THE RISE OF THE POLITICAL MODEL OF CORPORATE GOVERNANCE AND CORPORATE CONTROL

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In this Article, Professor Pound proposes a broad model for corporate governance in the post-takeover era. He argues that the takeover mechanism, which was the common method of effecting changes in corporate policy and control in the 1980s, has largely been supplanted by other, more democratic mechanisms. These mechanisms range from formal proxy fights to informal discussions between board members and investors. Professor Pound argues that this evolution reflects the reassertion of a "political model" of oversight after a long period of dormancy. Using empirical evidence, he illustrates that this model is preferable to the takeover model as a means of monitoring corporate management. Importantly, he predicts that the political model will prove more sustainable than other current, broad-based reform proposals because it better accords with American principles of democratic governance.

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INTRODUCTION

The past two years have seen the most vivid and riveting changes in American corporate governance in many decades. News reports have chronicled the sudden departure of chief executive officers at the largest American corporations.[1] Responsible for these departures are energized

[1] See, e.g., Leah N. Spiro & John Byrne, A Quiet Coup at American Express, Bus. Wk., Dec. 21, 1992, at 30, 30-31 (describing hasty departure of longtime American Express CEO James Robinson after series of conflicts with its board); James B. Treece, The Board Revolt: Business as Usual Won't Cut It Anymore at a Humbled GM, Bus. Wk., Apr. 20, 1992, at 30, 31-36 (describing General Motors's board's move to force Robert Stemple's resignation as

corporate boards, led by independent directors seeking to become more involved in overseeing the direction of their corporations.[2] Underlying these more active boards, in turn, are major institutional investors. Large public pension funds, money managers, and other institutions have prodded boards to become more active; at the same time, they have called to the attention of the public and investors boards that have consistently failed to do their duty to maximize corporate performance.[3]

This is a very different world of corporate governance than the one we knew at the end of the 1980s. Then, the only obvious vehicle for corporate change was the takeover. The notion that boards should rise up against CEOs, and that independent board members would engender a serious debate about corporate strategy and performance, were laughable. The prevailing view then was that boards were shills, dispersed investors were forever passive, and corporate governance revolved around herculean, expensive, and hostile contests of wills between the CEO who ran the company and the outsider who wanted to run the company.[4] Economists, who were in their element in a corporate world dominated by transactions and short-term price movements, argued that the prevailing dynamics were intrinsic to the American market. In their view, takeovers were an efficient means of corporate governance because it was inherent in the American financial system that shareholders would be passive and directors uninvolved.[5]

Seldom has an entire philosophy proved so wrong in so short a time. The very things that most American observers believed could never happen indeed have come to pass: investors have become more active and boards have been energized. The new era of corporate governance has repudiated the predictions of economists, and alongside the takeover

CEO); Westinghouse Names Jordan to Top Posts, Wall St. J., July 1, 1993, at A3 (detailing Westinghouse's replacement of former CEO Paul Lego with Michael Jordan).

2 For example, new IBM CEO, Louis V. Gerstner, has established an array of new board committees, staffed with outside directors, to help keep the corporation's governance and management on track. See Michael W. Miller, IBM, Overhauling Its Board, Will Create "Governance" Panel of Outside Directors, Wall St. J., July 30, 1993, at A3; see also Judith H. Dobrzynski, A Wake-Up Call for Corporate Boards, Bus. Wk., Apr. 20, 1992, at 35 (describing radical changes in General Motors's board since its CEO shake-up).

3 Judith H. Dobrzynski, Relationship Investing: A New Shareholder Is Emerging—Patient and Involved, Bus. Wk., Mar. 15, 1993, at 68, 69-75 (describing trend of greater involvement by institutional investors in corporate governance debate).

4 See, e.g., Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 843 (1981) ("Corporate law and economics combine to make the proxy fight an unattractive displacement mechanism.").

5 See, e.g., Michael C. Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept.-Oct. 1989, at 61, 61-74 (discussing virtues of takeover era for corporate America's health); see also Greg A. Jarrell et al., The Market for Corporate Control: The Empirical Evidence Since 1980, 2 J. Econ. Persp. 49, 49-68 (1988) (performing quantitative analysis of effects of takeovers on all relevant participants).

model has risen an effective political model, along the lines that corporate statutes originally envisioned, in which shareholders elect directors and directors monitor managers.

A roster of major American corporations—General Motors, Westinghouse, IBM, American Express, Eastman Kodak, Digital Equipment—provides the most vivid evidence of the scope of these recent changes. Dramatic shifts in direction have occurred in each of these corporations over the past two years, occasioned not by takeovers but by the activism of investors and boards of directors.[6] How could change occur so quickly in the arena of corporate governance, and what forces will guide the new era that seems to be upon us?

There is broad agreement that "something new" is arising that is radically different from the governance system of the recent past. There is also widening agreement that the focus of the new process is on large institutional investors. But while some analyses have examined the consequences of the disappearance of old mechanisms,[7] and others have explored the incentives and behavior of institutional investors,[8] no widespread agreement on a broad paradigm that describes the dynamics now arising in the field of corporate governance has been reached.

The lack of a defining paradigm has created a sense of intellectual vertigo in the debate over corporate governance reform. Freed from the yoke of the takeover model, many scholars have offered new suggestions for improving the governance system in the post-takeover world. For example, Professors Ronald Gilson and Reiner Kraakman have sug-

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[6] Details of these abrupt changes in philosophy and approach of management are littered throughout daily newspapers and magazines. See, e.g., Warren Brown & Frank Swoboda, Managing the March of Change, Wash. Post, Jan. 31, 1993, at H1 (highlighting General Motors's top-down adjustments of its management philosophy and corporate structure led by its active board of directors); Laurie Hays, With IBM at a Crossroads, Gerstner Seems to Be Charting a Middle Course, Wall St. J., July 26, 1993, at A3 (describing changes implemented by new CEO Gerstner and IBM's more vocal board); Erle Norton, Westinghouse Plans to Sell Unit to Eaton Corp., Wall St. J., Aug. 12, 1993, at A3 (detailing Westinghouse's latest innovations in its management course since CEO Michael Jordan was elected by board); Joan E. Rigdon & G. Christian Hill, New Focus, Wall St. J., Oct. 29, 1993, at A1 (describing Kodak's change in strategy after significant input from its active board); Glenn Rifkin, The New Chief at Digital Outlines His Strategy, N.Y. Times, Oct. 2, 1992, at D3 (depicting Digital's ambitious plans since Robert Palmer took CEO reins); Michael Siconolfi, Shearson Names Fuld, Hill to New Office of Chairman in Wide Reorganization, Wall St. J., Jan. 12, 1993, at B6 (detailing board restructuring of American Express soon after CEO Robinson was replaced).

[7] Compare Michael C. Jensen, Corporate Control and the Politics of Finance, J. Applied Corp. Fin., Summer 1991, at 13 (criticizing forces that have led to disappearance of hostile takeovers) with Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187 (1991) (applauding same trends).

[8] See, e.g., Bernard S. Black, Agents Watching Agents: The Promise of Institutional Shareholder Voice, 39 UCLA L. Rev. 811 (1992) (analyzing whether institutional investors will take up slack and monitor management).

gested that institutions elect independent directors to corporate boards;[9] attorney Martin Lipton and Professor Jay Lorsch have argued for limited, incremental reform in the relationship of boards and CEOs to shareholders;[10] and attorney Ira Millstein has argued for increased emphasis on long-term, "relationship investing."[11] In order to address the desirability or efficiency of any of these specific suggestions, one needs to begin with a broad view of market operation and incentives in the absence of further reform. Without a broad paradigm, one risks engaging in a classic "second-best" analysis, warned against by economists, in which one unwittingly proposes a cure that is worse than the disease.[12]

This Article proposes such a paradigm. The paradigm which I offer applies a broad historical perspective to current trends in corporate governance and takes account of new incentives created in the governance arena as a result of these recent changes. The current transformation in corporate governance is only one of many that have occurred in the past century and a half. Although largely forgotten by current observers, past shifts offer important insights into the present situation.

Seen in an historical context, what is happening within the corporate governance arena is simple yet dramatic. It is the reassertion of a "political model" of corporate governance over a transactions- and market-based one. By "political," I mean an approach in which active investors seek to change corporate policy by developing voting support from dispersed shareholders, rather than by simply purchasing voting power or control. I call it "political" because this form of corporate governance bears a strong resemblance to the model of governance that we typically associate with the public sector. Within a political model of corporate governance, insurgents use public processes to educate voters and to propose alternatives to the policies of incumbents. This process, and the debate it engenders, promotes an informed, participatory, and substantive approach to oversight of management.

The political model of governance is reemerging in the U.S. market after a long period of dormancy. From well before the turn of the century until the late 1950s, the political model was a major factor, if not

9 See Ronald J. Gilson & Reiner Kraakman, Reinventing the Outside Director: An Agenda for Institutional Shareholders, 43 Stan. L. Rev. 863, 883-92 (1991).

10 See Martin Lipton & Jay W. Lorsch, A Modest Proposal for Improved Corporate Governance (Subcouncil on Corporate Governance and Financial Markets of the Competitiveness Policy Council Working Paper, 1992).

11 See Ira Millstein, The Evolving Role of Institutional Investors in Corporate Governance (American Bar Association Panel on Institutional Investors Working Paper, 1992).

12 The second-best problem obtains whenever a system performs below its optimum, and implies that it is impossible to rank alternatives that do not attain the optimum. The original work is R.G. Lipsey & Kelvin Lancaster, The General Theory of Second Best, 24 Rev. Econ. Stud. 11 (1956-1957).

the dominant factor, in corporate governance. Since 1960 it has been eclipsed by the hostile takeover and the transaction-based "market for corporate control." In the past few years, however, a series of changes in state corporation law, firm-specific takeover protections, and a sweeping political backlash against hostile control transactions have dampened the takeover mechanism. Concurrently, the increasingly concentrated ownership of major American corporations has created incentives for more informal negotiation- and voting-based approaches by institutional and other active investors.

The most significant and defining aspect of the new political process is the rise of informal, political mechanisms to supplant, and even replace, the extreme measure of the formal voting challenge. Institutional ownership concentration creates a more sophisticated and smaller audience of investors, facilitating a wide variety of less formal approaches to organizing a critical mass of shareholder support. Where a corporation is owned by a few large institutions, instead of thousands of relatively uninformed individuals, management and directors may be more readily influenced by outsiders who circulate alternative policy proposals to major investors, make informal suggestions for new director nominees, seconded by major institutions, or solicit votes for a shareholder proposal which suggests specific reforms to corporate policy or board structure. These incremental and informal means of suasion bring the political model of governance much closer to democratic politics in the public sector, in which the informed and ongoing participation of citizens, as much or more than electoral challenges, influences policy.

The reemergence of the political model of corporate governance is not an arid prediction; it is a reality. At no time since before 1930 has such a varied array of new oversight activities arisen in the voting arena. In addition to the vivid, widely-chronicled events at companies like Westinghouse, American Express, and General Motors, a myriad of initiatives has occurred that illustrate the flexibility of the political model. Examples include the joint effort by active investor Richard Rainwater and the California and Pennsylvania public pension funds to bring about incremental change at Honeywell;[13] Carl Icahn's establishment of an independent shareholders' committee at USX;[14] and Wellington Management's and Loomis Sayles's public campaigns to engender executive succession at Chrysler.[15] The increased incidence of private negotiations

[13] This campaign is described in Karen Van Nuys, Corporate Governance Through the Proxy Process: Institutional Voting Patterns in the 1989 Honeywell Proxy Solicitation, 34 J. Fin. Econ. 101 (1993).

[14] See John Pound, Beyond Takeovers: Politics Comes to Corporate Control, Harv. Bus. Rev., Mar.-Apr. 1992, at 83, 84-86.

[15] See John Pound, After Takeovers, Quiet Diplomacy, Wall St. J., June 8, 1992, at A10.

between major corporate managements and private and public institutions about executive compensation, corporate structure and strategy, and board effectiveness must also be seen as part of this trend.

The political model offers significant advantages over the market-based model it replaces. One set of advantages is economic. Because the political model is flexible, it can address specific problems at a corporation without imposing changes in control, changes in management, and the enormous transaction costs attendant to them. The political model is also less disruptive and more specialized, allowing corporate constituents to fix problems with less risk of creating new, potentially worse ones.

A second and even more compelling advantage of the political model is its political sustainability. The political approach to corporate governance accords with American values about how major institutions in our society should be governed, emphasizing due process, substantive debate, and the use of formal voting referenda. The market model, by contrast, directly contravenes widely shared principles of governance in American society. As a result, it inevitably invites resistance and regulation. The cumulative evidence of history is compelling in this regard. The acquisition model appears to eschew—indeed to mock—due process, and it has always generated intense public suspicion, antipathy, and, ultimately, retaliation.

This Article proceeds in four parts. Part I briefly traces the development of corporate oversight, placing the current transformation in an historical context. Part II begins by analyzing the predominant form of corporate control transaction in the 1980s—the hostile takeover—in light of the goals of an "ideal" governance system. Next, Part II describes the political model that is now supplanting the takeover model and assesses its costs and benefits. Part III then describes the conditions that have caused the reemergence of the political model, presenting evidence of its resurgence during the past few years. Finally, Part IV compares the political model with other broad-based proposals for structural reform of corporate governance, including proposals to improve boards of directors and to promote "relationship investing," and determines that the political model is the preferable approach.

I

The Historical Context

In order to assess the current transformation in and competing proposals for the structure of corporate governance, it is necessary first to understand the historical context of corporate governance mechanisms that have been used in the past. To many observers, the historical precedent seems obvious. Until recently, the main engine for corporate governance was the hostile takeover. Now, takeovers have been all but eradicated, at least temporarily. The result is a unique situation in which the market for corporate control has been shut down and no obvious alternative system for effectively enforcing accountability exists.[16]

A longer-term view of the history of American corporate governance, however, suggests a different conclusion. While not diminishing the importance of the current transformation, the historical record shows that a vigorous market in corporate oversight existed long before the hostile tender offer first arose approximately thirty-five years ago. Oversight activity, spurred by investors whom modern observers would term "corporate raiders," was evident in American financial markets beginning in the early 1800s.[17] Over time two broad categories of monitoring activity have developed: acquisitions and proxy challenges.[18] However, innovations in ownership structure, politics, law, and regulation have led to sharp shifts in both acquisition and proxy tactics.

A long-term perspective thus suggests that the current transformation is different in degree but not in kind from ones that occurred in earlier times. This Part presents an abbreviated overview of the development of corporate control mechanisms in the United States over the past century and a half and places the "takeover decade" in historical perspective.

A. The Principal-Agent Problem and the Failure of the Board

The history of American corporate governance begins with the development of dispersed share ownership in the early 1800s. By the middle of that century, it was widely acknowledged in the business world that a troubling lack of oversight existed between providers of capital and management, with suboptimal decisions often being the result. In 1863, James Ayer wrote:

> Time has changed the relation of owners and managers, until only traces of their original condition remain. . . . The present stockholders . . . are scattered all over New England, and other States. They have bought their shares as an investment, and with the delusive hope that somebody is interested in [the company] who can and will take care of [the company].[19]

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[16] For examples of this widely shared opinion, see Jensen, supra note 5, at 64; Black, supra note 8, at 820.

[17] For an entertaining and accurate history, see Carter F. Henderson & Albert C. Lasher, 20 Million Careless Capitalists (1967).

[18] The predominance of these two mechanisms is acknowledged in basic legal texts. See, e.g., Robert C. Clark, Corporate Law 357-400 (1986) (on proxy system); id. at 463-592 (on control shifts).

[19] James C. Ayer, Some of the Usages and Abuses in the Management of Our Manufacturing Corporations 3 (1863).

It was widely thought that the nominal cure for dispersed ownership structure and shareholder apathy was an energized board of directors that would work to protect shareholders' interests.[20] But there was also widespread concern that the board of directors, as a small group close to management, would not have sufficient incentives or independence to do the job of monitoring. The link between shareholders and boards was perceived to be weak.[21]

An 1877 editorial in *The New York Times* provides a colorful commentary:

> The old relations between directors and stockholders, between managers and the public, exist no longer. The power incident to a directorship is used most frequently for the furtherance of interests . . . which indeed are often antagonistic to shareholders' interests. Directors may shun as a lunatic a man who arises at a meeting, or avails himself of a seat at a board, to remind them that they are simply trustees for others, that they have no right to lock up secrets or do anything not consistent with a fiduciary position; but unless they learn the lesson from somebody and act on it, they will look in vain for the confidence that is essential to a renewal of corporate prosperity.[22]

These concerns about corporate oversight, which were first fully articulated in the early 1800s, have persisted. Professors Adolph Berle and Gardiner Means rearticulated them in 1932.[23] In the past two years, *Fortune*, *Business Week*, and other major journals have published feature articles questioning whether and when boards of directors will become energized protectors of shareholders' interests.[24]

B. Two Model Solutions: Takeovers and Politics

As I will document in this Section, a series of market-based solutions have been used in the United States to correct both the collective-choice problem and the dysfunction of boards. Market-based solutions depend on the depth and liquidity of American capital markets. These conditions provide an incentive for entrepreneurs to amass block investments and mount challenges to management when clear evidence of underperformance exists. By mounting a successful challenge, an entrepreneur can capture a portion of the value gain that can be achieved at

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[20] See id.

[21] See id. at 4 (discussing board abuse of shareholder elections).

[22] Distrust of Corporate Management, N.Y. Times, Feb. 2, 1877, at 4.

[23] Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).

[24] See, e.g., Myron Mageret, Directors, Wake Up!, Fortune, June 15, 1992, at 85 (discussing efforts of large institutional investors to reinvigorate boards of sagging companies); James B. Treece, It Can't Happen Here, Can It?, Bus. Wk., Apr. 20, 1992, at 36 (surveying board reactions to investor discontent at five major corporations).

the company, thereby acting as a "catalyst" or agent for more dispersed shareholders who lack the information, skills, or incentives to undertake corrective action on their own.[25] Large investors typically have pursued two kinds of market-based tactics in the corporate oversight arena—acquisitions and proxy challenges. In an acquisition, the acquirer purchases the company from existing owners at a premium to its market value, presumably because there is value to be gained by running the company better; thus, both the acquirer and outside shareholders share in the profits.[26] In a proxy challenge, the outside investor seeks election of an alternative slate of directors in an underperforming firm. If successful, the investor derives benefits by increasing corporate performance, thereby elevating the value of both his investment and that of other outside shareholders. In addition, the successful insurgent reaps the direct benefits associated with running the company.[27]

Formal proxy voting challenges are only the most visible part of what I call the "political model" of corporate governance. The broader political process is best explained by analogy to the public-sector governance process in a democratic state. The basic legal structure of the corporate governance process mimics that found in the public sector and is subject, broadly speaking, to the same dynamics. Like public-sector representatives, members of the corporate board (and implicitly corporate managers) are subject to reelection. Regular, periodic access to the corporate franchise gives shareholders, like public citizens in a democracy, a baseline of power.

That power, however, is not manifested merely through formal voting challenges. Instead, power can be exercised through a rich variety of means. These may include the simple communication of concerns from shareholders to management; private negotiation between shareholders, management, and directors; rallying of support for specific issues or policy changes; and the establishment of formal lobbying campaigns. Underlying each of these informal initiatives is the veiled threat of a voting challenge aimed at board representation or control. In the corporate sec-

25 In formal economic parlance, entrepreneurial investors solve the collective choice problem that afflicts dispersed shareholders by internalizing the costs associated with taking action. For a recent formal exposition of this phenomenon, see generally Andrei Shleifer & Robert W. Vishny, Large Shareholders and Corporate Control, 94 J. Pol. Econ. 461 (1986).

