would tie the compensation of professional directors directly to company performance. <u>See</u> note 68 <u>supra</u>. Although we do not oppose experimentation with such incentives, we are concerned that they might adversely affect the screening of dedicated professionals. Conversely, however, secondary monitoring and the occasional discharge of a director after poor performance are central to our proposal. The risk of discharge is not only an incentive but also a means of defining the institutional mandate of professional directors. Thus, the fact that these directors could truthfully speak as if their jobs were on the line would lend their voices special weight.

ails corporate governance in the United States. The professional directors that we propose might often fail to improve the corporate governance system. In some companies, they would be out-voted and isolated by management's nominees; in others, management would successfully disguise problems and close off alternative strategies before professional directors could act. In no event would professional directors enjoy as much influence as an LBO Association or a major Japanese or German bank. Inevitably, the separation of ownership and control would persist after the introduction of professional directors -- narrowed, but by no means eliminated. In our view, however, these are not very interesting criticisms of professional directors. The appropriate yardstick for judging the merits of our proposal is not the norm of the controlling shareholder who personally manages the business, but the norm of the traditional outside director who may be barely familiar with the business. As measured against the traditional system of outside directors, we are confident that a core of professional directors would mark a major step forward in reforming the governance of American corporations.

VI. CAN INSTITUTIONAL INVESTORS ELECT PROFESSIONAL DIRECTORS?

Our proposal depends upon the ability of institutional investors to select a critical minority of the directors of their portfolio companies. Whether institutional investors can accomplish this depends on two issues. The first is purely political: Can institutional investors actually cause their directors to be elected? The second is legal: Are existing regulatory barriers so daunting that institutional investors will be deterred from trying?

A. Do Institutional Investors Have the Votes?

In a substantial number of companies, institutional investors clearly do have the votes to elect a critical minority of professional directors. A 1989 study found that institutional investors held 50 percent of the equity of the 50 largest American corporations, 53.2 percent of the equity of the largest 100, and 48.1 percent of the equity of the largest 1,000.[80] General Motors, which has performed notoriously poorly in its market recently, illustrates both the potential power of institutional investors and the need to exercise it. Institutional investors hold 82 percent of GM's equity.[81] Both the power and, given GM's performance, the reason to place professional directors on its board are clearly there; all that is lacking is a decision by the institutions to use their power.

Of course, data on aggregate equity provide a reliable measure of the power of institutional investors only if they can be expected to act in unison. Based on their prior conduct, this expectation may seem to be misplaced. Institutional investors lack a history of voting monolithically to oppose management's slate of board nominees, or even to reject controversial management policies such as poison

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80 C. Brancato, supra note 7, at Table 7.

81 Another study examined the proportion of institutional holdings in 100 randomly chosen issuers of actively traded equities. Conard, Beyond Managerial Capitalism: Investor Capitalism?, 22 Mich. J.L.Ref. 118 (1989). Institutional holdings in the sample ran from as high as 90 percent to as low as 6 percent, with thirty companies having institutional holdings of more than 60 percent and 60 companies having institutional holdings of more than 40 percent. Only 7 companies had institutional holdings of less than 20 percent. Id. at 132.

pills.[82] Not only have institutional investors failed to oppose management's candidates for the board with their own nominees, but many institutions have voted with management even in proxy fights, including the Texaco and Lockheed contests, that were financed by an insurgent. Despite this history, however, there are several reasons to expect more cohesive voting by institutional investors on professional directors.

First, electing a core of professional directors would neither require, nor even suggest, the possibility of replacing management. In the Lockheed proxy fight, for example, it is easy to understand how institutional investors might have voted for management out of mistrust for the insurgent's talented but managerially inexperienced team, even though they might also have preferred to see management monitored more effectively. Consistent with this approach, institutional investors seem to have voted to subject incumbent management to greater monitoring (by approving proposals that will more fully expose the company to the market for corporate control),[83] while also voting to retain management's board slate. In our view, a core of professional directors would be a better monitoring mechanism than the market for corporate control. Thus, institutional investors that now vote against management by favoring

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[82]The companies targeted for shareholder proposals with respect to poison pills were selected because of their high institutional ownership. Of the 32 companies chosen for anti-pill proposals in 1987, institutional holdings varied from a low of 36 percent to a high of 78 percent, with an average of 56.6%. While 4 of the proposals received more than 40 percent of the votes cast, the average vote for the proposals was only 29.4%, although this average had increased to 39.5 percent by 1988. R. Gilson & R. Kraakman, supra note 13, at 121-2. In all events, the proposals failed to garner the support of substantial numbers of institutional investors.