26 For a classic exposition of the takeover phenomenon, see generally Michael C. Jensen, Takeovers: Folklore and Science, Harv. Bus. Rev., Nov.-Dec. 1984, at 109. For a formal framework, see generally Shleifer & Vishny, supra note 25.

27 Formal analysis once again can be found in Shleifer & Vishny, supra note 25. Interesting historical expositions reached the same conclusions long before the advent of formalism. See generally, e.g., Leland C. Whetten, The Influence of Proxy Contests on Social and Economic Trends (1963); Sumner H. Slichter, Thinking Ahead: Breakup of the Business Cycle, Harv. Bus. Rev., Jan.-Feb. 1955, at 19.

tor, as in the public sector, it is this threat that keeps elected representatives accountable to their constituents while in office.[28]

Takeovers and politics are not the only solutions to the oversight problem that have appeared in the U.S. market to date; however, they are by far the most long-lasting and robust. In the late 1800s and early 1900s, voting trusts proliferated as a means of concentrating the voting power of dispersed shareholders.[29] Trusts died out in the 1930s, apparently due to substantive problems with incentive alignment and the suspicion of power concentration which they created.[30] Legal remedies, most notably the derivative action lawsuit, were also available, but typically they were aimed only at the worst abuses of corporate governance.[31]

By 1850, both acquisitions and proxy challenges began to predominate the U.S. market. Acquisition contests bore a striking similarity to those of the 1980s. Many involved hostile offers, attempts to sweep the street of unaffiliated stock, negotiations to buy friendly blocks, and concurrent proxy contests for control of the board. Equally familiar defensive moves involved issuance of new voting stock, abrupt changes in corporate charters and bylaws, and appeals to (and sometimes briberies of) state legislatures to enact new laws to protect incumbents. Acquisition contests were typically accompanied by meteoric increases in the price of the target firm's stock. The term "corporate raider" entered the lexicon to refer to aggressive investors seeking to acquire control of large companies through such means.[32]

Proxy challenges spanned a broad spectrum of activities. By the mid-1850s, formal proxy contests were commonplace.[33] Throughout the 1800s, monitoring also occurred through a host of more informal politically based activities, in which shareholders organized themselves into

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28 As I will discuss below, these kinds of informal political mechanisms have been little-recognized in the past few decades because of the overwhelming presence of high-profile devices like tender offers. See Parts I.C, II.A infra.

29 See generally William Z. Ripley, Trusts, Pools, and Corporations (2d ed. 1916).

30 See generally John A. Leavitt, The Voting Trust: A Device for Corporate Control (1941).

31 See, e.g., R. Clark, supra note 18, at 639-74.

32 See C. Henderson & A. Lasher, supra note 17, at 55-65 (giving useful anecdotal account). Business histories also provide empirical evidence, although couched in different rhetorical terms. See generally, e.g., William W. Fowler, Ten Years on Wall Street (1870) (describing stock market dynamics in mid-nineteenth century, including takeovers); Alexander Noyes, Forty Years of American Finance: A Short Financial History of the Government and People of the United States Since the Civil War, 1865-1907 (1909) (containing descriptions of market dynamics in nineteenth century). Contemporaneous accounts can be found in national publications such as The New York Times. See, e.g., A Combination Against the Public, N.Y. Times, Apr. 18, 1870, at 4.

33 Once again, a picture of proxy challenges can be derived from contemporary publications as well as business histories. See, e.g., Monetary Affairs, N.Y. Times, Apr. 3, 1860, at 2 (reporting on contested election at Michigan Southern and Northern Indiana Railroad).

cells to exert pressure on management for specific changes. For example, Professor Ayer documented the formation of shareholder committees that were specifically convened to investigate poor performance and apparent bad faith actions by management at a number of New England public companies in the early 1800s.[34] By the mid-1800s, financial periodicals frequently reported that shareholders were circulating proposals suggesting changes in policy at large corporations.[35] Later in the century, shareholders mounted petition drives and organized informal committees to press for changes at a wide variety of companies.[36]

The merger market and the political process continued as robust means of corporate governance through the first half of the twentieth century. Political oversight became more oriented toward the formal proxy contest and less toward informal oversight through committee and petition, probably due to the rapidly increasing dispersion of shares in the hands of relatively uninformed individual owners.[37] The early 1900s saw a significant number of formal, broad-based proxy contests at major corporations, including successful fights for control at General Motors (1915), Standard Oil (1929), and Transamerica (1932).[38] In addition, many smaller proxy initiatives were mounted to obtain board representation, oppose merger agreements, and win the right to provide financing to the corporation.[39]

Acquisition activity also continued through this period, as did de-

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[34] See J. Ayer, supra note 19, at 2-7.

[35] An example is an 1862 New York Times report that unhappy shareholders were objecting to a bond issue devoted to building a new rail line. See Monetary Affairs, N.Y. Times, May 17, 1862, at 3.

[36] The New York Times reported in 1885 that dissatisfied shareholders were petitioning the Broadway and Seventh Avenue Railway for more information about finances. The Times concluded: "Their curiosity seems reasonable. They have an inkling that their company has issued $500,000 of bonds of its own and guaranteed $1,125,000 for the Broadway surface road, but they do not know by what authority or for what purpose." N.Y. Times, Dec. 9, 1885, at 4.

[37] The mass entry of individual investors into capital markets between 1890 and 1920 is one of the most vivid and interesting aspects of American corporate history. For an interesting perspective, see The Industrial Arts Index, which indexed business periodicals over that period. The Index documents an explosion of research and reporting on the growth of individual ownership and a concurrent wave of reform in state corporate law designed to protect less informed investors. See 1-45 Industrial Arts Index (1913-1957).

[38] For a brief account of these fights, see C. Henderson & A. Lasher, supra note 17, at 201. For a detailed journalistic account of the Giannini-Transamerica fight, see David Karr, Fight for Control 41-59 (1956).

[39] In 1930, for example, an article in The New York Times reported ten proxy contests underway with a diversity of objectives, including, for example, financing receivership problems, opposition to mergers, and representation and control of boards. The Times reported that "[o]pinion on Wall Street is that the livelier interest which stockholders are taking in their companies as exhibited by these disagreements is a good omen as to the progress of business." Fights for Proxies in Ten Companies Waged, Wall Street Thinks It Good Business Omen, N.Y. Times, Apr. 6, 1930, at 9.

fensive strategies against acquisitions.[40] One of the most controversial defensive tactics was the issuance of dual-class voting stock. Unequal voting rights at major corporations caused such a widespread backlash from shareholders that the New York Stock Exchange issued guidelines effectively prohibiting the practice.[41]

After World War II, a new era dominated by the political approach to oversight—specifically, by the proxy contest—arose. This era, in particular the period between 1946 and 1956, marked the emergence of the modern lexicon of corporate oversight. A series of active investors appeared whose vocation consisted of taking stakes in "undervalued" and underperforming corporations and agitating for change. Their most common weapon was the proxy fight for board representation or control. Prominent active investors included Norton Simon, Pat Lannan, Robert Young, Louis Wolfson, and Leopold Silberstein.[42] The dynamics of these early corporate control contests, and the public response to them,[43] were all remarkably similar to those that arose at the peak of "takeover fever" in the 1980s.[44]

C. *After 1960: The Dominance of Tender Offers*

In 1956 a new corporate governance mechanism arose in the U.S. market: the cash tender offer for shares. Such offers were made directly

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40 The 1920s are commonly seen by economists as one of three major "merger waves" in the past 100 years in the United States. See J. Fred Weston et al., Mergers, Restructuring, and Corporate Control 11 (1990).

41 The popular call-to-arms against nonvoting stock was first made in William Z. Ripley, From Main Street to Wall Street, Atlantic Monthly, Jan.-June 1926, at 94. For further discussion, see Adolf A. Berle, Jr., Protection of Non-Voting Stock, 4 Harv. Bus. Rev. 257 (1926).

42 Simon began by taking over the ailing Hunt Packing Company and in subsequent years built an industrial empire. See J. Patrick Lannan, The Raiders: Challenge to Management, Time, July 25, 1955, at 80, 80. Young and Wolfson caused a nationwide sensation in 1954 and 1955 with their high-profile campaigns for control of the New York Central Railroad and Montgomery Ward. See generally D. Karr, supra note 38. Silberstein, who arrived in the United States as an immigrant in the 1940s, strung together a series of takeovers that included Industrial Brownhoist and Fairbanks, Morse. See Dero A. Saunders, Belligerent Penn-Texas, Fortune, Mar. 1957, at 138, 257 (describing takeover battle for Fairbanks, Morse).

43 Articles in the popular press give a general sense of the prominence of proxy-fight activity during this period. See, e.g., Robert M. Bleiberg, Battle by Proxy, Barron's, May 22, 1950, at 9; Wayne G. Broehl, Jr., What's Behind the Proxy Battles?, Mgt. Rev., May 1956, at 360, 369; Lannan, supra note 42, at 80-81; L.A. Lukens, The Stockholder Takes a New Look at Management, Mag. Wall Street Bus. Analyst, July 10, 1954, at 443 [hereinafter Lukens, The Stockholder Takes a New Look]; L.A. Lukens, Why Over-Conservatism in Management Attracts Financial Raiding, Mag. Wall Street & Bus. Analyst, May 14, 1955, at 220 [hereinafter Lukens, Over-Conservatism in Management]; John C. Perham, Revolt of the Stockholder, Barron's, Apr. 26, 1954, at 3. For academic perspectives, see generally Leland C. Whetten, Cumulative Voting for Directors: Its Origin and Significance, Studies in Business and Economics (1959); L. Whetten, supra note 27.

44 See notes 77-88 and accompanying text infra.

to holders of common stock without the consent or even notification of management. Observers chronicled fewer than ten such offers in each of the years between 1956 and 1960.[45] By 1963, however, there were twenty-nine cash tenders for firms listed on the New York Stock Exchange.[46] It was becoming clear that the cash tender offer was replacing the proxy contest as the vehicle of choice for active "raider" investors.

The popularity of the cash tender was attributable to the fact that substantial influence could be purchased with relatively low transaction costs. By the early 1950s, large-scale proxy contests had escalated in complexity and cost; fees totalling over $1 million were frequently expended on advertising, legal services, and solicitation.[47] In a tender offer, by contrast, there was no need to convince other, less-informed shareholders of either party's case. Instead, raiders could purchase influence for a slight premium to the market price in a matter of days or even hours. Victor Muscat, a well-known corporate raider of the time, described the difference succinctly: " 'They [proxy fights] aren't worth the trouble. Tender offers are easier. At least the money is going into stock and not such things as proxy solicitations and court suits.' "[48]

Tender offers continued to grow in frequency and visibility through the 1960s. They were quickly linked with contingent financing, in which banks provided funding upon the completion of the offer. This made offers cheap, because no funds had to be secured by the offering group prior to execution.[49] The late 1970s and early 1980s saw the maturation of new phenomena that made acquisitions even more predominant in the governance arena. The first was a broadened use of investment partnerships to create pools of capital, usually contributed by pension funds, in

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45 For the statistical history, see generally Douglas V. Austin & Jay A. Fishman, Corporations in Conflict—The Tender Offer (1970) (covering tender offers from 1956-1967). For a detailed journalistic account of the rise of tender offers, see generally C. Henderson & A. Lasher, supra note 17.

46 See D. Austin & J. Fishman, supra note 45, at 207.

47 See C. Henderson & A. Lasher, supra note 17, at 214-15 (documenting escalation of costs).

48 C. Henderson & A. Lasher, supra note 17, at 10. Muscat personified the essence of the antiestablishment corporate raider-reformer (he even named his shell company Defiance Industries). Muscat and his two investor colleagues were often referred to in the financial press as "The Three Muscateers."

49 In their book, Henderson and Lasher describe an offer in the early 1960s in which the active investor had spent over a year assembling blind contingent financing from over 25 banks that regularly supplied credit to the investor's corporation. When the offer was made public, many of the banks were shocked at what their money had gone to finance. See C. Henderson & A. Lasher, supra note 17, at 208-09. For data on the increase in tender offers from 1956-1967, see D. Austin & J. Fishman, supra note 45, at 10. Statistics on the frequency of tender offers can be found in the Tender Offer Database, compiled by the University of Rochester Managerial Economics Research Center.

order to pursue highly leveraged buyout activity.[50] The second was the creation of a public contingent debt market for buyout offers, a market spearheaded by the junk bond activities of Drexel Burnham Lambert.[51]

The most noticeable historical trend of the post-1960 era was the virtual eradication of the political model as a mainstream form of oversight. By the late 1960s and 1970s, tender offers had come to dominate the landscape of corporate governance and control. By the 1980s, proxy contests at large corporations were usually linked to tender offers, used to evict a recalcitrant board that had refused to negotiate with an offeror.[52]

Along with the dominance of tender offers came a pervasive change in the rhetoric of corporate governance. The concept of shareholders' rights became a derivative of the takeover debate. To be pro-shareholder also meant to be pro-takeover. Those who opposed the widespread adoption of takeover defenses (which often not only deterred takeovers but also removed shareholder access to such traditional governance mechanisms as special meetings, action by written consent, and removal of directors without cause) were accused of serving as shills for the raiders.[53]

The decade of the 1980s was thus unique in American corporate governance. It represented the culmination of a thirty-year trend away from governance-through-politics toward governance-by-takeover. The vividness of the takeover phenomenon virtually eradicated the collective memory of scholars, observers, and market participants of an earlier political era.

II

Competing Models of Corporate Governance: The Takeover Model and the Political Model

As the previous Part demonstrated, throughout the history of American corporate governance, the takeover model and the political model have competed for dominance. In this Part, I will critically ana-

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[50] An example is Kohlberg Kravis Roberts (KKR), which used its capital as an equity sliver in highly leveraged, friendly acquisitions. See generally George Anders, Merchants of Debt (1992). The much-despised "pools" put together by corporate barons in the 1800s are an interesting and important parallel. See generally, e.g., W. Ripley, supra note 29.

[51] For a general overview of the phenomena, see Glenn Yago, Junk Bonds: How High-Yield Securities Restructured Corporate America (1991).

[52] For documentation of the success and frequency of the proxy-contest-cum-tender-offer strategy, see generally John Pound, Proxy Contests and the Efficiency of Shareholder Oversight, 20 J. Fin. Econ. 237 (1988). See also Georgeson & Co., Proxy Contest Study: Oct. 1984 to Sept. 1990 (Dec. 14, 1990) (on file with author).

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

lyze the economic and political strengths and weaknesses of the two paradigms. I will argue that the political model offers significant advantages over the takeover model.

A. *The Takeover Model*

Dean Henry Manne, writing in 1965, captured the sentiment of an entire era when he stated that acquisitions were the most efficient mechanism for overseeing management and correcting inefficiencies in existing corporate policies.[54] By the mid-1980s, economists and other free-market adherents argued that takeovers vector-dominated other forms of oversight.[55] Indeed, their dominance had become so complete that there was little acknowledgement that other oversight systems were anything more than a curiosity.

But how do takeovers stack up in hindsight? I will argue in this Section that takeovers clearly accomplish certain goals of corporate governance quickly and effectively. But they also carry political and economic costs that were under-appreciated throughout the 1980s.[56]

1. *Structural Advantages*

The advantages of the takeover model were well-articulated by its proponents beginning with Manne's seminal work in 1965.[57] Takeovers offer all the advantages that economists traditionally associate with a pure "market" approach to governance. They are based on decentralized decisionmaking, wide opportunity for participation, and competition. By rewarding investors who spot undervalued companies and develop a plan to improve them, takeovers create a thriving market for information and research on corporate policy, a coterie of active investors competing for "good deals," and a vigorous "market" for corporate control.[58]

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[54] Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110, 119 (1965).

[55] See, e.g., Jensen, supra note 5, at 61 (arguing that entire concept of public corporation was becoming obsolete); see also Symposium, The Market for Corporate Control, 11 J. Fin. Econ. 5 (1983) (containing empirical studies on "the market for corporate control"—widely considered to be definitive financial perspective on takeovers—which included over a dozen investigations of tender offer phenomenon but only one analysis of proxy process).

[56] Many takeovers studied in the 1980s were not in fact "governance" events, but instead managerial initiatives designed to achieve diversification that were, in retrospect, unwise. In addition, much takeover activity was prompted by shifts in industry conditions, for example in the airline industry where deregulation prompted consolidation. The literature on takeovers to date has not partitioned and compared their effects along motivational lines as either manager-motivated, industry-motivated, or motivated by incumbent firm mistakes with respect to their own operations. Clearly it is only the latter category of takeovers that constitute takeovers operating as governance, and until these are analyzed separately, one cannot be entirely certain about the weight of the evidence.

[57] See Manne, supra note 54.

[58] The "market for corporate control" model can be found in Manne, supra note 54, at

Proponents have also argued that takeovers are efficient because they eschew cumbersome and bureaucratic "processes" associated with traditional voting-based challenges. Takeovers dispense with the need for formal and time-consuming solicitation, for planning challenges around annual meetings or petitioning for special meetings, and for ex post negotiations with remaining shareholders about the nature of corporate change. The takeover mechanism is remarkably simple and direct. An active investor can make an acquisition offer on any day of the year, and a few days later own a controlling interest in the company.[59]

Some economists have also argued that the acquisition model offers a solution to complex information problems that occur in the proxy process.[60] In a takeover contest, shareholders are not asked to evaluate complex alternative business plans for the company. Rather, they need only assess who is offering a higher value for their shares. This decision framework offers advantages for the relatively uninformed shareholder. In addition, it saves the active investor the expense of a costly information campaign aimed at shareholders who do not really understand the subtleties of the corporation's policy.

Tender offers are also attractive and cheap for active investors because they are contingent. Since a tender offer is not an irrevocable commitment to purchase shares, it can be used as a simple way of "polling" shareholders on their views of corporate value. For example, an offer can be extended inviting shareholders to tender. If enough shareholders tender, shares are purchased and a change of control effectuated. If not, shares are returned, and the dissident folds his tent. This also stands in stark contrast to the formal proxy contest, in which an extensive, expensive outreach campaign must be undertaken to determine shareholders' views on the substantive merits of a dissident case.

An additional advantage of takeovers is that shareholders are offered the chance to sell out and realize an immediate premium, rather than being asked to hold on to their shares while someone else undertakes changes that may or may not improve performance. The "bond"

112-14. A description of the role of active investors can be found in Jensen, supra note 5, at 65-66.

[59] See D. Austin & J. Fishman, supra note 45, at 8-9 (giving advantages of tender offers compared to proxy contexts); C. Henderson & A. Lasher, supra note 17, at 211 ("The tender offer is designed as a blitzkrieg. . . .").

[60] The information problems associated with proxy contests have been discussed at length elsewhere. See, e.g., Linda E. DeAngelo, Managerial Competition, Information Costs, and Corporate Governance: The Use of Accounting Performance Measures in Proxy Contests, 10 J. Acct. & Econ. 3, 5-8 (1988); John Pound, Proxy Voting and the SEC, 29 J. Fin. Econ. 241, 269-83 (1991). For the argument that takeovers overcome the information problem see Richard S. Ruback, An Economic View of the Market for Corporate Control, 9 Del. J. Corp. L. 613, 615 (1984).

inherent in tender offers serves as a check on adverse selection. Would-be bidders who cannot increase value, and/or whose main goal is to abscond with corporate assets, will not be able to offer the requisite premium.[61]

Takeover proponents have also argued that by transferring assets to new owners, acquisitions facilitate quick shifts in policy. With ownership in the hands of a small partnership, the company may no longer be public, allowing new owners to make drastic changes without protracted negotiations with entrenched interests or remaining public shareholders.[62] Because the new owners are likely to have borrowed significantly to finance the acquisition, they are likely to have stronger incentives to increase profitability than did the previous owners. Thus, the combined effect of private ownership and high finance costs arguably improves performance.[63]

2. *Structural Drawbacks*

During the peak of the takeover boom, the advantages of takeovers seemed formidable to those steeped in the transaction-based model of economics. However, with the hindsight of only a few years, it is clear that the disadvantages of the takeover model are significant.