[83]The proposals are described TAN 11-12 supra.

proposals to subject the company to the market for control should be even more willing to vote for a core of professional directors.

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

Thus, we believe that the institutional votes for implementing a professional director governance structure would be forthcoming. More speculatively, it is possible that management would not even oppose a determined effort to propose such a structure. Precisely because management would lack both a good reason for opposing professional directors and a solid assurance of successfully opposing them, its best strategy might well be to cooperate with institutional investors in placing a core of professional directors on the board. Indeed, management might actually welcome cooperation if it feared a takeover bid, since alienating large shareholders by opposing professional directors -- and possibly losing a proxy fight as well --

would hardly be an auspicious way to begin a takeover defense. Finally, and most speculatively of all, management might embrace the concept of professional directors simply because it is a good idea.

B. Regulatory Barriers to Electing Professional Directors.

While the foregoing analysis indicates that institutional investors would have the aggregate votes and the disposition to elect a core of professional directors over a wide range of portfolio companies, a potential problem remains: Institutions must be able to coordinate their votes to exercise their power. Commentators have pointed to a number of regulatory barriers to cooperative electoral action by institutional investors that, they argue, would significantly inhibit if not preclude such a proactive strategy.[84] Although these barriers are real, in our view their importance is easily exaggerated. In some cases, the application of a supposedly preclusive regulation is in substantial doubt and, in all events, little results from a subsequent determination that that the regulation applies. In other cases, compliance with the regulation is simply not very costly.

1. The Federal Proxy Rules. The litany of regulatory barriers to coordinated action by institutional investors typically begins with an expansive account of the application of the federal proxy rules. These rules reach any solicitation of more than ten shareholders,[85] and the term "solicitation" is also broadly defined in

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[84] See, e.g., B. Black, Streamlining the Proxy Process: Access and Deregulation, Columbia Law School mimeo, Nov. 1989; Conard, supra note 81, at 152-63; A. Sommer, Corporate Governance in the Nineties: Managers vs. Institutions 22-27 (1990); Dent, supra note 56, at 903-07; Johnson, supra note 27, at 52.

[85] SEC Rule 14a-2, 17 C.F.R. §240.14a-2 (1990).

determining their reach.[86] If a communication falls within the scope of the proxy rules, the solicitor must file with the Securities and Exchange Commission,[87] a proxy statement that is subject to the anti-fraud provisions of Rule 14a-9.

For an important mechanical reason, the problem posed by the proxy rules is most acute in two circumstances: (1) when institutional investors oppose a management-sponsored proposal; or (2) when they support a shareholder-sponsored proposal that, under Rule 14a-8, management must both include in the company's proxy statement and provide a line on the company's proxy card allowing shareholders to vote in favor of it.[88] In these settings, institutional investors are said to be chilled in their participation in the proxy process by the risk that, if they were to discuss proposals in these categories among themselves, they might be found after the fact to have engaged in "solicitation" under the broad terms of the proxy rules. Perversely, however, this chilling effect occurs only because the rule governing shareholder proposals offers institutional investors the opportunity to act collectively <u>without</u> complying with the normal proxy filing requirements: In the absence of Rule 14a-8, every shareholder proposal would require compliance with the proxy filing requirements. If shareholder proposals could not be included with the company's statement, shareholders could not vote in favor

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[86]The term extends to "[t]he furnishing of a proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." SEC Rule 14a-1(l), 17 C.F.R. §240.14a-1(l) (1990).
[87]SEC Rule 14a-2(b)(1), 17 C.F.R. §240.14a-(2)(b)(1)(1990).
[88]SEC Rule 14a-8, 17 C.F.R. §240.14a-8 (1990).

of these proposals unless they were sent a proxy card, which would constitute a solicitation requiring a proxy filing.

The critical fact for present purposes, however, is that Rule 14a-8 does not require a company to include an institutional investor's nominees for director in the company's proxy statement or to provide a place on the company's proxy card for shareholders to vote for such nominees.[89] There is no uncertainty over the breadth of the proxy rules to deter institututional investors from electing professional directors; the rules clearly apply. Rather, the only issue is whether the cost of compliance ought to deter institutional investors, or an organizational intermediary operating on their behalf, from nominating professional directors.

We offer what may be a controversial position: The compliance burden associated with an effort to elect a minority of professional directors would not be significant. Because the professional director strategy does not require its proponents to contest control of any company, they would merely need to submit very simple proxy statements containing little more than a description of the nominees' background and of the nominators' goals. Such a statement would not be expensive to prepare in today's competitive market for legal services. Moreover, the costs of distributing the statement and receiving the proxies would also be low. Although competitive proxy solicitations staged with prominent newspaper advertisements by professional solicitors are expensive, institutional investors would hardly need such a costly public campaign to communicate with each

[89] SEC Rule 14a-8(c)(8); 17 C.F.R. § 240.14-8(c)(8).

other. In any case, management's vigorous opposition might well provide would-be professional directors with the most effective publicity they could desire, since the natural inference to be drawn from such opposition would be that management was seeking to preserve its power. Indeed, given the weakness of the case for opposing professional directors, we suspect institutional investors would only need to conduct a few campaigns before companies began to include institutional nominees voluntarily in the official management slate. In this case, there would be no proxy expenses at all.

To be sure, reform of the proxy rules to facilitate more active participation by institutional investors is still a desirable goal. Elmer Johnson, for example, has sensibly suggested that just as financial dealings between large investors are now exempt from the Securitites Act of 1933 by Rule 144A, electoral dealings between large investors should be exempt from the proxy rules.[90] Others have suggested that large shareholders have access to management's proxy statement, thereby allowing institutional investors to sponser director nominees in the same way they now sponsor shareholder proposals.[91] Our point is not to oppose such reforms. Rather, we mean only to argue that there is no reason for institutional investors to wait for reform before acting.

2. Securities Exchange Act §13(d).

The second filing requirement that is said to constitute a significant barrier to collective action by institutional investors is a

[90] *See* Johnson, *supra* note 27, at 52.
[91] *See* TAN 54-56 *supra*.

family of regulations promulgated under Section 13(d) of the Securities Exchange Act of 1934.[92] The first of these regulations are Rules 13d-1 and 13d-2. Rule 13d-1 requires any shareholder, or group of shareholders, that acquires over five percent of an issuer's stock to file a Schedule 13D statement with the SEC setting forth information concerning the beneficial owner of the securities, including the number of shares owned, and the purpose, and method of finance, of the acquisition.[93] Rule 13d-2, in turn, requires that a Schedule 13D be amended in the event of a material change, including a change of one percent or more in the percentage of the issuer's stock held.[94]

Because most institutional investors do not own more than five percent of an issuer's stock, this filing requirement seems at first cut to be beside the point. The problem, however, is the filing obligation imposed by Rules 13d-1 and 13d-2 is triggered by the formation of any group "for the purpose of acquiring, holding, voting or disposing of" a company's stock that, in the aggregate, holds more than five percent of a class of an issuer's equity securities.[95] . To make matters worse, whether and when a group has formed is treated as a question of fact that does not require a formal agreement among the putative group members. Thus, if several institutional investors were to communicate and subsequently take parallel action, a court might later conclude that these investors had formed a group and, therefore, had violated Section 13(d) if a filing had not been made

[92] 15 U.S.C. §§78p (1988).
[93] SEC Rule 13d-1, 17 C.F.R. § 240.13d-1.
[94] SEC Rule 13d-2, 17 C.F.R. § 240.13d-2.
[95] SEC Rule 13d-5(b)(1), 17 C.F.R. § 240.13d(b)(1).

within 10 days after the date on which the court concluded the group was formed.[96] To be sure, Rules 13d-1 and 13d-2(b) relieve eligible institutional investors of most of the burden of Sec. 13(d) by allowing them to make a very abbreviated filing, which must be initially made and subsequently updated only at the end of the calendar year, and whose contents are limited to essentially a statement of the number of shares held.[97] However, this relief is available only if each institution in the group has no purpose of "changing or influencing control of the issuer."[98] The conventional wisdom, as Professor Conard puts it, is that "[t]he practical effect [of Section 13d] is to deter prudent investors from nominating and electing directors...."[99]

We are deeply skeptical about whether §13(d)(1) is appropriately applied to concerted action by institutional investors to elect a minority of professional directors (although we have no reason to doubt that Professor Conard fairly states the conventional wisdom), and about whether such activity would appropriately preclude an abbreviated filing under Rule 13d-1(b). Moreover, even if a full Schedule 13D filing were required, we believe that the conventional wisdom greatly exaggerates the burden of the obligation.