The primary problem with takeovers is their extremity. Takeovers offer a single option for correcting mistakes made by corporate management: sale of the company. The model thus does not incorporate the flexibility to fine-tune—to change single policies or to suggest incremental changes in incentives. Instead, takeovers address performance shortfalls by imposing sweeping change on all corporate constituents, particularly the incumbent management team.

If a change in management were always the best way to correct corporate mistakes, the lack of flexibility would not be a problem. This is the business world most often modelled by economists, who posit that there are more capable and less capable management teams, and that the market for corporate control offers different teams a chance to compete. In the real world, however, things are not so simple. Terrific manage-

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61 If tender offers exist, then proxy contests may be subject to adverse selection. Bidders who cannot increase value will try to gain control through proxy contests, while bidders who can add value will signal their seriousness through tender offers. See Pound, supra note 52, at 261-68.

62 See generally Sanjai Bhagat et al., Hostile Takeovers in the 1980s: The Return to Corporate Specialization, in Brookings Papers on Economic Activity: Microeconomics 1 (1990) (documenting posttakeover operational changes such as divestitures, layoffs, tax savings measures, and investment cuts).

63 Cf. Jensen, supra note 5, at 70 ("[I]t is difficult to find any systematic losers in these [LBO] transactions, and almost all of the gains appear to come from real increases in productivity.").

ment teams make terrible mistakes, and one of the central goals of corporate governance must be to correct those mistakes without removing capable management. Given the complexities of real corporations, the all-or-nothing nature of the takeover is often ill-suited to remedy corporate problems that do not necessarily demand the transfer of the company or even the replacement of management.[64]

The extreme nature of the takeover solution itself creates a series of tangible costs. First, there are enormous transaction costs associated with buying and selling corporate assets.[65] Second, the cure might be worse than the disease. The new management team, while correcting specific mistakes of the old team, may make worse mistakes of its own.[66] Third, the extremity of the takeover remedy presents a significant threat to a management group, which might otherwise be willing to change specific policies but is terrified of losing control.[67] Indeed, the threat of takeovers may make incumbent managements less receptive to market signals, because there is no opportunity to adapt to market concerns and negotiate. Under the takeover model, management's sole response to shareholder discontent must be a bullet-proof defense; any nod to the rights of shareholders and shareholder input risks a loss of control.[68]

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[64] Since the publication of Manne's seminal article, supra note 54, economists have tended to make the theoretical argument that the purpose of corporate governance is to allow "competing management teams" to engage in rivalries for control of corporate assets. This is a vastly different view from the more intuitively appealing idea that corporations and their managements should have some baseline continuity and are concerned with preventing management mistakes. The magnitude of individual mistakes, moreover, may be huge. For example, USX management made two bad acquisitions in the oil industry that caused its market value to decrease by nearly 17%; Stop and Shop made an ill-considered decision to diversify geographically and into discount retailing. See generally Pound, supra note 14 (discussing these and other examples). Empirical evidence such as the finding that firms making a bad acquisition decision are themselves likely to become takeover targets, suggests the same story. See, e.g., Mark L. Mitchell & Kenneth Lehn, Do Bad Bidders Become Good Targets? (1988) (unpublished manuscript, on file with author). But a single bad decision does not cancel the long-term contributions of a talented manager. Instead, the implication is that the governance system should find some way to prevent aberrational mistakes while promoting a manager's long-term management of the enterprise.

[65] See, e.g., Steven N. Kaplan & Jeremy C. Stein, The Evolution of Buyout Pricing and Financial Structure in the 1980s, 108 Q.J. Econ. 313, 343-44 (1993) (showing that total buyout-related fees were as much as six percent of the capital raised in sample of 124 buyouts completed between 1980 and 1989).

[66] See, e.g., Karen H. Wruck, What Really Went Wrong at Revco?, J. Applied Corp. Fin., Summer 1991, at 79, 90 (arguing that management disarray, weak LBO sponsor, fee structure guaranteed to produce overpayment, and midstream shift in strategy, combined with use of debt financing, led Revco to file under Chapter 11 of the Bankruptcy Code).

[67] See Louis Lowenstein, What's Wrong with Wall Street 119-59 (1988) (describing how takeovers scare management and unfavorably impact corporate health).

[68] Note also that the threat of takeovers may lead managers to take value-destroying "man-the-barricades" actions. See, e.g., George Anders & Francine Schwadel, Costly Advice: Wall Streeters Helped Interco Defeat Raiders at a Healthy Price, Wall St. J., July 11, 1990, at A1 (describing how Interco management, in response to hostile offer, pursued ill-advised lever-

In addition, the takeover mechanism in reality offers fewer informational and "reputational" guarantees to shareholders than economists have sometimes argued. It is true that shareholders get bought out at a premium in takeover transactions. Various theorists have argued, however, that it is not clear that the premium offered is always efficient.[69] Moreover, while the takeover mechanism may offer a guarantee of value to preexisting shareholders, it does not necessarily offer the best guarantee of value to society as a whole. Raiders can make successful offers, buy companies at huge premiums, and then prove unable to run them, destroying the corporate franchise. To pursue a takeover offer, an active investor often needs to convince only a few individuals—his key investment bankers—of the legitimacy of his plans for the target corporation.[70] This means that the active investor is subjected to remarkably little scrutiny, particularly given the fact that investment banks have a penchant for promoting transactions.

Perhaps the most significant of these drawbacks is that takeovers are an episodic and inherently unstable process of governance. Rather than promoting stability and organic change from within, the takeover mechanism transfers the corporation to a small coterie of new owners. These new owners will ultimately be as prone to making their own mistakes as were the previous managers of the corporation.[71] This in turn may necessitate another sale or active investment by a new set of owners. Moreover, the next set of mistakes are less likely to be detected and corrected posttakeover, because the sale of the company would have removed the assets from public ownership and public scrutiny and placed them in the

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aged recapitalization involving such huge quantities of debt that company became bankrupt).

[69] Early evidence suggested that the takeover market was competitive and that efficient premiums were paid. See, e.g., Richard S. Ruback, Assessing Competition in the Market for Corporate Acquisitions, 11 J. Fin. Econ. 141, 142 (1983). Later evidence undermined this rather simplistic view. One line of research suggested that bidders could overpay. See, e.g., Bernard S. Black, Bidder Overpayment in Takeovers, 41 Stan. L. Rev. 597, 634-43 (1989) (reviewing available evidence for consistency with overpayment hypothesis). Another line concurrently suggested that shareholders could be coerced to tender at too low a price. See, e.g., Lucian A. Bebchuk, The Pressure to Tender: An Analysis and a Proposed Remedy, in Knights, Raiders, and Targets, at 371, 371-72 (John C. Coffee, Jr., et al. eds., 1988) (discussing distortions in shareholders' tender decisions during takeover bid and proposing solutions). A large body of literature on partial-information auctions is inconclusive on this score. See, e.g., Naveen Khanna, Optimal Bidding for Tender Offers (1988) (unpublished manuscript, on file with author) (describing bidding process as game with incomplete information).

[70] See Kaplan & Stein, supra note 65, at 345.

[71] The experience of Campeau's buyout of Federated Department Stores provides a good example. See, e.g., Betting the Store: Campeau at Last Gets Federated—Now Can He Make a Go of It?, Wall St. J., Apr. 4, 1988, at A1 (describing posttakeover challenges facing Campeau as new owner of Federated); Carol Hymowitz, et al., Squeezed Stores: Campeau Retail Chains Are Heavily in Debt, Face Rising Troubles, Wall St. J., Dec. 14, 1988, at A1 (describing Federated takeover and resulting debt crisis for Campeau).

hands of a smaller and more protected set of owner-managers.[72]

Takeovers thus involve significant costs. The problem can be boiled down to a simple analogy. Takeovers give talented individuals like Henry Kravis and George Roberts the opportunity to buy companies, reorganize the asset base, and install new, more effective boards and oversight mechanisms. This begs the question: why should a governance system depend upon individuals like Kravis and Roberts to buy major companies in order to make these companies' boards effective? Should not the role of a governance system be to correct major corporate mistakes and ensure effective boards while keeping the corporation public and maintaining continuity? The remainder of this Article argues that it should. However, before proceeding to an analysis of the most obvious alternative—the political model—let us first review the empirical record on the takeover as a method of ensuring corporate performance.

3. *Economic Results*

The economic literature of the past decade purported to confirm the desirability of the takeover mechanism. These studies concluded that, on average, takeovers paid premiums to shareholders[73] and operating performance tended to improve posttakeover.[74] In hindsight, however, these findings do not provide compelling proof of the economic desirability of the takeover mechanism. The economic literature failed to examine how takeovers fare relative to alternative means of oversight. In order to judge takeovers effectively, one must measure their effects against well-formulated alternative systems of governance. The aggregate evidence on the effects of takeover transactions provides no clues about the value effects of alternative systems, but rather implicitly measures their effects relative to the alternative of doing nothing at all.[75]

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72 A number of observers display a somewhat romantic view of the "sole proprietor" model of business ownership and management, which in a sense is what an investment partnership represents. See, e.g., Jensen, supra note 5, at 68-73. It remains unclear whether the benefits from control transactions come from the small partnership model or merely from the injection of a new perspective. One partner in an LBO organization told me that 90% of all large organizations could work better if someone simply were to come in and shake them out of their complacency, and that it was this kind of shakeup that was the most significant contribution of the LBO phenomenon.

73 For a good listing of the literature published prior to 1989, see J. Weston et al., supra note 40, at 163.

74 The literature on operating performance, as opposed to stock prices, is still evolving. See, e.g., Paul M. Healy et al., Does Corporate Performance Improve after Mergers?, 32 J. Fin. Econ. 135, 164 (1992) (arguing that merged firms show postmerger improvements in operating cash flow returns as result of increase in asset productivity); see also Krisna G. Palepu, Consequences of Leveraged Buyouts, 27 J. Fin. Econ. 247, 247-62 (1990) (summarizing burgeoning literature on LBOs).

75 A few formal models have made this point, although on a less general level. See, e.g., Bebchuk, supra note 69, at 379-80 (explaining why shareholder rejection of a bid can prove

Even if one assesses the economic record on its own terms, it is important to recognize that the data have substantial interpretive limitations. First, economic evaluations of takeovers measure central tendencies. Underlying the central tendencies of takeovers are a wide variety of outcomes, some of which involve very bad outcomes for a variety of constituents. In addition, these analyses did not measure the costs associated with remedying problems at firms where the takeover mechanism proved useless. Many of the largest and most complex problems in corporate America were left untouched by the takeover mechanism. The more notable failures of the takeover model include the decade-long decline at General Motors, the skid of Digital Equipment beginning in 1986, and the decline of IBM through the late 1980s and early 1990s.[76] The troubles of these corporate giants were obvious, yet the takeover model did not exert pressure on them to institute profitable changes. Takeovers appear to be most effective in addressing the problem of high cash flows and undervaluation. They have proven far less effective as a mechanism for remedying complex problems of business strategy and failures in long-term performance.

4. *Political Response*

In addition to their economic drawbacks, takeovers have even more dramatic political shortcomings. The rise of the tender offer mechanism in the 1980s bred a thoroughgoing political backlash. The strength of the political reaction against takeovers is perhaps best measured by the series of revisions made to state corporate laws over the past decade, all of which in one form or another restrict takeovers. Arguably, never before in American history has state corporate law so broadly constrained the rights of large shareholders. Many changes, such as the freeze-out laws of New York[77] and New Jersey,[78] are aimed directly at the takeover process.[79] Others go even further, imposing across-the-board restrictions on large shareholders who obtain ownership of a company without manage-

value maximizing, even though bid includes premium over prebid market price of target's shares); David Austen-Smith & Patricia O'Brien, Takeover Defenses and Shareholder Voting (1987) (unpublished manuscript, on file with author) (describing information and signalling issues that attend takeover defenses).

76 Digital Equipment's stock skidded from $200 per share in 1987 to the low $30s in 1992. See Value Line Investment Survey, Quarterly Reports on Digital Equipment Corp. (1987-1992); cf. Gary McWilliams, Crunch Time at DEC, Bus. Wk., May 4, 1992, at 30, 31 (asserting that DEC is no longer at "top of its game" as it was in 1987). For coverage of the decline at GM, see Treece, supra note 1, at 30. For an account of the decline at IBM, see John W. Verity, Out of One Big Blue, Many Little Blues, Bus. Wk., Dec. 9, 1991, at 33.

77 N.Y. Bus. Corp. L. § 912 (McKinney 1993).

78 N.J. Stat. Ann. §§ 14A:10A-1 to -6 (West 1993).

79 For a survey of the New York and New Jersey statutes, see Investor Responsibility Research Center, State Takeover Laws (1989) [hereinafter State Takeover Laws].

ment consent.[80] Such laws were passed in order to protect employees from the unscrupulous activities of acquisition barons.[81]

From the vantage point of history, the deep suspicion engendered by hostile tender offers was predictable. Throughout American corporate history, acquisitions have raised political suspicion and popular concern. In the late 1800s *The New York Times* commented that recent acquisition contests proved "what manner of men they are who take the lead in colossal transactions . . . and inflict distress upon multitudes."[82] Similarly, in 1929, the *Magazine of Wall Street*—hardly an anti-investor publication—argued that the large mergers of the time were caused by greed, lust for power, and desire to eliminate competition.[83] The popular concern over the effects of acquisitions that reemerged in the 1980s is thus a longstanding part of the American political landscape.

It is easy to explain the political response to the takeover phenomenon of the 1980s as a simple reflection of interest group politics. Shareholders are dispersed and disorganized; in contrast, managers are powerful, organized, and well-connected to state legislatures and federal lawmakers. However, history suggests that there is more to the story than bald interest group politics. The backlash against takeovers also stemmed from rhetoric, image, and process.

There appear to be at least three fundamental causes for the longstanding suspicion of acquisitions among politicians and the public. First, there is, as Professor Mark Roe has documented, a fundamental American distrust of "financiers" and "Wall Street," and a resulting desire to contain excesses of financial power.[84] The deep cynicism about

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[80] See Haw. Rev. Stat. § 416-171 (1985) (control share acquisition statute); Ind. Code Ann. § 23-1-42 (Burns 1989) (same); Minn. Stat. Ann. § 302A.671 (West 1985) (same); Mo. Rev. Stat. § 351.407 (1993) (same); Ohio Rev. Code Ann. § 1701.831 (Anderson 1992) (same); Wis. Stat. § 180.1150 (1992) (same).

[81] See generally State Takeover Laws, supra note 79 (describing these laws and tests of their economic impact); Jonathan M. Karpoff & Paul H. Malatesta, The Wealth Effects of Second-Generation State Takeover Legislation, 25 J. Fin. Econ. 291 (1989) (providing economic evidence of wealth effects of state antitakeover laws); see also Roberta Romano, The Political Economy of State Takeover Statutes, 73 Va. L. Rev. 111, 122-42 (1987) (discussing political motives behind enactment of takeover statutes).

[82] Corporate Management and Responsibility, N.Y. Times, Nov. 20, 1868, at 4.

[83] Theodore M. Knappen, What Inspires Today's Mergers?, Mag. Wall Street, Apr. 4, 1929, at 999, 1000.

[84] See Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10, 32-33 (1991) [hereinafter Roe, A Political Theory] (arguing that structure of American financial market was determined through political, not economic, process); see also Joseph A. Grundfest, Subordination of American Capital, 27 J. Fin. Econ. 89, 89-90 (1990) (arguing that American politics constrains American financial markets); Mark J. Roe, Takeover Politics 2 (Brookings Discussion Papers in Economics No. 91-4, 1991) [hereinafter Roe, Takeover Politics] (noting "a popular wariness of accumulated power on Wall Street"); James Flanigan, Public Interest Also at Stake in Takeover Fights, L.A. Times, Apr. 24, 1987, Part 4, at 1 (citing Harris study showing 70% of American people believe takeovers weaken country);

finance is perhaps nowhere better reflected than in a 1940 speech by then-SEC Chairman William O. Douglas:

> In the eyes of high finance, business becomes pieces of paper—mere conglomerations of stocks, bonds, notes, debentures. Transportation, manufacture, distribution, investment become not vital processes in economic society but channels of money which can be diverted and appropriated by those in control.... For such reasons one of the chief characteristics of such finance is its inhumanity, its disregard of social and human values.[85]

The second source of suspicion toward acquisitions in the 1980s was the nature of the hostile takeover mechanism itself. Governance initiatives force hard choices and sometimes inflict pain on a variety of constituencies. One political reality of this shared pain is that a corporate mechanism will be sustainable only to the degree that it reflects broad cultural values about systems of governance. Takeovers did not reflect these values. American notions of institutional governance, derived from the public-sector democratic political process, emphasize due process, disclosure of information, and public accountability. Takeovers, in contrast, are notorious for their speed, secrecy, and avoidance of due process. Takeover practitioners thus appear to be unaccountable to those constituents, including the public-at-large, who believe that they have a right to know who is running the corporation and on whose behalf. As a result, takeover bids were not perceived as painful but necessary steps in American competitive restructuring, but rather as painful and unnecessarily cutthroat initiatives motivated by greed and empire-building.[86]

Finally, a third cause of takeover cynicism is the rapid pace of economic change that takeovers foster. Rapid change is generally not tolerated in the American political system. Indeed, the many checks and balances within our political system are designed to protect constituencies by hedging against excessively fast changes in policy. There is a deep American belief in fairness and implicit contracts, which holds that

Pollster Says U.S. Public Dislikes Corporate Raiders, Wash. Post, Apr. 2, 1987, at E1 (noting pollster Louis Harris's description of America's distrust of corporate raiders).

85 William O. Douglas, Democracy and Finance 9 (1940).

86 For the general point, see Roe, A Political Theory, supra note 84, at 16-17 (discussing public's negative perceptions of takeovers). Leveraged buyouts were perhaps the ultimate example of the accountability problem. LBOs removed major corporations from the public arena and placed them in the hands of small, shady partnerships. The resistance of those partnerships to political pressure for information and disclosure not only made them appear unaccountable, but also communicated a disdain for the basic notion of public scrutiny. The result was the kind of criticism found in the Pulitzer Prize-winning series of reports in the Wall Street Journal purporting to document the huge "human cost" of the Safeway LBO. See, e.g., Susan C. Faludi, The Reckoning: Safeway LBO Yields Vast Profits but Exacts a Heavy Human Toll, Wall St. J., May 16, 1990, at A1 (noting that many former Safeway employees still had not found full-time employment more than a year after layoffs).

change, when it occurs, must occur slowly.[87] This means that there must be accountability and a process whereby the losers can at least plead their case and seek to soften the blow.[88]

On balance, the takeover model has not borne out its positive reviews from economists. Acquisitions offer no assurance that the new managers will make fewer mistakes than their predecessors made. The purported economic and informational benefits of takeovers to shareholders are also questionable. Most importantly, the peremptory nature of the takeover mechanism makes it an inherently unstable form of corporate oversight in a nation accustomed to more open and accountable forms of governance.

B. The Political Model

For at least several decades, commentators have regarded the political model of corporate oversight as the poor stepchild of the acquisition-based model.[89] However, both economic and historical analysis suggest that the political system of corporate oversight offers significant advantages over takeovers. This Section discusses the advantages and disadvantages of the political approach.

1. Structural Advantages

If one examines the political model of oversight simply by analyzing the corporate voting process as defined under state corporate law, a dreary picture emerges. State law provides shareholders with certain voting rights which enable them to resolve disputes with the managers

[87] Government policies, such as disaster relief, aim to protect people from violent disruption, and throughout the system there is the notion that individuals should not be excessively damaged. When oil prices rose suddenly in 1973 and again in 1979, federal policy sought to cap prices and institute income transfers to those customers most adversely affected. See Daniel Yergin, The Prize, 617-19, 659-60, 693-96 (1991).

[88] Very few economists used the pace-of-change argument to argue against takeovers. An exception is Andrei Shleifer & Lawrence H. Summers, Breach of Trust in Hostile Takeovers, in Corporate Takeovers: Causes and Consequences 33, 53-54 (Alan J. Auerbach ed., 1988) (arguing that takeovers may represent wealth transfers from employees to financiers). Proponents of state law restrictions on takeovers forged alliances with labor unions, calling on a deep public fear that takeovers were hurting workers, despite evidence suggesting that takeovers were not antilabor. For an example of such evidence, see Frank R. Lichtenberg & Donald Siegel, The Effect of Control Changes on the Productivity of U.S. Manufacturing Plants, 2 J. Applied Corp. Fin. 60, 67 (1989) (finding no evidence that change of ownership tends to be followed by layoffs and wage cuts); Romano, supra note 81, at 135.

[89] Manne first noted the difficulties associated with the political mechanism, saying that proxy contests are "the most expensive, the most uncertain, and the least used of the various techniques" available for changing corporate control. Manne, supra note 54, at 114. Arguably, Manne was incorrect as to the last point even as an empirical matter, because he compared all mergers (many of which related to interfirm issues and thus were not "governance events") with the relatively smaller sample of proxy contests (all of which were "governance events").

who oversee the corporation on their behalf. As Dean Robert Clark has noted, however, these voting rights are remarkably limited.[90] They extend no further than the power to elect directors and to ratify or reject certain types of corporate combinations and certain provisions in the corporate charter.[91] Moreover, any shareholder wishing to mount a formal challenge to management must pay the freight for organizing and soliciting votes and has only a probabilistic chance of being reimbursed by the corporation.[92] Thus, one could argue that there is little that shareholders can do to monitor management under this framework, except to sit by idly until underperformance reaches intolerable levels. At that point, shareholders are offered the unappealing recourse of organizing a costly and time-consuming proxy contest. In contrast, the quick surgery of an acquisition seems preferable indeed.[93]

However, if one approaches the voting process from the perspective of democratic political theory rather than through a strict assessment of legal rights, a much different picture emerges.[94] As should be obvious to all Americans, citizens in a democracy have very restricted rights. The principal means of influencing policy—the right to vote for their representatives—is indirect and thus limited. Nevertheless, voters in a democratic system exert tremendous influence on political actors—not only at election time, but during virtually every moment between elections as well. Voters accomplish this through organizing in political groups which communicate their collective concerns about specific policy choices to elected representatives. These messages carry implicit voting weight. The goal of an elected representative in a democracy is to respond to voter preferences in a manner that ensures that the major groups of constituents (particularly highly organized ones) will be supportive when periodic elections ultimately occur. Despite the absence of formal options for participation by voters, the system is nevertheless highly responsive to informal actions which are designed to influence policy.

The political model of corporate oversight should be viewed in the

90 See Robert C. Clark, Agency Costs Versus Fiduciary Duties, in Principals and Agents: The Structure of Business 55, 57-58 (John W. Pratt & Richard J. Zeckhauser eds., 1985).

91 See R. Clark, supra note 18, at 94.

92 See id. at 395; see also Lucian A. Bebchuk & Marcel Kahan, A Framework for Analyzing Legal Policy Towards Proxy Contests, 78 Cal. L. Rev. 1071, 1122-26 (1990) (arguing that present rules, which fully reimburse incumbents but reimburse challengers only if they gain control of company, should be modified).

93 See Manne, supra note 54, at 117-19 (arguing in favor of acquisition mechanism).

94 See generally Robert A. Dahl, A Preface to Democratic Theory (1956) (stating classic modern reinterpretation of democratic paradigm). For similar analyses, see also generally William A. Kelso, American Democratic Theory (1978); Giovanni Sartori, The Theory of Democracy Revisited (1987).

same way. The raw power to vote the board out of office is not the nexus of the shareholder oversight process. Rather, the mere *existence* of this baseline voting entitlement itself allows shareholders to pursue a wide variety of less structured, ongoing forms of monitoring that do not directly revolve around the election of the board. One such monitoring tactic is the initiation of more limited voting challenges, such as a proposal to change corporate governance structure or to elect a single director. A second tactic is informal, between-elections negotiation and lobbying on specific aspects of corporate policy. The existence of baseline electoral power, together with the threat of its regular exercise, create the necessary leverage for these more informal tactics.[95]

The political model thus creates a process through which shareholders can govern the corporation in an ongoing manner. Thus, the goal of governance under the political model is not to provide competing management teams with a mechanism to take over the corporation, as it is under the acquisition model, but rather to enable shareholders to use their voting power to change only what needs to be changed. If pursued effectively over time, this kind of incremental oversight should in fact ensure that the corporation does not need to be taken over.[96]

To continue the hypothetical presented in Part II.A.2,[97] the assumption underlying the political model is that an underperforming corporation can be improved if shareholders vote to place a talented new director like Henry Kravis on the board. This stands in contrast to the assumption underlying the acquisition model, which posits that Mr. Kravis should simply buy the company. The former is clearly how the governance process is supposed to work; the latter is merely a second-best remedy imposed through the market only when the former, more desirable remedy has not occurred.

Seen through a broad lens of democracy, rather than through the narrow perspective of legal rules, the informal oversight strategies avail-

[95] This argument, so obvious when applied to a democracy, is seldom applied to corporations. A more common argument is that shareholders can remain passive and wait for an acquisition offer. See, e.g., R. Clark, supra note 18, at 95. One significant difference is that the existence of a true electoral challenge with a determined opposition candidate is not automatic in the corporate process. But the prospect remains just the same.

[96] From an economic perspective, it is important to note that the political process does not eliminate the prospect of control challenges, but instead, changes the incentives to undertake control challenges. The political process offers a means to transfer control but does not make this option easy or cheap. Under the political model, transfers of control will be more costly and difficult than other kinds of initiatives intended to capture less dramatic goals. This provides an incentive for active investors to do only that which is necessary to address corporate problems. In effect, the political process price-rations the option of a full control challenge, making it attractive only in situations where the value gains are so great that a transfer of control is warranted.

[97] See p. 1024 supra.

able to shareholders are remarkably varied. The political model allows shareholders to pursue change both trivial and sweeping. The only limit is the imagination of the proponent. If a goal can be defined, a strategy can be devised to pursue it.[98] Does the company need to spin off a major division? An active shareholder can solicit votes for a proposal urging the company to engage in a spinoff, as did Carl Icahn at USX.[99] Does the company need to be dissuaded from diversifying into an industry it knows nothing about? An active shareholder can articulate an alternative business plan and show that the company can do better by sticking to its core business, as did Harold Simmons at Lockheed in 1990 and 1991.[100] Does the company need to replace passive directors and inject a new perspective into the board? An active shareholder can run a campaign to place a limited number of independent experts on the board, as did fund manager Julian Robertson at Cleveland-Cliffs in 1991.[101] This is less costly than a proxy contest for control because shareholders view it as an incremental initiative and the full dynamics of "war" may not exist. Or a long-term shareholder can identify expert directors, forward their names to the nominating committee, and urge twenty other large shareholders to do the same. Does the company need to increase disclosure of its operations? An active shareholder can run a campaign for improved disclosure, as did shareholders at many companies in the pre-SEC era.[102]

In the vast number of cases in which sweeping change is not needed, the political process also carries cost advantages over takeovers. This may seem ironic, in that the tender offer mechanism was spurred in part by its apparent cost advantage over proxy contests.[103] But the potential savings of tender offers were predicated on the goal of achieving control. When the political process is used to pursue limited and discrete change, it can be cheap indeed. For example, one can generate significant pres-

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98 Under state corporate law, shareholders may seek to elect directors and change the corporate charter and bylaws, except to the extent prohibited by the charter or bylaws themselves. See R. Clark, supra note 18, at 93. The shareholder proposal rule allows shareholders a low-cost mechanism to obtain a vote on substantive proposals. See id. at 374. More broadly than this, however, a direct legal fulcrum is not necessary to generate pressure in a world of engaged owners. Congressional lobbying is again an appropriate analogy; lobbyists have informal, rather than direct, means of influence over legislators.

99 See Pound, supra note 15, at A10.

100 For a protagonist's account of the Lockheed contest, see J. Landis Martin, The Lessons of NL Versus Lockheed, in Institutional Investing: The Challenges and Responsibilities of the 21st Century 375 (Arnold W. Sametz & James L. Bicksler eds., 1991).

101 See Zachary Schiller, There's Still Life in This Rustbelt Relic, Bus. Wk., July 15, 1991, at 32 (discussing Cleveland-Cliffs contest).

102 In 1907, for example, a shareholder group mounted a campaign for more disclosure at Bethlehem Steel after an announced dividend cut. See Minority May Sue Bethlehem Steel, N.Y. Times, May 4, 1907, at 3.

103 See text accompanying notes 59-60 supra.

sure for new directors simply by writing a letter to the nominating committee and circulating it to the top one hundred shareholders and the press.[104] This is obviously much less expensive than running a takeover campaign. In addition, the cost advantages associated with tender offers as a means of corporate control have eroded as regulations and laws have made them more difficult.[105]

Moreover, the ongoing, incremental monitoring generated within the political model of corporate governance avoids a series of costs associated with takeovers. It obviates both the need to pay huge fees to intermediaries for brokering the sale of assets and the need to arrange financing or impose a new financial structure on the corporation in order to remedy problems that are in reality based on operating policies. Perhaps the most significant savings associated with the political model is that it avoids the costly cycle in which new owners buy the corporation only to make serious mistakes of their own and be forced to sell the corporation to a new set of owners.

Another significant advantage of the political system is that it lessens the need for control challenges, thereby reducing the threat to incumbents. This reduced threat suggests not only less corporate disruption, but ultimately more corporate responsiveness to those who hold the voting power. The political process gives managers the opportunity to read outside signals and respond without fear of immediate loss of control or career. They are therefore likely to spend more time trying to adapt to market signals and less time defending against market-driven intervention by shareholders.

The political process also arguably offers a fuller opportunity for the market to monitor those active investors who would themselves monitor management. It thus operates as a test of their expertise and honesty. The political process demands consensus; it works only if an insurgent convinces many dispersed investors to support an alternative program for the company. A dishonest dissident is more likely to be caught in the spotlight of public scrutiny than in a deal arranged with a few equally suspect investment bankers. The political process thus builds in a defense against dishonest and incompetent insurgents which the takeover mechanism does not.[106]

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104 Even treating the costs as solicitation, my experience in proxy initiatives suggests that this tactic could be accomplished for less than $5,000.

105 See notes 77-79 and accompanying text supra.

106 The ability to monitor would-be monitors also ensures that the political process does not become driven by cranks and crank proposals. Some observers have argued that the availability of informal mechanisms and low-cost alternatives means that the political process promotes uncounseled "meddling." See, e.g., The Chairman and the Board: Charles Wohlstetter, Contel Corp., Directors & Boards, Spring 1991, at 64, 62-63. This argument ignores the safeguards that are built into the political process, however. Studies show that the results of voting

As this Section has shown, the political model represents a more sustained and organic approach to governance than the highly disruptive and episodic takeover model. After a political initiative, the target corporation remains public, often under the same management. A broad group of public shareholders retains claims on profits and voting control. If the corporation again needs intervention in the future, it can be undertaken in the same manner; the game remains governed by the same rules. Finally, there is no need for the perpetual asset-shopping and deal-making that takeover mechanisms inevitably prompt. There is less threat to incumbents and hence greater openness on the part of management to market signals suggesting the need for incremental change.

2. *Historical Limitations*

If the political process is a more efficient means of corporate oversight than the outright challenge for control, why has it not displaced the takeover? The answer is that the long era of widely dispersed share ownership that predominated during most of the twentieth century severely limited its potential. The dispersion of shares in the hands of largely uninformed individual investors created two specific obstacles to a political process of corporate governance.

First, the political process was not immune from the problem of self-dealing by active investors. Uninformed, dispersed shareholders were not in a good position to monitor the large investors who mounted proxy challenges. The clearest instances of such self-dealing occurred at the extreme end of the political spectrum, in contests involving control of the corporate board. A number of such contests involved promises made and later blatantly broken by the dissident investor. Examples of this continue up through relatively recent times. To illustrate, during the 1985 takeover of Datapoint, Asher Edelman ran a proxy contest promising liquidation of the company.[107] Once in control, he cancelled the liquidation plan and instigated a series of questionable deals, including an arrangement whereby his own partnership would manage Datapoint's cash and investment portfolio and pay itself thirty percent of total profits earned—an exorbitant commission. When investor Martin Ackerman launched a bid to remove Edelman in 1989, Edelman manipulated various corporate charter and bylaw provisions to entrench himself and deny

on corporate initiatives respond strongly to a wide variety of information, including the identity of the initiative's sponsor, the type of proposal being made, and the performance and credibility of incumbent management. See generally Lilli A. Gordon & John Pound, Information, Ownership Structure, and Shareholder Voting: Evidence from Shareholder-Sponsored Corporate Governance Proposals to Change Corporate Governance, 48 J. Fin. 697 (1993).

107 The Edelman-Datapoint story is chronicled in J. Van Heekerin, Asher Edelman and Datapoint (1992) (unpublished manuscript, on file with author).

Ackerman the opportunity to run a fair fight.

The second pervasive obstacle to political mechanisms of corporate governance—one argued vigorously by economists—is the difficulty of mounting informational campaigns involving complex issues and long-term concerns about corporate policy. Political mechanisms function only if a dissident investor can convince dispersed shareholders to support his cause; this necessitates a costly and intensive campaign of information and persuasion. When the situation is complicated and involves subtleties—for example, prospective performance shortfalls rather than demonstrated past performance shortfalls—the task of educating shareholders is formidable, if not impossible.[108] This means that the political process cannot solve a series of subtle corporate problems that an acquisition by an informed and expert new owner could address.[109]

This problem persists to some degree within the political mechanism. An example is the Belzbergs' 1989 proxy contest at Armstrong World Industries.[110] Armstrong had a history of strong performance and high profitability. A detailed review indicated that the company was pouring capital into new investment in a stagnant industry. The market, recognizing the potential for loss, had lowered Armstrong's value and rendered it a ripe candidate for acquisition. The Belzbergs ran a proxy contest for four seats on Armstrong's twelve-person board. Armstrong produced a series of convincing communications documenting its strong historical performance and defeated the Belzberg effort.[111] Within two years, Armstrong's fundamental performance and share price had plummeted, confirming precisely the concerns that had motivated the Belzberg initiative.[112]

Importantly, however, these concerns are minimized in today's market, which is becoming more sensitive to the subtleties of performance as institutional sophistication increases. In the past few years, institutional investors have focused more intensely on performance and dealt with difficult issues at companies such as American Express, Eastman Kodak,

108 This problem is made worse by voters' well-known bias toward the status quo. See William Samuelson & Richard Zeckhauser, Status Quo Bias in Individual Decision Making, 1 J. Risk & Uncertainty 7, 7-11 (1988) (reporting results of studies showing voters' preference for incumbents).

109 See DeAngelo, supra note 60, at 34 (stating that when information in proxy contest is costly, dissident shareholders rely on imperfect measures of corporate performance to convince shareholders to vote for new managers).

110 See Proxy Statement of Armstrong World Industries and Shareholder Committee for Improved Corporate Governance at Armstrong World Industries (1989); Barbara Wickens & Larry Black, A Fight for Control, Maclean's, May 14, 1990, at 48.

111 See Wickens & Black, supra note 110, at 48.

112 See Armstrong Chief Sees Break-Even Results for Fourth Period, Wall St. J., Jan. 10, 1991, at B5; see also Value Line Investment Survey, Quarterly Reports on Armstrong World Industries (reporting on second quarter 1989 and first quarter 1992).

and IBM.[113] This increasing conversance is diminishing the information limitation of the political model, and this trend will continue as institutional learning deepens.

3. *Economic Results*

How does the political model measure up in terms of the economic evidence generated to date? Broadly speaking, aggregate data suggest that politically based oversight activities are economically beneficial. Studies show significant share price increases accompanying proxy initiatives[114] and an even more pervasive effect in changing corporate policies.[115]

The positive effect of proxy initiatives is probably larger than the literature suggests. First, the utility of these studies is limited because the standard event-study techniques of finance do not apply well to the kinds of activity typical in a political process. Some political initiatives never even become public. Others evolve out of negotiation and never present a clear series of definitive "events" whose value can be measured. In addition, those political initiatives that do involve well-defined events often involve complex expectational dynamics that make it difficult to judge the exact value gains associated with an initiative. Event-study analysis asks a simplistic question: "Did the initiative add value?" But in the context of proxy activity, this is often not the right question. The more appropriate question in these situations is: "Did the event add value relative to what would have happened in its absence?" Because the latter outcome is not observable, the utility of tests based on actual value outcomes is very low.

In the Gintel-XTRA proxy contest, for example, mutual fund manager Robert Gintel obtained control of XTRA, replacing its board with a new one but leaving it as a public corporation.[116] He immediately dis-

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[113] See text accompanying notes 226-238 infra.

[114] See e.g., Harry DeAngelo & Linda DeAngelo, Proxy Contests and the Governance of Publicly Held Corporations, 23 J. Fin. Econ. 29, 39-46 (1989) (chronicling value gains associated with proxy initiatives); Peter Dodd & Jerold B. Warner, On Corporate Governance: A Study of Proxy Contests, 11 J. Fin. Econ. 401, 434-35 (1983) (same); John Pound, Shareholder Activism and Share Values: The Causes and Consequences of Dissident Countersolicitations Against Management Antitakeover Proposals, 32 J. L. & Econ. 357, 366 (1989) (showing corporate gain in value when informed outside shareholders defeat antitakeover amendments).

[115] See DeAngelo & DeAngelo, supra note 114, at 52 (concluding that less than one-fifth of sample firms were run by same management team within three years after proxy contest); see also Georgeson & Co., supra note 52 (providing data on frequency with which proxy contest protagonists accomplish their goals); Pound, supra note 52, at 251 (same).