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96 See R. Gilson, The Law and Finance of Corporate Acquisitions 943-4 (1986).
97 SEC Rule 13d-2(b), 17 C.F.R. §§ 13d-1(b), 13d-2(b). Rule 13d-1(b)(2) also requires a separate abbreviated filing when eligible institutions exceed 10% of a class of equity securities and an update within 15 days of a calendar month in which holdings fluctuate by more than 5% of the class.
98 SEC Rule 13d-1(b)(1-2), 17 C.F.R. §240.13d-5(1-2).
99 Conard, supra note 81, at 162.

The first step in analyzing the application of §13d(1) to action by a group of institutional investors (or their organizational intermediary) that wishes to implement our agenda is to understand that, under Rule 13d-5(b)(1), only the formation of a special kind of group imputes to the group beneficial ownership of the securities belonging to the group's members. In the context of § 13(d), aggregation is required only if the members of a group have agreed to act together "for the purpose of ... voting ... equity securities of an issuer... ."[100] But as we have previously argued, an effort to elect a minority of professional directors does not require that institutional investors agree to vote their shares in favor of particular nominees. Indeed, the fiduciary obligation that institutional investors owe to their beneficiaries might prevent many of these investors from giving more than a revocable proxy with respect to its shares, an act that does not itself amount to beneficial ownership.[101]

Of course, institutional investors who wishes to implement our proposal would find it helpful (although not strictly necessary[102]), to be able to coordinate selection of appropriate nominees for director, or, as is more likely, agree to share the election expenses of an intermediary organization. But here there seems to be no regulatory

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[100] SEC Rule 13d-5(b)(1), 17 C.F.R. § 240-5(b)(1).

[101] Calumet Industries v. MacClure, 464 F. Supp. 19 (N.D. Ill. 1978); Moran v. Household International, Inc., 500 A.2d 1346 (S.Ct. Del. 1985). A revocable proxy would not constitute beneficial ownership under the definition in Rule 13d-3(a) because the revocability of the proxy prevents the transfer of the voting "power" that the definition requires. It would be an awkward, if not bizarre, construction of Rule 13d-5 for the formation of a group for the purpose of holding of a revocable proxy to result in beneficial ownership when the actual holding of the proxy falls outside the definition of beneficial ownership.

[102] <u>See</u> TAN 74 <u>supra</u>.

barrier. These activities simply do not involve "voting equity securities." Thus, even if undertaken by a formal group, nominating directors or sharing expenses does not, under the language of Rule 13d-5, result in the formation of the kind of group that is deemed to acquire the beneficial ownership of its members' shares. In the absence of aggregation under Rule 13d-5's definition of beneficial ownership, no filing under §13(d)(1) would be required unless an individual institution owned more than five percent.[103]

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[103] Connoly & Martin, Shareholder Communications -- Legal Restraints Governing Group Activity: Part II, 4 Insights 16 (April, 1990), provide three examples of institutional investor activity that they apparently believe results in the formation of a Section 13(d) group. In each case, we find the conclusion puzzling. The first example reports, seeming with approval, that a group of institutional investors filed a Schedule 13D because they had written a letter to a special committee of the board of directors that had been formed to consider a proposal by the company's majority shareholder to purchase the remaining outstanding shares. The letter asserted that the proposal was inadequate and requested that the Special Committee take unspecified actions in connection with its consideration of the proposal. Id. at 18. The authors offer no explanation of why that behavior had the purpose of "acquiring, holding, voting or disposing of equity securities of an issuer" so as to trigger the group aggregation requirements of Rule 13d-5. While the character of the unspecified actions might explain the result, the authors apparently did not think the conclusion turned on them since they were not disclosed.