[116] The history of the XTRA case can be quickly gleaned from the Value Line Investment Survey's quarterly reports on XTRA over that period. See Value Line Investment Survey, Quarterly Reports on XTRA (1989-1991). For a report on the outcome of the contest, see Gary Putka, Xtra Directors Seemingly Out in Holder Vote, Wall St. J., Mar. 16, 1990, at A4.

covered a situation worse than he had imagined and had to announce the bad news to the market. In the short-term—the horizon used by economists in event studies—the Gintel initiative reduced value because the impact of these announcements was a decline in the value of XTRA shares. This, however, is hardly the correct metric to apply in measuring the effect of the initiative. Gintel's contest rescued a corporation that was being liquidated under previous management. XTRA's performance has subsequently improved.[117]

In addition, new evidence from the past two years reveals that the emerging, more incremental, institutionally based oversight is particularly salutary in economic effects. For instance, one study documents that proxy initiatives aimed at changing specific policies or adding a minority of new board members have substantial positive long-term effects on stock prices.[118] A second study, examining the impact of economic activism by the California Public Employees Retirement System (CalPERS), documents that CalPERS's governance activities have added to long-term value.[119] Both studies reveal results that are almost always positive. This evidence confirms that political activism is particularly beneficial if it does not confer control, because in this case the danger of self-dealing by insurgents is mitigated. Such noncontrol-oriented activities are precisely what is emerging in the present market.

The economic advantages of one model of corporate governance over another will inevitably depend (at least to some degree) upon structural and behavioral trends in the market—i.e., stockholder dispersion, risk aversion in periods of economic recession, etc. The next Section argues that the political model nonetheless offers an important advantage over takeovers which is not subject to the vicissitudes of the market: political legitimacy.

4. *Political Legitimacy*

As I will document in this Section, for over a century, proxy challenges, proxy activity, and informal political initiatives have been supported by the public and legislators. The reason is simple and obvious. The proxy process embodies precisely the same approach to governance as the American democratic political process. As such, it resonates with deeply held public notions about how large entities should be governed.

117 See Suzanne Alexander, Dissident Shareholders Put Xtra on Road to Recovery, Wall St. J., Mar. 9, 1993, at B4.

118 See Lilli A. Gordon & John Pound, Active Investing in the U.S. Equity Market: Past Performance and Future Prospects, Report to the California Public Employees' Retirement System 30-43 (Jan. 11, 1993).

119 See Stephen L. Nesbitt, Long-Term Rewards from Corporate Governance (Jan. 5, 1994) (study by Wilshire Assocs., Santa Monica, Cal., on file with author).

As discussed earlier, the defining characteristics of a proxy challenge stand in sharp contrast to those of tender offers and other acquisition-based challenges.[120] Each difference helps to explain the more positive appraisals of proxy initiatives by policymakers and the public. In a proxy challenge, there is insurgency, but it is insurgency in the same sense as in presidential or congressional elections. Proxy fights involve a public challenger who articulates an alternative agenda and initiates a substantive campaign for the support of voters. There is sunlight rather than secrecy, since the insurgent investor must disseminate a great deal of information in order to make a public case and sway voters. Further, there is time for investors and the public to learn about the insurgent and his motives. Indeed, dissidents often attempt to petition for more time, because as insurgents, they must overcome voters' inclination to maintain the status quo in order to convince shareholders of the superiority of an alternative corporate plan.[121] Proxy challenges require coalition-building, because the insurgent cannot win without broad support from other shareholders. Finally, voters are provided the due process associated with an election.

Proxy challenges are also politically viable because they usually imply incremental rather than wholesale change for the corporation. In the aftermath of a successful proxy contest, even one for full control, the corporation remains public and the stake of the successful insurgent remains small. In more limited challenges—involving efforts to elect a few directors to the board or to alter certain aspects of corporate policy, for example—the active shareholder cannot pursue sweeping change because the investor has not gained control. The record of nonacquisition-directed proxy contest activity suggests fewer sudden and dramatic changes in corporate asset structure, employment, and ownership.[122]

The more hostile the challenge to management, the sharper the dichotomy between acquisition-based and political mechanisms. In a proxy campaign, a more resistant management means that a more intense public campaign by dissidents will be needed to build broad public support. The proxy mechanism thus has a built-in self-correcting tendency, in which more extreme cases force dissident shareholders to use tactics that more squarely comport with public-sector principles of gov-

120 See text accompanying notes 25-27 supra.

121 See Pound, supra note 52, at 241 (stating that dissident shareholders need time to track down and identify voters in order to overcome management's superior information).

122 In a sense this point is tautological, given that takeovers always result in a sale or change of control. But evidence on the relative frequency of sales also buttresses this conclusion. See DeAngelo & DeAngelo, supra note 114, at 30. For evidence on postcontest change at some large proxy contest targets in the 1950s, see generally D. Karr, supra note 38; see also Sanford Fine, Measurements of the Effectiveness of Change, in 1 Proxy Fights as Managerial Revolutions 25, 33-39 (Harold L. Wattel ed., 1966).

ernance. The reverse is true in the case of a takeover bid. In a takeover, the greater the resistance of management, the more due process must be avoided, because the hostile bidder's only hope is to obtain control in a quick and secret "hit" before the target's defenses can be marshalled. The takeover mechanism thus tilts intrinsically toward political instability. The resulting secrecy around such deals naturally breeds public suspicion.

The differences between the political ramifications of proxy activity and takeovers become most vivid when one examines their cultural reflections during the eras in which these contrasting mechanisms of corporate governance flourished. The height of proxy activity in the American market came in the mid-1950s. The response was a surprisingly broad popular affirmation of this practice as "democratic capitalism," a concept that included the right of outsiders to challenge the system and lobby for change. This sentiment was reflected in the popular press of the era which printed stories that all but endorsed the activities of "corporate raiders."[123] Other expressions of popular culture such as the movie *The Solid Gold Cadillac*, in which a CEO's secretary undertakes a proxy fight against him and succeeds in controlling the corporation, also captured the prevailing sense of public affirmation.[124] Popular books, such as David Karr's *Fight for Control*, chronicled in populist terms the challenges brought by insurgents against complacent managements.[125]

It hardly needs stating that such affirmations are nowhere to be found in popular writings on the takeover mechanism in the 1980s. In books, movies, and popular reporting, takeover artists were portrayed as cynical, wealthy manipulators, out to make millions by exploiting corporations and their shareholders. Suspicion of their motives was pervasive, and popular support of their activities was rare. In 1985, for example, *Business Week* published a cover story entitled "The Raiders";[126] the cover painting depicted a not-very-disguised T. Boone Pickens with his face obscured by an outlaw's kerchief. The 1987 film *Wall Street* chronicled the pursuits of a corrupt and greed-driven raider who ruthlessly

[123] See, e.g., Lannan, supra note 42, at 81; see also Lukens, Over-Conservativism in Management, supra note 43, at 220; Charles M. Williams, Thinking Ahead: Stockholders' Rebellion, Harv. Bus. Rev., July-Aug. 1955, at 21.

[124] The Solid Gold Cadillac (Columbia Pictures 1956).

[125] Consider, for example, the following passage from David Karr's book:

> The well-mannered man in the oak-paneled library . . . is as concerned about what makes you tick as your congressman, your senator, or your President. You may own only a few shares, yet without you there is no home in the country, no company plane, no corporation-owned limousine at his disposal. Without you there are no dues paid for him at the country club, no charge account at the Stork Club in New York, no "Miss Jones, I want four in the tenth row center for tonight. Charge it to entertainment."

D. Karr, supra note 38, at 2.

[126] Stewart Toy, The Raiders, Bus. Wk., Mar. 4, 1985, at 80.

manipulated stocks, conducted insider trading, and contributed to the destruction of major corporations.[127] Virtually all books on the subject chronicled the alleged abuses and arrogance of financial entrepreneurs engaged in both hostile and friendly deals.[128]

In the final analysis, perhaps the ultimate evidence of the political viability of proxy contests is the remarkable absence of regulation enacted to constrain their use. The few regulations that have been levied on proxy contests can in fact be seen as strengthening their resemblance to the public-sector democratic governance process. For example, in the 1950s, new rules required dissidents to disclose their identity, ownership, and goals.[129] While elevating costs, and thus dampening incentives for proxy activity, these rules more closely conformed to due process requirements of full disclosure of information to voters about their choices. The only other significant regulatory restraints upon the open proxy process came in response to hostile takeovers in the 1980s. These are clearly attributable to the fact that proxy contests were increasingly an ancillary part of the takeover process.[130] Thus, they were not repudiations of the political model on its own merits, but rather were intended to stop "takeover artists" from using the proxy process to accomplish their goals.[131]

III

The Emergence of a Strengthened Political Model

Both economics and politics thus suggest that the political model of governance is better than the control-transferring acquisition model for monitoring management and, when necessary, inducing change. This Part argues that for the first time since the appearance of the hostile tender offer in the United States more than thirty-five years ago, economic and political factors have realigned against acquisition-based governance and in favor of a more democratic approach. This new environment presents an opportunity to expand and develop the political model into a sustainable and dominant form of governance. As this Part will demonstrate, such an evolution is currently occurring. The corporate arena that is emerging bears a strong resemblance to the public-sector political system, complete with both formal and informal processes by which shareholders can influence management.

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127 Wall Street (Twentieth Century Fox 1987).

128 See, e.g., Connie Bruck, The Predator's Ball: The Junk Bond Raiders and the Man who Staked Them (1988); James B. Stewart, Den of Thieves (1991).

129 For an extensive description of the proxy rules see generally Pound, supra note 60.

130 See text accompanying note 52 supra.

131 See, e.g., Lee Berton, Fighting Takeovers: Some Companies Try New Tactics to Block Moves to Gain Control, Wall St. J., July 11, 1967, at A1 (describing new approaches taken to block hostile offers).

A. Realignment: New Incentives for the Political Model

1. New Deterrents to Acquisition-Based Governance

Recent years have seen the emergence of a new set of barriers to the acquisition model of corporate governance.[132] Some of these deterrents to acquisitions and control challenges, such as a particularly high level of public antipathy, are clearly temporary. In contrast, the most significant and permanent deterrent to full-control and acquisition bids is the new collection of federal regulations, state laws, and corporation-specific restrictions that erect legal and financial obstacles to these transactions. At the federal level, restrictions began with the imposition of the Williams Act[133] in 1968. The Williams Act created a web of procedural and disclosure regulations on tender offers where none had previously existed.[134] Since 1968, the federal government has imposed additional regulations on disclosure, more tightly drawn insider trading concerns, sometimes-vigorous antitrust policies, and restrictions on the use of contingent financing instruments enacted both through the Federal Reserve and congressional legislation.[135]

At the state level, major deterrents to takeovers include thirty-nine so-called "second generation" state takeover laws adopted since 1984.[136] Many of these impose significant and even extreme costs on hostile control contests and acquisitions. Examples are the freeze-out laws of New Jersey and New York, which prohibit an acquisition by a hostile large shareholder for five years,[137] and the control share acquisition laws of Illinois, Ohio, Pennsylvania, and many other states,[138] which strip hostile shareholders of their voting rights unless a majority of other shareholders votes to restore them.[139]

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132 See J. Harold Mulherin & Annette Poulsen, Does a Proxy Have Real Moxie?: The Performance Effects of Proxy Contests in the 1980s, at 1 (Oct. 1, 1992) (unpublished manuscript, on file with author) ("In recent years . . . the growing use of shark repellents and poison pills, [and] the imposition[ ] of state antitakeover laws . . . raise significant hurdles to tender offers.").

133 Pub. L. No. 90-439, 82 Stat. 454 (1968). The Williams Act is contained in §§ 13(d)-(e) and 14(d)-(f) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988).

134 See generally Thomas L. Hazen, The Law of Securities Regulation § 17.6, at 336 (2d ed. 1990); Gregg Jarrell & Michael Bradley, The Economic Effects of Federal and State Regulations of Cash Tender Offers, 23 J. L. & Econ. 371 (1980).

135 See Roberta Romano, A Guide to Takeovers: Theory, Evidence, and Regulation, 9 Yale J. Reg. 119, 156 (1992).

136 See State Takeover Laws, supra note 79, at 2.

137 See N.J. Stat. Ann. §§ 14A:10A-1 to -6 (West 1993); N.Y. Bus. Corp. L. § 912 (McKinney 1993).

138 See, e.g., Ill. Ann. Stat. ch. 21, para. 7.82 (Smith-Hurd 1993); Ohio Rev. Code § 1701.831 (Anderson 1993); Pa. Stat. Ann. tit. 15, § 1910 (1990).

139 The control share acquisitions laws are unprecedented in their revocation of the voting rights of large holders unfriendly to management. These laws turn around the fundamental

Protections have also exploded at the corporate level. These include poison pill plans, classified boards, and a litany of other defenses designed to shut down shareholder input.[140] A more informal deterrent to takeover activity is the sophisticated community of litigators and support firms armed and ready to go into court. These legal teams can impose significant costs on aggressors by appealing to federal securities and antitrust laws.[141]

It can be argued that these changes do not doom the takeover mechanism, but simply suggest a change in acquisition tactics and a greater fiduciary burden on outside directors to evaluate acquisition offers. This may indeed be the case; clearly, the acquisition mechanism is not gone entirely or forever. Still, the transaction costs of acquisitions have risen dramatically since the era epitomized by Victor Muscat in the early 1960s. Minimum offering periods, extensive disclosure, litigation, and critical scrutiny from the press, politicians, and the public are the inevitable consequences of a hostile takeover initiative in 1993, suggesting that the "wild west" days of the early 1960s *are* over forever.

Strengthening these deterrents to acquisitions and full-control bids are other forces that have made informal politically based oversight and limited voting challenges cheaper and more effective. The most significant of these trends is the rising concentration of institutional ownership. More concentrated ownership increases the general level of expertise and informedness among major corporate shareholders. The dramatic rise in institutional ownership is well-documented and much-discussed in the governance literature.[142] However, most of the literature has focused on whether institutions themselves are equipped to "monitor" companies, and has not examined how institutional concentration affects the overall incentives for active outside investors to mount political and proxy challenges. Regardless of how active institutions themselves be-

economics of market-based oversight, which depends upon the amassing of large ownership stakes to create the incentive for oversight and the power necessary to get the job done. See generally sources cited in note 81 supra.

140 For a listing that shows the remarkable series of protections that have been adopted since the early 1980s, see Investor Responsibility Research Center, Takeover Defense Directory (1980-1990) (annual publication covering approximately 1500 largest American companies). For a recent study of the effects of these protections on corporate performance, see Gordon & Pound, supra note 106; for a survey of the very broad literature examining their effects on stock price, see J. Weston et al., supra note 40.

141 For a general discussion of defensive litigation, see Gregg Jarrell, The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?, 28 J. L. & Econ. 151 (1985). For a review of the effects of successful defenses that kept companies independent, see Michael Bradley et al., The Rationale Behind Interfirm Tender Offers: Information or Synergy?, 11 J. Fin. Econ. 183 (1983).

142 See generally, e.g., Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520 (1990); John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277 (1991).

come, institutional concentration significantly heightens the incentives for incremental, political monitoring, as Section A.3 will explain.

2. *The New Proxy Rules*

Another important incentive for the political model of corporate oversight is the relaxation of the proxy rules accomplished in 1992.[143] Since at least 1956, the SEC's former proxy rules created a serious deterrent to informal, political oversight activity by elevating the costs associated with informal communication.[144] In 1992, the SEC amended the proxy rules to facilitate communication among investors and make filing and compliance less costly.[145] The new rules have made it easier for shareholders to seek limited change through the proxy process, such as the addition of a new individual to the corporate board.[146]

3. *Institutional Ownership and the Incentives for Politically Based Oversight*

Institutional ownership concentration has been much misunderstood in the literature on corporate governance. A number of analysts have argued that the typical large institutional holding at major corporations—now in the one to three percent range—remains far too small to create an incentive for effective monitoring.[147] When examined more closely, however, this conclusion is simply wrong. The percentage of stock held by a specific investor is largely irrelevant to the decision to monitor. What is relevant is the raw dollar amount at stake, relative to the economic costs and benefits of becoming informed. With a sufficiently high raw dollar level of holdings, the incentive to become active is great, even if the proportion of total stock held is very small.[148]

143 The new rules exempt communications by "disinterested" parties—parties who are not actually actively soliciting votes—from the proxy statement filing and delivery requirements. See 17 C.F.R. § 240.14a-2(b)(1) (1993). This greatly expands the market for private communication. The only shortcoming in the rules is that they fail to clarify the definition of solicitation itself, and thus do not create a "bright line" test for solicitations, as opposed to communications that might ultimately end with a solicitation but are not so intended ex ante. A clear test for solicitations is becoming increasingly necessary in a world where major institutions negotiate with management, resorting to solicitation only if they are rebuffed.

144 See 17 C.F.R. §§ 2404.14a-1 to -13 (1991).

145 See 17 C.F.R. §§ 240.14a-2(b)(1), -3(c), -4(b) (1992).

146 On the latter point, see the SEC's proposal to relax the bona fide nominee rule, 17 C.F.R. § 240.14a-4(d) (1993), and the analysis of that rule contained in Ronald J. Gilson et al., How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors, 17 J. Corp. L. 29, 38-42 (1991).

147 See, e.g., Coffee, supra note 142, at 1292; Jay W. Lorsch, Real Ownership Is Impossible, Harv. Bus. Rev., Nov.-Dec. 1991, at 139, 139-40.

148 Conversely, there may be no incentive to act even at high levels of ownership concentration if the dollar size of the holding is very low. See Coffee, supra note 142, at 1291-93 (arguing that most institutions' dollar holdings fall below necessary threshold); see also Black, supra

Consider, for example, a one percent holding in the Mobil Corporation, a company worth over $20 billion in total. The market value of this holding at the present time is over $200 million. An institution holding such a relatively tiny proportional stake stands to gain $20 million if an initiative occurs that raises the value of Mobil by ten percent, and to lose $20 million if management action or an outside initiative decreases value by ten percent. This wealth exposure is more than sufficient to spur an institutional holder to action. At the very least, such a stake suggests that if faced with an initiative by an outside holder, it would be prudent for the investor to commission an independent expert analysis prior to making a voting decision. It might also behoove such an investor to expend resources to inform other major holders if there is a reasonable chance of influencing their votes. At the other extreme, if an institution believes that it knows how to increase Mobil's value by ten percent, it has an incentive to invest in a full-blown proxy campaign, because the $3 to $5 million that such campaigns can cost in the modern environment[149] represents twenty-five percent or less of the potential value gains that could be realized by a change in policy.

At most Fortune 500 corporations, a significant share of stock is held by institutions that pass this requisite threshold value of holdings.[150] Indeed, if the test is whether the potential dollar gains are sufficiently large to merit a few thousand dollars of research on corporate policy to judge the merit of a dissident plan, then a majority of stock at many, if not most leading companies, is held by institutions that have sufficient incentives to make informed voting decisions.

The result is a dramatic change in the cost calculus associated with an active investor's attempt to impose incremental change at a corporation. The current concentration of institutional ownership is sufficient to create a wholly different set of market incentives, one that promotes the "political" approach to governance. The issue is not whether individual institutions have somehow crossed a threshold and now act like long-term relationship investors. The correct question is whether concentration has become sufficient to breed more informed voting decisions and a shift from mass ownership to ownership by relatively small groups or coalitions. The clear answer is that this transformation has indeed

note 142, at 575-91 (providing elegant general analysis of incentives to monitor).

149 Cf. Martin, supra note 100, at 378 (noting that proxy contests cost millions of dollars).

150 See generally the quarterly publication, Spectrum 3 Ownership Profiles. This volume compiles ownership by money managers and public pension funds on a quarterly basis from SEC filings. At virtually any large company, there are several one percent or greater owners, and at some companies there is a remarkable concentration of ownership. For example, in 1992, at Tektronix, a billion-dollar company, five institutions collectively owned approximately 35% of the stock. See id. (Dec. 31, 1992).

occurred.

a. Minimization of the Traditional Limitations of the Political Model. The greater informedness and political sensitivity of institutional investors also go a considerable distance toward correcting the two traditional problems with politically based governance: the prospect of self-dealing by dissident investors and the inability of dissident investors to make a sophisticated case.