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

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

We do not deny that the SEC or a court could construe the word "voting" in Rule 13d-5 more broadly than the plain language of the rule supports. For example, just as the SEC broadly interprets the term "solicitation" under the proxy rules to include very preliminary acts that ultimately lead to the giving of a proxy,[104] it could also interpret the term "voting" under Rule 13d-5 to include all actions by a group that ultimately lead to a corporate vote on a matter, even if the group does not dictate how its members actually vote on the matter. Yet it is difficult to imagine what public policy would be served by such an interpretation. Casting so broad a net under Rule 13d-5 would accomplish little at great cost. During an actual voting contest, a Schedule 13D filing would add nothing to the disclosures that would be required by the proxy rules or forced by the political exegencies of a proxy fight. And by burdening the efforts of institutional investors to make corporate elections meaningful, the proxy process would be made less, not more effective. One does not secure more effective corporate governance by needlessly raising its costs.

Even if the SEC were to construe Rule 13d-5 broadly to require the aggregation of shares owned by institutional investors pursuing the election of a minority of professional directors for purposes of the §13(d)(1) filing requirement, Rule 13d-1(b)(1) would greatly reduce the cost burden imposed by the filing requirement. Institutional investors that meet the Rule's requirements may file Schedule 13G instead of Schedule 13D. Schedule 13G requires

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[104] See Connoly & Martin, Shareholder Communications -- Legal Restraints Governing Group Activity: Part I, 3 Insights 14 (Dec, 1989).

disclosure only of the identity and type of entity of the filer, and the number of shares beneficially owned, rather than the detailed description of such things as the purpose of the acquisition and the sources of its financing required by Schedule 13D.[105] Perhaps more important, the initial filing is required only within 45 days after the end of the calendar year in which the obligation accrues, and the burden of updating the filing is significantly reduced. Unlike a Schedule 13D filing, which must be updated "promptly" to reflect any material change, including an ownership change of more than one percent,[106] a Schedule 13G filing need be amended to reflect a change in share ownership only within 45 days after the end of each calendar quarter.[107]

The critical condition to the availability of Schedule 13G is that the person filing (in our case the group) must certify that it acquired the securities (by the formation of the group under Rule 13d-5) "not with the purpose nor with the effect of changing or influencing the control of the issuer."[108] Commentators have stated without pause (albeit also without citation or analysis) that "[a]ctivity such as nominating a candidate for the board of directors of the issuer, proposing corporate action requiring stockholder approval or soliciting proxies would generally prevent [compliance] with the

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[105] SEC Rule 13d-102, 17 C.F.R. § 240. 13d-2.
[106] Exchange Act Sec. 13(d)(2) and SEC Rule 13d-2(a) 17 C.F.R. § 240. 13d-2(a).
[107] SEC Rule 13d-2(b), 17 C.F.R. § 240. 13d-2(b). An amended Schedule 13G must also be filed within ten days after the close of the first month in which ownership exceeds 10 percent. SEC Rule 13d-1(b)(2), 17 C.F.R. § 240. 13d-1(b)(2). <u>See</u> note 97 <u>supra</u>.
[108] SEC Rule 13d-1(b)(1)(i), 17 C.F.R. § 240.13d-1(b)(1)(i).

'investment purpose' requirement of Schedule 13G."[109] This conclusion does not seem to us self-evident.

Our agenda contemplates the election of a minority of professional directors by passive institutional investors that explicitly do not wish to change or influence the identify of the parties who exercise control over the company. The goal is simply to better monitor -- and, if need be, to persuade -- those who do control the company.[110] To reach the broad application stated by commentators, the phrase "influencing the control of the issuer" must be construed to include not only an effort to influence the identify of the actors who control the company, but also any effort to influence, or in our case to monitor, how these actors exercise control. This, however, would be an oddly expansive construction of the concept of "control." For example, SEC Rule 405 under the Securities Act of 1933 defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person."[111] Seeking to elect a minority of directors who could not exercise control self-evidently does not influence the possession of the power to direct management; it merely provides the power only to monitor management.[112]

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[109]Connoly & Martin, supra note 103, at 20.

[110]See TAN 66-68 supra.

[111]SEC Rule 405, 17 C.F.R. § 230.405. The American Law Institute's Corporate Governance Project adopts a similar definition: "'Control' means the power ... to exercise a controlling influence over the management or policies of a business organization... ." The American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 1.05(a) (Tentative Draft No. 10, April 16, 1990).

[112]The commentators' assertion that an institutional investor's proffering any shareholder proposal amounts to seeking to influence control of the issuer -- that is, the power to direct management -- is simply difficult to understand.