Institutional ownership lessens the risk of self-dealing because when making voting decisions in contested situations, institutions actively look for safeguards.[151] Their concerns stem both from their sophistication—that is, their recognition of the potential for self-dealing—and their political vulnerability. Institutions do not want to be seen as the swing vote that threw out a reputable management team and ushered in an unscrupulous self-dealer. They therefore search for guarantees that the dissident will not "capture" corporate assets and repudiate investors' concerns once in office.

Moreover, the ability of dissident institutional investors to make a case is increased because political initiatives are now far less costly and far more likely to succeed. This is so for two reasons. First, the political constraints upon institutional behavior[152] mean that institutions increasingly must engage in sophisticated professional research in order to formulate a voting position in contested situations. This trend toward detailed research obviously minimizes the information problem significantly[153] and the overall greater informedness of institutions means that a sophisticated case can be made about corporate policy, the structure of the board, and other important issues. Second, the number of voters who must be contacted and convinced to achieve a significant degree of voting power is far smaller today than in past decades. The result is a vast reduction in the costs associated with a limited solicitation to change corporate policy.

Consider a concrete example. In 1990, Carl Icahn undertook a solicitation to change corporate policy at the USX corporation.[154] USX—

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151 This conclusion is based upon my personal experience in soliciting votes from institutions and in advising institutions on how to vote in proxy contests.

152 See text accompanying note 162 infra.

153 Of course, the problem of informational inefficiency is not entirely eliminated, as the Armstrong World case should make clear. See text accompanying notes 110-12 supra. Information deficits will tend to persist with regard to companies in which performance appears good and corporate troubles are subtle. Indeed, it is in precisely these cases that the acquisition mechanism is really the only way for an active investor to "convince" shareholders to make changes.

154 See Pound, supra note 15, at A10. The details of this case are drawn from my personal experience as a participant in the solicitation.

at the time among the top twenty on the Fortune 500 list—had a vastly dispersed individual shareholder base. As of 1990, there were over 125,000 shareholders of record, not including the additional tens of thousands of individual shareholders holding stock in nominee name.[155] A solicitation that depended upon reaching a critical mass of these individual shareholders would necessarily have had to stick to very basic themes. It would also have been extremely expensive. Document preparation and mailing costs alone for a low-profile campaign, involving perhaps four mailings, would have cost several million dollars. In addition, newspaper and other mass media advertisements would have been necessary, raising the ante by millions more.

USX's institutional ownership profile created a very different situation, however. At the time of the pending solicitation, over sixty percent of USX stock was held by institutional owners filing Form 13F reports with the SEC. Moreover, the top twenty-five owners accounted for over forty percent of shares.[156] It is not difficult to divine how completely this shifted the dynamics of the initiative. It meant that significant pressure could be exerted on the company by gaining the support of less than twenty major institutional holders. Instead of a campaign based on slogans and mass mailings, the initiative could be pursued through visits and detailed presentations about corporate policy by a few dozen major investors, most of whom were centered in three or four major cities. Moreover, the use of mass communication could be severely curtailed, not only because repeated messages to individual holders is less effective, but also because many institutional holders view advertisements—once the bread and butter of proxy contests—as a distracting and uninformative waste of corporate and investor resources.

As a result of these considerations, planning for Icahn's USX campaign assumed a budget of less than $1 million.[157] To put this expenditure in perspective, consider that one percent of USX was valued at $80 million at the time. The benefit associated with a limited campaign to change USX policy would thus have been compelling for a one percent holder. For Carl Icahn, an investor with a fifteen percent stake, amounting to just over $1 billion, a $1 million expenditure constituted approximately one-tenth of one percent of the value of his holdings.

155 Summary information of USX share ownership is available in the Value Line Investment Survey's quarterly reports on USX. See Value Line Investment Survey, Quarterly Reports on USX (1990).

156 See generally Spectrum 3 Ownership Profiles (June 30, 1990).

157 The budget estimate is based on personal knowledge stemming from my involvement in the Icahn campaign.

b. Political Sustainability. In addition to minimizing the traditional limitations of the political model for governance activity, institutional investors have also altered the broad political forces at work in corporate governance. The reason is their own political vulnerability, which stems from their structure and exposure. Major money managers represent dozens or even hundreds of clients, predominantly corporations; major public pension funds represent millions of individual beneficiaries. This renders these institutions highly visible and ripe for formal and informal political retaliation.

The result is that major institutions display a high degree of sensitivity to the politics of governance activity.[158] Their sensitivities reflect those of the corporate community and the public. Thus institutional investors tend to shy away from activity that will create political costs even when it is profitable, because any action that they take in the governance arena creates long-term business consequences. They will not support raiders willy-nilly, but rather demand "acceptable" forms of oversight that they can justify to their constituents in the political process.

There is strong anecdotal and scientific evidence attesting to the political sensitivity of institutions and their resulting inclination to support the status quo. In a recent survey of public pension funds, I found that a lopsided plurality said that they would not vote for a corporate "raider" if the broad consensus was that he was a short-term opportunist, even if he were promoting an offer that would boost stock price in the short term.[159] CalPERS has never voted in support of Carl Icahn, despite his ability to generate huge value gains through proxy contests and takeovers.[160] A variety of empirical studies shows that certain types of institutions, in particular banks and insurance companies, are more likely to support management than dissident investors from the outside.[161]

Many analysts have treated the political vulnerability of institutions as a disadvantage in the governance arena.[162] Their argument is that

158 See generally Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Colum. L. Rev. 795 (1993) (discussing this issue with respect to public pension funds).

159 This information comes from data I compiled in 1991-92.

160 See Dale M. Hanson, Chief Executive Officer of CalPERS, Remarks at the Stanford University Center for Economic Policy Research Conference on Corporate Governance (May 1, 1992).

161 See generally, e.g., James A. Brickley et al., Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267 (1988) (testing relationship between institutional ownership and voting outcomes); Pound, supra note 52, at 259-60 (finding that institutions as a whole are conservative in voting for dissidents in contested situations). Taken together, these two studies suggest that institutions become more promanagement when dissent pressure increases because of higher political risk associated with a prodissident vote.

162 See, e.g., Jensen, supra note 5, at 21.

institutions ultimately will be unable to press for change because their political sensitivity will gut their effectiveness. However, this is incorrect. Institutions will be able to press for the *right* amount of change—the amount that will be tolerated politically. The plural nature of the client and beneficiary base mean that the political pressures placed on these institutions will be representative of the public and business reaction to corporate governance initiatives. Institutions thus serve as a reliable barometer of the broader political concerns that arise in response to governance activity. Given their emerging voting power, all factors indicate that institutions—quite unintentionally—will tend to police the governance arena, discouraging extreme or politically unpopular governance intervention and encouraging more moderate measures that are politically sustainable.

This is a tremendously important contribution of institutional ownership. The most efficient governance mechanisms in the world are not worth much in the long term if they are quickly or thoroughly repudiated by the political process. Individual investors, even if they dislike particular transactions like takeovers, tend to be driven at the margin by the economics of a given transaction. Institutions are not. They are driven by a long-term concern for profit maximization that directly incorporates political concerns.

B. Foundations: Evidence That a Strengthened Political Model Is Emerging

Taken together, the forces outlined in the previous Section are already creating a new environment in corporate governance which bears a strong resemblance to the public-sector political process. For incumbents, the reduction of the control and acquisition threats means a reduced and indeed remote threat of displacement, just as is true for incumbent politicians. Concurrently, voters have become more active and informed. Institutional investors have taken on the role of interest groups, researching issues, gauging the preferences of constituents, and bringing pressure to bear on incumbent managers and directors. The new proxy rules further facilitate this process. As in democratic politics, the goal of pressure is not to throw out management, except in very extreme cases. Instead, it is to influence policy decisions through a continual process of feedback and lobbying.

In this Section I provide evidence of the shift in the corporate governance arena toward the use of political tactics aimed at engendering incremental change. In analyzing these changes, it is useful to organize them along a broad spectrum suggested by the democratic political model itself. I begin at the more traditional end of that spectrum, examining changes that have occurred in formal proxy contests for representation and control. I then move along the spectrum to review new developments and tactics of a less formal and more incremental nature than full-blown proxy contests. I end with the least formal mechanism—private negotiations between management and investors.[163]

1. *The New Dynamics of Formal Proxy Contests*

On a cursory examination, the major proxy contests of the past few years appear very similar to their forbearers: expensive, litigation-filled struggles for control of board seats.[164] Closer analysis, however, reveals that this is clearly not the case. A series of new trends in the proxy contest arena reflects the emerging political paradigm.

The first important change is a movement away from contests for control. This movement, as argued earlier,[165] stems both from new state and corporation-specific protections that make it more difficult to acquire corporations and from the weakening link between proxy contests and takeover bids. It also stems from the increasing reluctance of major institutions to simply cede control of major corporations to outside entrepreneurs. The result is that there has not been a single proxy challenge fought for control of a major U.S. corporation for about four years.[166] A number of significant contests have occurred, but each of these has been over representation, the increasing goal of choice among institutions and active investors.

This trend is replicated in smaller contests. The most successful

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[163] I do not claim that each of the initiatives and outcomes discussed here is optimal from the viewpoint of all parties. Such a result would be surprising indeed in a fast-changing market characterized by new and evolving strategies. Some of the outcomes described resulted because a dissident investor sought more traditional goals, was unexpectedly defeated by the new alignments and incentives in the governance arena, and had to fall back on a political approach. Other initiatives, particularly those involving major public pension funds, represent conscious experimentation on the part of long-term market participants seeking to innovate; as such, particular examples stand a good chance of being suboptimal when judged from an ex post perspective. Conclusive aggregate evidence of the long-term effectiveness of the political approach must await several years of activity and a well-developed empirical record. The examples given are meant to show that a political approach is indeed emerging, to provide a perspective on the range of approaches being developed, and to offer suggestive evidence on the kinds of negotiated and incremental outcomes that are arising under the political model.

[164] The Lockheed contest in 1990, for example, involved all the usual sideshows, including extensive litigation over Lockheed's establishment of an ESOP. See Martin, supra note 100, at 375-80.

[165] See text accompanying notes 140-45.

[166] The 1990 Lockheed contest was the last. This initiative was really aimed at securing endorsement for a precatory proposal requesting management to add three Simmons-designated directors to the Lockheed board. The conclusion that the Lockheed contest is the most recent fight for control of a major U.S. corporation is based on statistics on proxy contests since 1990 on file with the author. Statistics are also available from Georgeson & Co., New York, and D.F. King & Co., New York.

contests of the recent past include Cleveland-Cliffs Corporation—where a dissident investor sought and won five seats on a twelve-person board[167]—and Van Dorn Company—where a dissident sought three seats, obtained one, and built an alliance with other, existing dissident members of the corporate board.[168] There has been only one successful full-control proxy challenge in the three proxy seasons that have run their course since January 1, 1990. That challenge was at XTRA Corporation, where mutual fund manager Robert Gintel replaced the entire board after a protracted period of stagnant performance.[169]

Also evident in proxy contests in the past few years are more sophisticated communications strategies designed to provide institutions with a full complement of information about dissident plans. In 1990 and 1991, Harold Simmons provided a detailed alternative business plan for Lockheed Corporation. Like an opposition party candidate in a political contest, Simmons laid out an explicit platform for the company.[170] In 1992, dissidents at Jefferson-Pilot Corporation provided a similarly detailed business plan, clearing with the SEC a set of background materials that were virtually unprecedented in their breadth and depth.[171]

Recent proxy contests have also involved a new emphasis on expert, independent board members. Dissident slates have been structured to appeal to institutional investors, to certify that the initiative will improve the board, and to provide institutions with a guarantee against self-dealing. Several approaches have been taken. At USX, for example, Carl Icahn sponsored a slate of four candidates who were entirely independent of his organization and provided funding for them to conduct their own independent analyses and campaigns, thereby certifying that he would have no direct influence on the corporation or the board.[172] Similarly, investor Julian Robertson sponsored an entirely independent five-member slate at Cleveland-Cliffs.[173] At Jefferson-Pilot, the dissident's slate included the sponsoring investor but was structured so that independent

167 See Schiller, supra note 101, at 32.

168 See Diana B. Henriques, Mr. Perot, Meet Mr. Frazier, N.Y. Times, June 21, 1992, § 3, at 15.

169 See note 116 and accompanying text supra.

170 See NL Industries's advertisement, Wall St. J., Mar. 12, 1990, at C15 (soliciting proxies for its nominees from Lockheed shareholders).

171 See Proxy Materials and Institutional Briefing Book for Solicitation by the Jefferson-Pilot Shareholders Committee (1992) (on file with author). These materials contain, among other things, a full financial restructuring plan and a regression analysis relating market value to various factors in the insurance industry. A number of observers with whom I have spoken have commented that the fact that these materials were cleared by the SEC indicated that the staff was already beginning to act as if the preclearance process had been deregulated as proposed under the new proxy rules.

172 See Pound, supra note 15, at A10.

173 See Schiller, supra note 101, at 32.

candidates who had no previous affiliation with the dissident were in the majority, ensuring that the sponsor could not "rig" anything without being kicked out by his own independent nominees.[174]

An additional dynamic emerging in proxy contests is the challenge by investors with smaller stakes and longer-term investment positions. This suggests a return to the pre-tender offer period, when even the most aggressive raiders recognized that success at a given firm could take three to five years of activity in order to convince outside holders of the seriousness and superiority of the dissident's position.[175] At USX, for instance, Carl Icahn mounted two back-to-back campaigns; it was the second campaign, coupled with a clear promise to return and conduct a third one if necessary, that created success.[176] At Jefferson-Pilot, the dissident investor, who was a descendant of the founder but owned only one percent of outstanding shares, mounted a multiyear campaign using formal and informal tactics to replace the CEO.[177]

Finally, and perhaps most significantly, recent proxy seasons have seen the rise of "negotiated" settlements. These settlements have not involved bipartisan deals between management and dissidents, as was once common, but rather intervention by large institutional investors. In several contests, leading active institutions have stepped in to propose alternatives. In doing so, they have behaved less like reactive voters and more like proactive arbitrators or brokers in the political process, settling differences between rival camps through negotiation. The compromises have typically involved moderate but not sweeping change and solutions that respect broad political principles of due process.

The earliest example of this occurred in the 1988 battle between Carl Icahn and Texaco.[178] That contest was decided in large part by a series of meetings between major institutions and Texaco's CEO. The result was a majority vote for incumbent management, but with the promise of significant restructuring and the appointment of a new, insti-

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[174] See Proxy Statement of the Jefferson-Pilot Shareholders Committee (1992) (on file with author).

[175] Cf. D. Karr, supra note 38 (describing number of contests in 1950s that took two to three years to be resolved).

[176] See Pound, supra note 14, at 84-86.

[177] For a detailed account of the Jefferson-Pilot situation, see David Bailey, Where There's a Will, There's a Way; Corporate Battle Between Heiress Louise Price Parsons and Jefferson Pilot Corp.'s CEO Roger Soles, Bus. N.C., Aug. 1992, at 12. See also Diana B. Henriques, A Nasty Mood at Jefferson-Pilot, N.Y. Times, Apr. 26, 1992, § 3, at 15.

[178] For reports on the contest see, e.g., Big Investors Meet Texaco, N.Y. Times, Jan. 24, 1989, at D5; Robert J. Cole, Investors Delaying on Proxy, N.Y. Times, June 16, 1988, at D4; Allanna Sullivan & Caleb Solomon, Texaco Claims Defeat of Icahn in Proxy Fight, Wall St. J., June 20, 1988, at A3; Texaco Weighs Plan to Alter Board, N.Y. Times, June 11, 1988, at 41. The events at Texaco can also be followed through the Wall Street Journal News Index for 1988 and 1989.

tution-supported independent director. The subsequent restructuring significantly lifted the value of Texaco.[179]

A similar but more significant set of compromises ultimately settled the contest between Harold Simmons and Lockheed in 1990.[180] In response to proposals from a group of institutions, management promised to appoint several new independent directors in consultation with the institutions and to reform the company's corporate governance structure.[181] The result was a victory for management in the vote, but also a more systematic outreach to institutions.[182]

2. *Formal Proxy Challenges Without Board Representation*

Moving along the spectrum of political activity, the next manifestation of the new political process is the use of formal voting challenges as a means to provoke *debate* over specific corporate policies—the corporate counterpart of public-sector referendum campaigns. By articulating an alternative policy and securing shareholder endorsement, such voting challenges put pressure on the corporation to adopt specific changes without directly challenging the tenure of elected representatives. However, there remains an implicit threat if the gap between incumbent politics and shareholder preferences remains or widens.

In the past few years, a series of high-profile contests over alternative corporate structure and strategy proposals has occurred. For example, Carl Icahn instituted a shareholder proposal which suggested that USX spin off its steel operations.[183] That proposal was supported by an extensive communications and advertising campaign, and gained forty-three percent of votes cast, ultimately setting the stage for the financial separation of USX's two lines of business.[184] Other such ballot initiatives have received widespread attention even without the use of such intensive

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179 For a review of value effects of the negotiated settlement, see Value Line Investment Survey, Quarterly Reports on Texaco (1988-1989).

180 For a general description of the Lockheed battle, see Martin, supra note 100; see also Lockheed Defeated Simmons Candidates, Official Tally Shows, Wall St. J., Apr. 17, 1990, at B2; Rick Wartzman & Frederick Rose, Lockheed's Management Claims Victory, Simmons Insists Battle 'Too Close to Call,' Wall St. J., Mar. 30, 1990, at A2.

181 See Wartzman & Rose, supra note 180, at A2.

182 See Lockheed Defeated Simmons Candidates, Official Tally Shows, supra note 180, at B2.

183 See Pound, supra note 14, at 84.

184 See id.; see also Clare Ansberry & Thomas F. O'Boyle, Icahn Loses Proxy Bid to Force USX to Spin Off Steel Business, Wall St. J., May 8, 1990, at A3. It is not clear that the large-scale communications campaign mounted by Icahn (including, for example, full-page newspaper advertisements) was necessary or even helpful. The same or better results might have been obtained if the campaign had consisted solely of visits to institutions. In the 1991 Lockheed campaign, Harold Simmons and Lockheed officials took a mutual no-advertising pledge, agreeing that the expenditures were counterproductive for everyone.

or expensive support campaigns. Consider for example the 1992 shareholder proposal that Sears undertake an independent study to determine the value of the company were it to spin off its nonmerchandising businesses, such as its financial services segment, whose superior performance was being buried among other lesser performing divisions in Sears's huge structure.[185] This proposal, brought by an agent at the company's Allstate insurance division, was supported by shareholder-activist Robert Monks, who undertook an independent solicitation to collect votes in its favor.[186] The solicitation was also itself a "first" in the recent history of proxy initiatives—a third-party solicitation on behalf of a proxy protagonist.[187]

Another recent issue campaign highlighting the changing dynamics of the corporate governance arena involved the Honeywell Corporation.[188] An investment partnership which included active investor Richard Rainwater owned a small percentage of Honeywell when management proposed a new set of antitakeover amendments in 1989. Rainwater sought out institutional cosponsors who would oppose the proposed takeover protections. Two major public pension funds—CalPERS and the Pennsylvania Public Employees Retirement Systems—joined Rainwater in the solicitation. In return for their support, these institutions extracted Rainwater's promise that he would not try to take over the company. Both public funds wished to turn back the Honeywell proposals; at the same time, neither wanted to be seen as "supporting raiders." The result was a proxy solicitation that defeated the antitakeover proposals, a series of postsolicitation discussions between Honeywell management and Rainwater, and, ultimately, a value-enhancing restructuring. This contest and its aftermath are perfectly indicative of the changes being fostered by institutional ownership. The Honeywell contest was moderate but effective because of the involvement of the public funds and their ability to secure an ex ante bond that Rainwater would not launch a takeover bid.

A further move along the political spectrum reveals voting initiatives designed to change "generic" aspects of corporate governance and incentives, as distinct from initiatives that seek to change specific people,

185 For a particularly colorful summary of the Sears shareholders' proposals and votes, see Ellen Neuborne & Michelle Osborn, Shareholders Revolt at Sears: Mutual Funds, Pensions Lead the Charge, USA Today, May 15, 1992, at B1. For a vivid perspective on how Monks made his case, see his Wall Street Journal advertisement, Wall St. J., May 8, 1992, at A7.

186 See Christina Duff & Francine Schwadel, Sears Holders Set for Battle at Meeting, Armed with Abstentions and Proposals, Wall St. J., May 13, 1992, at A2, A6.

187 See Proxy Statement of Robert Monks in Opposition to the Board of Sears Roebuck and Co. (Apr. 1992) (on file with author).

188 For a comprehensive treatment of the Honeywell campaign, from which this account is taken, see generally Van Nuys, supra note 13.

strategies, or structure. In recent years a variety of such initiatives has been pursued.[189] Perhaps the best-known are initiatives to rescind certain antitakeover devices such as poison pills.[190] In a number of these initiatives, the sponsoring shareholder retained solicitors and conducted an active campaign on behalf of the proposal. Another new and growing class of proposals pertains to the structure and operation of the corporate board, covering such issues as the independence of directors and the makeup of the nominating and compensation committees.

These governance-related shareholder proposals suggest the seriousness with which incremental oversight is taken. Although shareholder proposals have been part of the governance landscape since at least the mid-to-late 1800s,[191] the activity of the past five years represents the first time that such proposals have been sponsored by large, professional investors, as opposed to individual, "gadfly" activists. This is also the first time that active solicitations have been conducted by professional investors on behalf of shareholder proposals.[192] In addition, the past five years have seen a growing number of instances in which active investors, seeking far more broad-ranging kinds of corporate change, have included corporate governance reforms on their agenda, clearly in an attempt to appeal to major institutional investors.[193]

An additional variant of the formal voting challenge which has surfaced is the "just vote no" campaign. In such a campaign, leading shareholders withhold their votes for incumbent members of the board, publicly announce their decision, and urge other holders to do the same. The dynamics are the same as those of a "no confidence" vote in Parliament. While withholding votes cannot unseat incumbents because they are reelected by default by a plurality of votes cast, such campaigns can send a sharp signal that market confidence is low.[194]

In 1992, "vote no" campaigns reached a new level of prominence.

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189 For a broad survey of voting on shareholder proposals, see the annual publication, Investor Responsibility Research Center, Summary of Voting Results (1990-1994). For an economic analysis of voting on proposals, see generally Gordon & Pound, supra note 106.

190 See generally Investor Responsibility Research Center, supra note 189.

191 See text accompanying notes 33-36 supra.

192 In interviewing fund personnel, I have discovered that several funds actively solicit support for shareholder proposals. Evidence suggests that proposals receive significantly more support (in both an economic and statistical sense) when they are sponsored by institutional investors, or by the United Shareholders Association, a professional lobbying group based in Washington that provides individual shareholders with assistance in targeting corporations and formulating shareholder proposals. See generally Gordon & Pound, supra note 106.

193 Harold Simmons, for example, included four proposals for reform of Lockheed's governance structure on the ballot in 1990. All four proposals won majority support. See Martin, supra note 100, at 376.

194 For an extensive treatment of this strategy, see Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 Stan. L. Rev. 857 (1993).

Informal "vote no" efforts resulted in nearly ten percent of all shares being withheld for directors at Champion International.[195] At the smaller Van Dorn Company, arbitrageur Guy Wyser-Pratte conducted a formal solicitation urging shareholders to withhold their votes from incumbents after the board rejected a friendly acquisition offer and failed to inform shareholders of the fact that a dissident holder would make alternative director nominations at the annual meeting.[196] This was the first instance of a formal solicitation aimed at inducing shareholders to withhold their votes for directors. In 1993, the Wisconsin State Investment Board ran a "vote no" campaign against specific board members—the members of the compensation committee—at Paramount Communications, Inc., to protest stagnant performance coupled with high executive compensation.[197]

3. *Public Lobbying Without a Vote*

An even further move along the tactical spectrum toward more informal mechanisms for influencing policy uncovers perhaps the most dramatic evidence of an emerging political process of corporate oversight: the appearance of a wide variety of approaches designed to engender formal debate about existing policies without a voting challenge. The most structured of these nonvoting mechanisms is the creation of a standing shareholder committee, or "shadow board," to debate current policies and suggest specific alternatives. Like a shadow cabinet in a parliamentary system, such a group can break the informational monopoly of incumbents and create an alternative agenda for policy. This, in turn, can heighten the pressure on incumbents to justify their policies and ultimately to change direction if these justifications fail to convince a majority of voters.

An example of a shadow board is the USX Shareholders Enhancement Committee, created by Carl Icahn in late-1990, which consisted of four experts on corporate restructuring and corporate governance.[198] Members were provided funds to conduct an independent analysis of USX and to propose alternative policies. Ultimately, each member of the Committee was to serve as a candidate for election as an independent director at USX in 1991; until then, however, the Committee was to

[195] See Investor Responsibility Research Center, Corporate Governance Highlights, May 22, 1992, at 1.

[196] See Robert J. Brennan, Van Dorn Holder, in a Novel Approach, Urges Rejection of Company's Nominees, Wall St. J., Apr. 27, 1992, at A7A.

[197] See Del Jones, Paramount Draws Fire, USA Today, Mar. 5, 1993, at 2B; Susan Pulliam, Paramount Is Targeted by Pension Fund Due To Weak Stock Price, Executive Pay, Wall St. J., Mar. 4, 1993, at A4.

[198] See Pound, supra note 14, at 84.

serve as a centralized forum for debate and the promulgation of an alternative agenda.[199] Several similar committees have been planned over the past two years by active investors at major corporations; no others have yet reached the implementation stage.[200]

A yet more informal and inexpensive approach to influencing corporate policy is the direct lobbying campaign. Like lobbying in the public sector, this can be an effective means of breaking the managerial monopoly in corporate policy and rallying other shareholders. Lobbying campaigns should constitute the most vigorous and widespread kind of activity in a political approach to corporate governance because they are the least costly way of presenting an alternative agenda. They allow an active investor to press concurrently for that alternative and also to determine whether broad support for a more formal initiative exists.

An illustrative example of such a lobbying campaign occurred late in 1993 at Medical Care America, Inc.[201] Medical Care received an unsolicited proposal for a strategic acquisition from Surgical Care Associates. The Medical Care board rejected the offer and refused to have discussions with Surgical Care.[202] In response, seven major shareholders of Medical Care met in New York and agreed to initiate a letter writing campaign in which institutional holders of Medical Care stock would be asked to urge members of the Medical Care board to change their position. Over the ensuing month, about twenty institutions, representing about forty percent of the company's outstanding stock, wrote such letters. Included were some of the largest corporate and public pension funds in the United States, as well as money managers and active investors.[203] The Medical Care board reversed its decision and entered into an open process for entertaining offers.[204] The ultimate resolution was a restructuring that kept Medical Care independent while eliminating its worst-performing division and substantially enhancing value.[205]

An additional example of the structured use of a lobbying campaign to leverage policy change is the one initiated by CalPERS during the past two proxy seasons.[206] In both years, CalPERS targeted twelve compa-

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199 See Letter from Carl C. Icahn to Charles Corry, Chairman of the Board, USX Corp. 1, 3-5 (Nov. 13, 1990) (on file with author).

200 I have participated in the preliminary planning for several such committees.

201 See John Pound, Where Shareholder Activism Is Paramount, Wall St. J., Dec. 7, 1993, at A16; Robert Tomosho, Group Seeks Talks With Medical Care Over Spurned Offer, Wall St. J., Nov. 12, 1993, at A8.

202 See Pound, supra note 201, at A16; Tomosho, supra note 201, at A8.

203 See Pound, supra note 201, at A16.

204 See Kathryn Jones, Medical Care to Sell a Unit to Caremark, N.Y. Times, Jan. 18, 1994, at D4.

205 See id.

206 See Judith H. Dobrzynski, Calpers Is Ready to Roar, but Will CEOs Listen?, Bus. Wk., Mar. 30, 1992, at 44.

nies in its portfolio that it deemed underperformers. Each company was then approached for discussions. In the winter months, after initial communications had been pursued with each, a list of the companies was made public. For each company, CalPERS listed one or several specific problems which its analysis had uncovered. CalPERS also described whether the company had been willing to engage in talks and negotiation or whether the company had been resistant to CalPERS's overtures.[207] By publicly identifying those companies that were resistant to outside input and those that were receptive to it, CalPERS created an incentive for firms to respond more readily to the fund's overtures in the future.

A more informal but pointed use of a lobbying campaign involved the Chrysler Corporation. Early in March 1992, two major Chrysler holders, Wellington Management Co. and Loomis Sayles & Co., went public with their concerns that the Chrysler board was failing to deal adequately with the issue of CEO succession, and argued that the board should resolve the impasse and appoint a successor to Lee Iacocca.[208] Within ten days, the Chrysler board (which had been resisting resolution of the succession issue), called a special weekend meeting[209] and appointed a new vice-chairman and chief operating officer.[210]

A fourth example of an effective lobbying campaign involved Guy Wyser-Pratte's efforts at Van Dorn Company. In March of 1992, a Van Dorn shareholder indicated that he would nominate himself and two others as alternative director candidates at the Van Dorn annual meeting; he did not circulate proxy materials but instead announced that he would attend the meeting and solicit votes only from those actually present.[211] Van Dorn's proxy materials contained no mention of the alternative nominees, nor any means of casting votes for director nominees other than those put forward by management.[212] Wyser-Pratte prepared, filed with the SEC, and circulated an informational proxy statement alerting Van Dorn shareholders to the likelihood that alternative director

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207 See id.

208 See Bradley A. Stertz, Some Holders in Chrysler Back Lutz for Chief, Wall St. J., Mar. 4, 1992, at A2.

209 See Bradley A. Stertz, Chrysler Board Plans Weekend Meeting in Continuing Search for Next Chairman, Wall St. J., Mar. 12, 1992, at A3.

210 See Bradley A. Stertz, Chrysler to Tap Eaton of GM for Top Posts, Wall St. J., Mar. 16, 1992, at A3; Bradley A. Stertz & Paul Ingrassia, How a Deadlock Led Chrysler to Go Outside for Its New Chairman, Wall St. J., Mar. 17, 1992, at A1.

211 See Henriques, supra note 168, at 15; see also Brennan, supra note 196, at A7A; Mary Lowengard, Proxy Poker, Investor Relations, July-Aug. 1992, at 11; Joan E. Rigdon, Van Dorn Appoints Panel to Consider Sale of Company, Wall St. J., Aug. 10, 1992, at C8; Gabriella Stern, Van Dorn Sees Possible Loss of a Board Seat, Wall St. J., May 4, 1992, at B13B; Van Dorn Co., Wall St. J., July 28, 1992, at A4.

212 See Notice of 1992 Annual Meeting of Shareholders and Proxy Statement of Van Dorn Company (Mar. 30, 1992) (on file with author).

candidates would be proposed at the meeting and that shareholders could only vote for these candidates by attending the meeting.[213] The result of this solicitation was the election of one dissident director at the meeting in May.[214] This may represent the first modern solicitation undertaken purely for informational purposes—to alert shareholders to information that could ensure a more efficient outcome—without collecting any votes.[215]

4. *Private Negotiations*

Residing at the opposite end of the spectrum from the formal proxy challenge is the most informal type of political activity, private negotiation between investors and management. As in the public-sector political process, such negotiations provide the most efficient and effective starting point for influencing the policies of incumbents. Negotiations provide an opportunity for all parties to gauge one another's flexibility, expertise, and "real intentions." Like negotiations between elected representatives and lobbyists, moreover, such overtures by investors carry weight, because the threat of a public campaign is always lurking should no compromise be found.

Once again, CalPERS provides a prominent example of the rise of private negotiations in the corporate governance process. CalPERS began its 1991-1992 program by requesting formal meetings with its twelve target companies,[216] which were not at that time publicly identified. These meetings focused on substantive matters of corporate policy. Companies that were receptive ultimately found that they were accorded positive recognition for their willingness to respond when CalPERS went public with its targets; recalcitrant managements, on the other hand, became the subjects of heightened pressure.[217] A series of other private negotiations involving a number of other funds has also occurred in the past year; in fact, several have been instigated not by the fund but by management.[218]

A variety of other approaches to negotiation are now being pursued by other active investors and institutions. Indeed, the phenomenon is

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213 See Solicitation by Guy P. Wyser-Pratte in Opposition to the Board of Directors of Van Dorn Company (Apr. 1992) (on file with author).

214 See Stern, supra note 211, at B13B.

215 See Georgeson & Co., Proxy Contest Studies (1980-1990) (on file with author).

216 See Dobrzynski, supra note 206, at 44; text accompanying notes 206-07 supra.

217 See Dobrzynski, supra note 206, at 44.

218 This information was gleaned from a number of personal conversations I have had with representatives of public funds and money managers. For example, the Colorado Public Employees Retirement System received a visit from American Express's CEO after it announced its intention to withhold its votes from the incumbent board candidates in protest over continued poor performance.

widespread—far more so than one would think from public reports—precisely because the goal is in part to keep the process private and thereby foster a more constructive relationship with management. Concrete examples tend to be found in situations which involve some attendant public disclosure. In 1993, for example, Taylor & Co. and entities affiliated with the Bass family indicated in a Schedule 13D filing that they sought changes in corporate governance structure and board composition at Beckman Instruments.[219] They indicated that they had proposed that Beckman add new board members in consultation with shareholders, initiate an improved shareholder communication process, and appoint a board committee to examine corporate governance issues.[220] Shortly thereafter, the board issued an announcement that it would pursue all three reforms. Quiet, substantive communications continued thereafter between the parties.[221]

5. *Institutional Voting Policies*

Further evidence also indicating the rising importance of the political model is the effort made by leading institutions to improve their voting sophistication on passive issues. Several leading funds, including the New York State Common Retirement Fund and CalPERS, have pursued ambitious campaigns to develop "smart" voting systems.[222] In a "smart" voting system, the economic performance of the target company is formally factored into voting decisions on directors, stock options, charter amendment proposals, and other such issues. The New York State Common Retirement Fund has developed a screening system to isolate firms with poor performance that will not receive its support. CalPERS has developed a similar system and complemented it with detailed analyses of subject companies, allowing it to determine a voting position on specific issues with even greater precision. Such systems offer the prospect that market tests will become increasingly prevalent in the voting arena.

6. *Management Response to Political Techniques*

The proliferation of these political techniques in the corporate governance arena has begun to generate a significant shift in the attitudes and practices of incumbents, and has created a new dynamic in the relationship between investors and corporations. Managers and directors are

219 See Randall Smith, Bass-Led Group Seeks the Appointment of New Directors to Board of Beckman, Wall St. J., Dec. 24, 1992, at A3.

220 See id.

221 This information, and other information concerning negotiations by active investors, has been gleaned from my experience working with these entities.

222 I have been involved in the development of several of these systems for major institutions.

beginning to recognize the need to adapt corporate governance structures to respond more proactively to the suggestions of their investors. The result is a significant departure from the past model of investor relations, which largely consisted of defensive moves by boards of directors designed to keep tabs on stock movements and to alert management if "undesirable" investors appeared to be accumulating positions in the corporation's stock. In the new environment, corporations are implementing structures that allow them to seek the input of major institutions and channel it to the highest levels of the corporation.

A particularly striking example of this can be found at the Lockheed Corporation. In response to dissident investor Harold Simmons, Lockheed CEO Daniel Tellep instituted a new investor-relations process centered around an "investor ombudsman," whose job it is to meet regularly with major institutional investors, canvass their opinions on broad matters of corporate policy, and channel that feedback to the CEO and the board. In the past two years, Lockheed's investor-relations process has successfully ventured into new territory. For example, Lockheed polled shareholders on their preferences regarding the financing of the company's repurchase program and ultimately implemented the solution that most shareholders favored.[223] The Lockheed example is a clear harbinger of the direction of corporate relations between investors and boards of directors in the next decade.

Further evidence of the increasing emphasis by corporations on a political response can be found in recent years. In July 1992, Ceridian Corporation (formerly Control Data Corporation) announced that it would hold a board meeting to which it would invite its top ten institutional shareholders.[224] In May 1992, CalPERS hosted a dinner to honor five corporations that had implemented newly receptive, forward-looking approaches in dealing with their major shareholders.[225] Both of these events signal the increasing openness of corporations to a political model of governance and demonstrate that this involvement need not be confrontational. Rather, when managements accept the need for greater shareholder input, they effectively help to develop an "early warning system" that can forestall widespread investor dissatisfaction.

223 Lockheed's current ombudsman, Walter E. Skowronski, has described the program in various presentations which I have attended.

224 See Investor Responsibility Research Center, Corporate Governance Highlights, July 17, 1992, at 2; see also Lawrence Perlman, A Perspective on the New Shareholder Activism, J. Applied Corp. Fin., Summer 1993, at 35.

225 This dinner, described in Pound, supra note 15, at A10, was held at the CalPERS offices on May 19, 1992.

7. *The New Dynamics Between Large Investors and Large Corporations*

A remarkable series of events in the past several years illustrates the new dynamics between large investors and large corporations. These examples incorporate and integrate all of the specific elements of the political model that I set forth in Sections 1-6 above. But, as the evidence shows, the whole is greater than the sum of its parts. What is beginning to happen is a fundamental shift in the psychology of board members and the broad textual relationship between investors and corporations.

The most vivid evidence of the shift is found in the dramatic and widely chronicled series of events occurring at large American corporations over the past two years. In a remarkable and unprecedented number of cases, boards of directors have made sudden changes to corporate policy and direction, including replacing a lagging CEO.[226] The roster of companies adopting such changes includes companies that had underperformed for years before board activism suddenly induced change. Examples include General Motors, IBM, Westinghouse, Eastman Kodak, Sears, and many others.[227]

In every one of these cases, evidence and commentary by participants indicate that a primary catalyst for enhanced board effectiveness was quiet, but persistent, pressure from major institutional investors.[228] This pressure was manifested in many ways, all consistent with the tactics of the political model as described above. Yet in each case the precise approach was different.

At Westinghouse, for example, a series of major institutions and the Council of Institutional Investors, acting independently, requested meetings with Westinghouse's CEO and board. A large number of shareholder proposals were also submitted to the company for inclusion in its proxy, suggesting changes in corporate governance structure. The Westinghouse board responded by meeting with institutions,[229] initiating corporate governance reforms,[230] and ultimately replacing the company's CEO in pursuit of improved performance.[231]

American Express felt the influence of institutions more directly. After generalized institutional prodding moved the board towards relieving long-term chairman and CEO James Robinson of his duties, Robin-

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226 See text accompanying notes 229-33 infra.

227 See note 6 supra.

228 See Leslie Wayne, Shareholders Exercise New Power with Nation's Biggest Companies, N.Y. Times, Feb. 1, 1993, at A1, D5.