As with the term "voting" in Rule 13d-5, one could insist upon a broad construction of the term "control" in Rule 13d-1(b) without embarrassing oneself. But just as with Rule 13d-5, there is no public policy reason to do so. Whatever else one may say about the purpose of our agenda, it necessarily contemplates a proxy solicitation. The proxy rules provide sufficient disclosure without burdening recourse to the proxy process by superimposing another layer of rules that were designed to regulate changes in control, and not the corporate governance activity of passive institutional investors.[113] The likelihood that these institutional investors would not themselves nominate professional directors, but merely fund an organizational intermediary to recruit and select nominees, would make an extension of the "control" concept to our proposal even more curious.

But what if institutional investors still fear that Rule 13d-5 or 13d-2 may be applied (even if erroneously): Might not this uncertainty itself deter them from implementing our agenda?

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[113]The release accompanying the SEC's recent proposed amendments of the rules governing the availability of Schedule 13G makes apparent that the goal of Schedule 13G is to limit the number of Schedule 13D filings so as to "allow the marketplace, as well as the staff of the Commission, to focus more quickly on acquisitions involving a potential change in control." Exchange Act Release No. 26598, Reporting of Beneficial Ownership in Publicly-Held Companies, Fed. Sec. L.Rep. (CCH) ¶ 84,410 [1989 Transfer Binder] (March 6, 1989) at p. 80,074. Indeed, as evidence that "the vast majority of persons filing on Schedule 13D have such a passive intent," the release states that a study of Schedule 13D filings "by the Commission's Office of Economic Analysis indicate[s] that 74 percent of the Schedule 13D [sic] studied reported no intention to change control of the issuer at the time of the initial filing." Id. (emphasis added, citation omitted). Institutional investors seeking to elect a minority of professional directors to monitor management more effectively also have no intention to change control of the issuer. As the release's discussion makes clear, Section 13(d) is concerned with changes in control, not with corporate governance activity by passive investors.

Whether §13(d) should have such a deterrent effect depends on the real burden of compliance or, in cases where institutional investors are uncertain about the point at which joint action gives rise to a group, the real burden of remedial action following a violation of the §13(d) filing requirement. In contrast to what appears to be the conventional wisdom, we believe that even filing and updating a Schedule 13D is less burdensome than is commonly thought. The content of a filing would not be difficult or expensive to prepare because the goal -- the "purpose of the transaction" in Item 4 -- is merely to elect professional directors to improve the monitoring of management. The goal is <u>not</u> to undertake a complex strategic change, such as a restructuring, whose description would inevitably be subject to disputation. Moreover, the obligation to update, while inconvenient, should be merely mechanical. For indexed investors, portfolio changes would be minimal. Even trading by active portfolio managers likely would involve less than one percent of an issuer's stock; in the context of electing a minority of professional directors, such trading would likely be immaterial and therefore not trigger an obligation to amend.[114]

Nor should the risk of an inadvertant violation, resulting from a retroactive determination that a group had been formed for purposes of a Schedule 13D filing, significantly deter institutional investors in light of the inconsequential remedies that typically follow a Section

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[114]Rule 13d-2 requires an amendment of a filed Schedule 13D in the event of a "material change." The Rule deems changes in holdings of one percent or more of the issuer's outstanding stock to be material. Changes "of less than such amounts may be material, depending on the facts and circumstances." In the context of electing a minority of professional directors, such small changes would hardly be material.

13(d) violation. Although courts have occasionally granted relief beyond mandating after-the-fact compliance with the Section 13(d) filing requirements, they have done so chiefly in situations involving either outright stock parking[115] or premeditated efforts to acquire control that were not disclosed in an earlier Schedule 13D filing.[116] Thus, institutional investors seeking to elect a core of professional directors have little to fear from either the costs of filing, or the costs of inadvertant failing to file, a Schedule 13D.[117]

3. Filings under Hart-Scott-Rodino.

Section 7A of the Clayton Act,[118] which was added by Title II of the Hart-Scott-Rodino Antitrust Improvement Act of 1976,[119] is the final filing requirement that is said to deter active participation in corporate governance by institutional investors.[120] In order to give federal enforcement agencies sufficient time to prevent anticompetitive acquisitions, this statute requires a party who intends to acquire a significant amount of an issuer's voting stock to file a lengthy notification form and wait 30 days before actually acquiring the stock. A broad exemption relieves institutional investors from the duty to comply as long as their acquisition is solely for investment purposes and involves less than

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115 See SEC v. First City Financial Corporation, (CCH) Fed. Sec. L. Rep. (1988-89 Transfer Binder) ¶ 93,978 (D.D.C. 1988) (disgorgement remedy).
116 See generally Maiwurn & Tobin, Creating Waves in the Market Place and Uncertainty in the Regulatory Framework, 38 Bus. Law. 419 (1983).
117 Once again, it is also worth noting that a single large institutional investor, such as CalPERS, that initiated a professional director program for a handful of companies, would have nothing to fear under even the wildest construction of the § 13(d) rules.
118 15 U.S.C. §18a (1989).
119 P.L. No. 94-435, 90 Stat. 1383 (1976).
120 See Sommer, supra note 69, at 27.

either 15 percent of the outstanding stock or securities valued at less than $25 million.[121] Yet, the problem is that the term "solely for the purpose of investment" requires that the holder have "no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer."[122] The Statement of Bases and Purposes, which accompanies both the exemption rule and the definition of the relevant terms, further states that "nominating a candidate for the board of directors" may constitute conduct inconsistent with an investment intent.[123]

Notwithstanding such ominous language, we believe that, as with the application of § 13(d), it is easy to overstate both the need to comply and the burden that compliance imposes. First, institutional investors might not be the parties who nominate directors under our proposal; an organizational intermediary holding no stock at all could recruit and propose nominees. Second, even if institutional investors were to select the candidates directly, nominating a professional director as part of a corporate governance strategy to monitor management should not result in a loss of the exemption, since the hallmark of this strategy is precisely that it is designed to support a larger policy of passive investment. Such a strategy is irrelevant to the antitrust concerns that motivate the statute. Finally, even if the enforcement agencies concluded that the exemption was unavailable, preparing the notification form would not be burdensome for most institutional investors, since it would

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[121] Rule §802.64.
[122] Rule §801.1(i)(1).
[123] 43 Fed. Reg. 33,450, 33,465 (1889).

involve little more than providing a description of the contents of their portfolio. Nor would the 30 day waiting period have significant consequences because the enforcement agencies would likely exercise their discretion to provide for its early termination.

4. Miscellaneous Regulatory Barriers.

A miscellany of additional regulatory barriers to institutional investor activism are also mentioned by commentators seeking to catalogue the legal reasons for passivity. As with the more significant issues posed by the proxy rules, Section 13(d) and Hart-Scott-Rodino, the import of these barriers is greatly overstated in our view.

a. Controlling Person and Deputization Liability. Under both the Securities Act of 1933 and the Securities Exchange Act of 1934, a party that "controls" a firm has a prima facie responsibility for all federal securities law violations committed by that firm.[124] This has led Professor Conard to raise the specter that institutional investors might incur controlling person liability if they "should combine with others to elect a majority of directors."[125] For purposes of our agenda, however, this risk is non-existent. The goal of our proposal is to elect a minority of professional directors, which is, as discussed previously,[126] very different from an efffort to seek control.

[124] Securities Act of 1933, § 15, 15 U.S.C. § 77o; Securities Exchange Act Sec. 20, 15 U.S.C. § 78t.
[125] Conard, supra note 81, at 159.
[126] TAN 110-113 supra.

b. Short Swing Profit Liability. Section 16(b) of the Securities Exchange Act[127] provides that an issuer can recover any profits realized by a director, officer or beneficial owner of 10 percent of an issuer's outstanding stock, from purchases and sales within a six-month period. Commentators have raised two concerns about the application of § 16(b) to institutional investors, which might be thought to bear on efforts to elect a minority of professional directors.

First, if a shareholder of a company causes the election of its own representative to serve as a director of the company, and that representative also has authority over the shareholder's investment decisions, the director-representative can be deemed to be a "deputy" of the shareholder, in which case §16(b) applies to the shareholder as if it were itself the director.[128] Under our proposal, however, the deputization concept should have no application. The goal of our proposal is to elect a minority of professional directors who are not otherwise connected with institutional investors. Indeed, if an intermediary organization is developed, institutional investors would not play any direct role, even in the selection of director nominees.

The second concern is that concerted action by institutional investors to elect a minority of independent directors may give rise to a group that, for purposes of §16(b), would be the beneficial owner of all shares in any particular company held by group

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[127] 15 U.S.C. § 78p(b).

[128] See Feder v. Martin-Marietta Corp., 406 F.2d 260, 263-64 (2nd Cir. 1969), cert. denied, 396 U.S. 1036 (1970); Conard, supra note 81, at 160-61.

members which, if it exceeded 10 percent, would subject any trading by group members to § 16(b).[129] Interestingly, while the SEC has adopted regulations defining the term "beneficial owner" for purposes of § 13(d),[130] it has not sought to define this term for purposes of § 16(b). Moreover, no court attempted to invoke a disgorgement obligation under § 16(b) by applying the group concept under Rule 13d-5, which triggers a reporting obligation under Rule 13d-1.[131]

Even were a court to fashion a § 16(b) parallel to Rule 13d-5 (despite the SEC's failure to act), it would hardly be likely to do so in the context of an effort by institutional investors to elect a minority of professional directors. Rule 13d-5 aggregates the holdings of a group for purposes of the §13(d) trigger only when the group was formed for purposes related to the statutory purpose: The group must be formed "for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer."[132] Section 16(b) is a prophylactic rule designed to keep large stockholders (among other suspected insiders) from trading on the inside information that a 10 percent shareholder is conclusively presumed to have. A shareholder group formed for the purpose of implementing our

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[129] J. Pound, Reforming Corporate Governance: Deregulation, Not More Regulation 8, paper presented at Salomon Brothers Center and Rutgers Center conference on The Fiduciary Responsibility of Institutional Investors (June 14-15, 1990); Dent, supra note 56, at 905.

[130] See TAN 100-101 supra.

[131] See Dent, supra note 56, at 905 n.135.

[132] Rule 13d-5(b)(1).

agenda, however, lacks any suspect attribute that would justify aggregation of shareholdings to trigger the application of § 16(b).[133]

5. Summary.

In short, none of the regulatory requirements that are most frequently cited as barriers to coordinated action by institutional investors are truly significant in their own right. Like the prospect of determined opposition from management, the regulatory obstacles to professional directors would be likely to dissolve once the first effort to elect institutional directors was launched.

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133 More tenuous arguments also can be constructed. One might argue that institutional investors sponsoring the election of a minority of professional directors could be treated asa group, and therefore as a single "interested person," for purposes of determining whether the combined holdings of the group crossed the ownership percentage that triggers a firm's flip-in poison pill. See Pound, supra note 129, at 9. Were that the case, the resulting dilution of the institutions' investment would make any thought of joint electoral action unthinkable. A fair reading of Moran v. Household International, Inc., 500 A.2d 1346 (Del. S.Ct., 1985), however, suggests that courts will be reluctant to construe a poison pill to restrict shareholder recourse to the proxy process, at least in the context of joint action by institutional investors that explicitly did not seek control of the board of directors. It should be remembered that the court held in Moran that the holder of proxies to vote shares was not the beneficial owner of those shares for purposes of a poison pill. Accordingly, the court held that "the mere acquisition of the right to vote 20% of the shares does not trigger the Rights." 500 A.2d at 1355. If actually securing the proxies does not trigger the pill, joint action to seek to secure them with respect to a non-control issue is hardly a problem. To be sure, one could write a poison pill that did reach this situation, but sustaining such a plan in the face of the strict standard for interfering with shareholder recourse to the proxy porcess set by Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del.Ch., 1988), would be difficult indeed.

A similar argument can be made with respect to state takeover statutes, like the Indiana Control Shares Acquisition Act, Indiana Bus. Corp. Law, Inc. Code § 23-1-42-1 et seq., whose application is triggered by a person acquiring voting power over a specified percentage of a corporation stock. Id. However, institutional investors pursuing the election of a minority of professional directors would not acquire voting power over each other's shares. See TAN 101 supra. Moreover, the trigger percentage in some statutes is typically 20 percent, high enough that the statute would be unlikely to pose a serious problem even if it applied.

VII. CONCLUSION.

Our goal here has been to demonstrate that the reform of corporate governance is a sensible strategy for institutional investors that wish to improve the performance of their portfolios, but that the current governance strategies pursued are not likely to accomplish enough. Eliminating takeover barriers is desirable, but the market for corporate control is hardly the best way to monitor management performance. Shareholder advisory committees are poor substitutes for representation on the board. And traditional independent directors have too little time and the wrong incentives for producing the desired results. The focus on outside directors is surely correct, but the key, we have argued, is not the independence of directors from management but their dependence on shareholders.

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

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