229 See id., at D5.

230 See id.

231 See John Pound, Westinghouse Lights Boardroom Path, Wall St. J., Dec. 11, 1992, at A12.

son fought hard to retain his title as chairman and an ongoing role for himself in the corporation. When the board showed signs of wavering,[232] several of American Express's large investors—members of the money management community—called a quiet breakfast meeting with Robinson's replacement as CEO, Harvey Golub, to register their opposition. Within days Robinson decided to resign as chairman.[233]

It should be evident to virtually any observer who follows the business press that these and other similar recent events have had significant cumulative effects on the dynamics of corporate governance. These effects are once again consistent with the predictions of the political model. Political strategies have made it possible for large, long-term institutional investors to place broad pressure on the boards of these underperforming companies and thereby engender change. Such changes have led to intense scrutiny by the public and the press and raised awareness among a much broader constituency of both investors and directors. Now, most individuals who sit on the boards of large corporations would state, if asked, that they are much more cognizant of their duties as directors and of the wishes of their shareholders.

Once again the analogy to the public-sector political process is apposite. When democracy works—particularly when it is successful at engendering change—the process is self-reinforcing. Evidence that citizens have had success in influencing policy makes incumbent officials more concerned about public opinion and galvanizes more citizens to action. An obvious example is the American civil rights movement. As the movement scored successes—incremental successes that often came at a high price—the confidence of its members was strengthened, the reach of its membership grew, and the sensitivity of public officials increased. The result, ultimately, was a mounting stream of events that broke into a flood of change that, in its wake, left a fundamentally altered dynamic that pervades American society.[234]

A similar dynamic has prevailed in corporate governance over the past ten years, and the ultimate result is the entrenchment of the political model. Like change in the public sector, the evolution of the political model has been incremental, proceeding on a trial-and-error basis with

232 See Steven Lipin, Three Directors at American Express Resign After Failing to Oust Chairman, Wall St. J., Jan. 28, 1993, at B3; Peter Pae et al., Defeating Board Foes, Robinson, Golub Win at American Express, Wall St. J., Jan. 26, 1993, at A1.

233 See Allen R. Myerson, American Express Chairman Quits After Days of Corporate Turmoil, N.Y. Times, Jan. 31, 1993, at 32; Allen R. Myerson, American Express: Try, Try Again, N.Y. Times, Feb. 1, 1993, at D1; American Express Defends Past and Looks to Future, N.Y. Times, Feb. 2, 1993, at D1.

234 See generally Taylor Branch, Parting the Waters: America in the King Years, 1954-1963 (1988) (recounting the civil rights movement led by Dr. Martin Luther King, Jr. and its impact on U.S. society).

the help of an expanding coalition of believers. One can argue that economists have been unreceptive to the political model's development in part because this process of evolution is so antithetical to their theories of market efficiency. In the economist's mind, the world is an equilibrium phenomenon in which "efficient" mechanisms quickly achieve dominance and prevail. But in fact, corporate governance is a world not simply of transactions, but also of politics and psychology where relationships between directors, managers, and investors are critically important. Such a world evolves slowly and imperfectly in response to changing incentives, codes of behavior, and accepted norms. The evidence presented in this Part demonstrates that such change has been occurring.

IV
THE POLITICAL MODEL VERSUS OTHER REFORMS

As the corporate governance landscape has shifted in the past few years, new suggestions for reform of the governance process have, not surprisingly, proliferated. Many suggestions are consistent with the political model described in this Article. These include, for example, Professors Ronald Gilson's and Reiner Kraakman's proposal for professional outside directors,[235] and Professor Joseph Grundfest's proposal that institutions "just vote no" for directors at underperforming companies.[236]

Other proposals, however, have been advanced to a greater or lesser degree as alternatives to renewed insurgent oversight activities by outside shareholders. Because they are cast as alternatives to direct shareholder action, these proposals deserve analysis in the context of the political paradigm articulated here. This Part analyzes three major proposals that have received considerable attention and assesses how each fits within the political paradigm.

A. Politics Versus a "Good Board of Directors"

A common proposal is that boards of directors be reformed to "work" in the manner initially envisioned by corporate law. Some commentators have advocated a greater sensitivity on the part of boards to the expectations of society that they will perform their duties carefully and thoroughly, perhaps motivated by stricter legal oversight.[237] Others,

[235] See generally Gilson & Kraakman, supra note 9.

[236] See generally Grundfest, supra note 194.

[237] See, e.g., William T. Allen, Corporate Directors in the Dawning Age of Post-Managerialism, Address at the Stanford University Center for Economic Policy Research Conference on Coporate Governance (May 1, 1992).

like Lipton and Lorsch, have argued that corporations should adopt a series of voluntary reforms to the board and the manner in which it interacts with shareholders.[238] Examples are smaller boards and regular meetings with top shareholders, better incentives for directors, and more frequent meetings.[239]

The goal of more effective boards is clearly not in conflict with the political model. Indeed, an effective board is in a real sense the fundamental goal of the political model, and, as I have just described, most political initiatives are ultimately aimed at making a board of directors more effective and responsive. The distinguishing feature of several recent board reform proposals, however, is that they argue for proactive reform by corporations and either explicitly or implicitly discourage initiatives by outside shareholders to accomplish these same goals. Lipton and Lorsch's proposal, for example, suggests that boards, once properly formulated, can be sufficiently powerful, independent, and expert to adequately guard shareholders' interests.[240] Lipton, in fact, has argued that outside pressure is often undesirable because it places unpleasant and destabilizing pressure on the board that may preclude thoughtful board- and corporation-instituted reform.[241]

There is a significant problem with the argument that boards should be left to reform themselves. It fails to recognize the clear suggestion of anecdotal and empirical evidence: that boards cannot be effective without sufficient pressure from outside the corporation. Historically, the board has been perhaps the most maligned player in the corporate governance process. Observers from the early eighteenth century to the present have argued that boards simply do not do their jobs effectively.[242] Empirical evidence corroborates the frequent weaknesses of the board mechanism absent a potential threat of pressure from shareholders, despite the many attempts by the SEC, the New York Stock Exchange, and other organizations to enforce adequate board conduct.[243]

238 See Lipton & Lorsch, supra note 10, at 6-8.

239 See id. at 14-28.

240 See id. at 28.

241 Lipton and Lorsch presented their suggestions for improving board operation during a panel discussion of the Subcouncil on Corporate Governance and Financial Markets of the Competitiveness Policy Council, held on August 5, 1992 at the General Mills headquarters in Minneapolis, MN. In response to a question from another panel member, Mr. Lipton commented that it was destabilizing and distracting when public funds such as CalPERS wrote to CEOs and board members complaining about performance. The notion is that boards must reform themselves and that outside shareholder pressure is never a good thing, even if it is directed toward improved performance and positive reforms.

242 For early commentary, see generally J. Ayer, supra note 19; Distrust of Corporate Management, supra note 22, at 4. In addition, Business Week and Fortune magazines have recently commented to this effect. See generally Mageret, supra note 24; Treece, supra note 24.

243 Organizational theorists who have studied boards from the inside provide a convincing

It is worth emphasizing the several problems that inherently preclude boards from being fully effective without at least some potential of outside shareholder activism or pressure. First, whatever the quality of board members, there will be no means of enforcing the bargain outside of a political process. To suggest that boards should be vigorous and that shareholders should therefore remain passive is similar to the suggestion that democracy could work well without elections.

Second, no matter how well-intentioned board members are, sociological and psychological forces cause boards to coalesce behind the CEO in the absence of countervailing pressure from outside the corporation. Boards function as small groups of individuals working together over extended periods of time. It has been long-documented in clinical psychology that small groups of individuals subconsciously arrive at consensus when attacking joint problems, even when they are not aware of this convergence.[244] Individuals in groups tend to find (often to their own surprise) that they think alike, despite differences in background and training. The subconscious propensity toward consensus is perhaps the strongest pressure that keeps members of corporate boards from asking

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collection of evidence on the shortcomings of boards. See generally, e.g., Jay W. Lorsch, Pawns or Potentates: The Reality of America's Corporate Boards (1989). Generations of earlier work echo the same themes. See generally, e.g., Stanley C. Vance, The Corporate Director: A Critical Evaluation (1968). Economists studying board operation purport to have found that outside directors "work" as a solution. See generally, e.g., Stuart Rosenstein & Jeffrey G. Wyatt, Outside Directors, Board Independence, and Shareholder Wealth, 26 J. Fin. Econ. 175 (1990); Michael S. Weisbach, Outside Directors and CEO Turnover, 20 J. Fin. Econ. 431 (1988). However, the evidence is not very convincing. The former study shows that the announcement of new outside board members results in a minuscule but statistically significant increase in stock prices; the latter shows that poorly performing firms are marginally more likely to change CEOs when outsiders constitute a majority on the board. This hardly answers the relevant question here: how well do boards work overall, relative to how they could and should work? Why then, for example, has it taken the GM and IBM boards over a decade to institute change?

244 The subconscious tendency toward consensus on boards is difficult to overemphasize. In a pioneering study, groups of individuals were placed in a darkened room and then were asked to observe a point of light emitting from a source five meters away. They were told that the point of light would move and were asked to give verbal estimates of how much it moved. In fact, the point of light did not move at all. Nonetheless, in the darkened environment, without a frame of reference, individuals perceived that it did indeed move. Within groups of individuals, answers converged closely around a single value. Across groups, answers diverged. Individuals questioned about their answers afterward displayed no awareness that they had been influenced by the others in the group. See Muzafer Sherif, An Experimental Approach to the Study of Attitudes, 1 Sociometry 90 (1937). A stream of research followed, similarly finding that individuals could be swayed from their intrinsic opinions by group opinion. See, e.g., Solomon E. Asch, Social Psychology (1952). The critical point of studies of boards of directors is not only that opinions tend to converge, but that the convergence is subconscious. Thus, it may be wrong to argue that a board of directors which endorses unpopular corporate policies is "being loyal" to the CEO in any conscious sense or because of poor incentives. Instead, what looks like "loyalty" may be the result of the subconscious social pressures that operate within a group.

hard questions or criticizing an existing policy.

To be sure, boards sometimes do provide effective monitoring. An example is the abrupt decision of the Compaq board to fire Rod Canion, the company's CEO, in the face of competitive difficulties in 1991.[245] It is notable that the Compaq board had some of the structural characteristics that commentators like Lipton and Lorsch argue are important, such as an independent chairman who is a significant stockholder in the company.[246] Also notable is the computer industry in which Compaq operates. Whatever their defects, boards may be more effective—and indeed the best available line of defense—in industries with complex information structures. In such industries, it may be difficult for outside shareholders to determine accurately what is going on, and hence an energized board may be the only really effective corporate governance safeguard.[247]

Seen in the broadest light, however, the political model of oversight is a necessary prerequisite to, not a substitute for, an improved board of directors. The problems that prevent the board from being an effective elected body—the lack of credible, periodic voting challenges, the lack of incentives, the lack of information other than that provided by management, and the tendency for small group dynamics to overwhelm individual judgment—can be addressed through informal political initiatives. Through the political process, shareholders can present alternative agendas and vigorously demonstrate shareholder support. Just like a large public demonstration in support of or in opposition to a specific policy in the public sector, this activism substantially influences the actions of board members by counteracting peer-group pressure for consensus. Political action thus offers a channel for feedback about corporate performance that *empowers* outside directors, allowing them to discharge their duties more effectively as the guardians of shareholders' interests.

B. Politics Versus "Better Incentives"

A second alternative to the political model suggested by many economists is strengthened incentives for management and the board. If management has the right incentives, the argument goes, it will make the right decisions. Some observers argue that precise, scientifically determined incentives are much better than messy and distracting pluralistic

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[245] See Jim Bartimo & Karen Blumenthal, Compaq's Canion Is Unexpected Casualty of the Brutal Personal Computer Wars, Wall St. J., Oct. 28, 1991, at B1.

[246] See generally Lipton & Lorsch, supra note 10 (arguing for variety of reforms to increase power of outside directors).

[247] See Richard Zeckhauser & John Pound, Are Large Shareholders Effective Monitors? An Investigation of Share Ownership and Corporate Performance, in Asymmetric Information, Corporate Finance, and Investment 151, 152 (R. Glenn Hubbard ed., 1990) (arguing that large shareholders can only add value at companies where the information structure is not too complex and "opaque").

debates over corporate policy.[248]

The pure incentive model might seem like the most natural linchpin of a governance system; the theory that good incentives lead to good decisions is powerful and compelling. The reality, however, has proven less so. Common sense suggests that incentives are no substitute for a vigorous process of democratic governance in which shareholders are free to engage in a wide-ranging, substantive debate about corporate policies.[249]

The first problem with the incentives argument is the intrinsic fallacy that incentives can be accurately established and enforced without independent oversight. It is hard to maintain an optimal mix of incentives if management has the unilateral power to establish its own system of rewards and penalties. Yet that is effectively what some economists propose when they suggest that the political oversight and shareholder involvement are unnecessary "once" incentives are set properly. This is a classic chicken-and-egg problem. Who sets efficient incentives for management (thereby eliminating the need for shareholder input) if shareholders cannot have input in setting the incentives?

Moreover, even if incentives are set correctly and enforced ex post, there are additional reasons why alone they are simply insufficient to ensure effective corporate governance. One reason stems from the observation that most major corporate performance shortfalls do not result from calculated decisions to pursue nonmaximizing objectives, but rather from genuine mistakes in a fast-changing, competitive environment. In a world in which corporate governance must address well-intentioned but misguided policies, incentives alone cannot ensure maximizing results.

An additional problem with incentives is that there are long-term interactions between incentives and wealth which are not well understood. For a successful manager, today's incentive system may become tomorrow's wealth cushion. At some point, most managers become wealth-satiated and pursue nonmaximizing objectives despite the drag on their own wealth. This may suit the individual manager, but it is

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248 For an example of the general argument for improved management incentives, see Michael C. Jensen & Kevin J. Murphy, CEO Incentives—It's Not How Much You Pay, But How, 90 Harv. Bus. Rev., May-June 1990, at 138. For a discussion of the idea that incentives are preferable to a political approach, see Myron Scholes, Executive Compensation, Address at the Stanford University Center for Economic Policy Research Conference on Corporate Governance (May 1, 1992).

249 It is interesting to note the longstanding nature of the debate and evidence on the inadequacy of incentives. Compare, for example, Michael C. Jensen & Kevin J. Murphy, Performance Pay and Top-Management Incentives, 98 J. Pol. Econ. 225, 262 (1990) (describing current system in which pay fluctuates only small amounts with performance) with John C. Baker & William L. Crum, Compensation of Corporation Executives—The 1928-1932 Record, Harv. Bus. Rev., Spring 1935, at 321, 333 (finding that compensation of executives during Depression did not decline as sharply as wages or dividends).

hardly optimal for the corporation if it results in inefficient resource allocation.[250]

A final problem with the incentive model is that improved incentives, when attained through stock ownership, at some point also create heightened insulation from market forces. This creates more, rather than less, room for a wealth-satiated manager either to make mistakes or to pursue nonmaximizing objectives without being subjected to outside pressure. Empirical evidence documents that when insider ownership is greater than twenty-five percent, valuation appears to decrease rather than increase, indicating that enhanced protection, not heightened incentives, is the dominant effect.[251]

Recent research shows that high ownership levels by board members—which should theoretically create good incentives—are a mixed blessing. One study shows that when board members who are large shareholders die, the result is an immediate value increase and usually a change in control.[252] This strongly suggests that the large owner in most cases was not contributing to value maximization.

What then of the body of work that purports to link changes in incentives structure, particularly leveraged buyouts, to increased performance? With the benefit of some hindsight, much of that work now appears to suggest that success was tied to simple organizational changes, such as a more effective board and capital budgeting process, and to the injection of good new managers. For example, Jensen has spoken of the organizational innovation represented by the LBO partnership; it is clearly this organization and the transfer of assets to new individuals, rather than pure incentives alone, that matters.[253] The most respected LBO practitioners have made the same point, and indeed some have indicated that they do not regard compensation structure as the primary determinant of performance. Gordon Cain, for example, has expressed the opinion that good people will do their best no matter how or what they are paid; their motive is personal pride.[254] At most, he argued, compensation packages are useful as a screening device when recruiting a new management team: the right individuals will have a preference for an

250 See generally Myron B. Slovin & Marie E. Sushka, Ownership Concentration, Corporate Control Activity, and Firm Value: Evidence from the Death of Inside Blockholders, 48 J. Fin. 1293, 1295-96 (1993) (discussing studies which conclude that increased concentration of insider ownership ultimately reduces firm value).

251 See, e.g., John J. McConnell & Henri Servaes, Additional Evidence on Equity Ownership and Corporate Value, 27 J. Fin. Econ. 595 (1990); Randall Morck et al., Management Ownership and Market Valuation: An Empirical Analysis, 20 J. Fin. Econ. 293 (1988).

252 See Slovin & Sushka, supra note 250, at 293-94.

253 See Jensen, supra note 5.

254 See Gordon Cain, Remarks at the Stanford University Center for Economic Policy Research Conference on Corporate Governance (May 1, 1992).

incentive-compatible compensation structure.[255]

Thus, as with the argument for "more effective" corporate boards, "better incentives" are not substitutes for an effective political oversight process. Rather, they are constructive complements to the political model. Incentives are a desirable, if not sufficient, component of the governance system: one important goal of the political process must be to ensure that managers have the right incentives. But without active shareholders and vigorous outside monitoring, there is simply no way to ensure that incentives will be properly set and enforced. The political system offers the right mechanism both to set incentives and to void compensation contracts that are irrational, outsized, or just plain inappropriate.

C. Politics Versus "Relationship Investing"

A third monitoring mechanism that has received much attention of late is the large, long-term, friendly blockholder. An increasingly used term of art is "relationship investing," a coinage that reflects the notion that these investors are not passive or disconnected, but instead work in partnership with management. A number of commentators have argued that "relationship investing" and relationships involving "patient capital" should be sought in the U.S. market.[256]

Once again, this proposal is consonant with a political model at one level, since the relationship investor can be seen as a kind of political monitor. Within the political spectrum described in Part III.B, relationship investing substitutes quiet, long-term negotiations and a "friendly" approach for more public, acrimonious debate. Some proponents, including Ira Millstein, argue for this approach, essentially urging institutional investors to concentrate on fewer portfolio firms and develop serious, substantive relationships that add value over time.[257]

But other proponents give relationship investing a quite different spin. They argue that the United States should pursue relationship investing in the mold of Germany and Japan, in which relationship investors have tight, long-term contractual relationships with corporations which effectively allow these corporations to eschew short-term value considerations. Such relationships, it is argued, promote corporate success because they allow management to ignore broad market signals and the wishes of other shareholders. Those promoting this approach maintain that such signals are misleading and confusing and that the relation-

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[255] See id.

[256] See, e.g., Louis Lowenstein, Sense and Nonsense in Corporate Finance 237 (1991).

[257] See generally Millstein, supra note 11 (arguing for streamlined portfolios that emphasize meaningful relations with fewer firms). An example is the Soros fund. See Jack Egan, The Makeover Man, 90's Style, U.S. News & World Rep., Aug. 17, 1992, at 62.

ship investor promotes stability by offering protection from confrontation, thereby allowing management to concentrate on strategic planning.[258]

The reality is that this kind of relationship investing has not fared well in the U.S. market. First, there has not been much of it in comparison to many other countries, including Germany and Japan. Second, the relationship investing that has occurred has had at best a mixed record. Recent evidence shows that relationship investing can sometimes add to value, but that such investments do so less often than investments that are not fully friendly and negotiated.[259] While nonnegotiated investments—which can of course lead to friendly dynamics—consistently beat the market, negotiated block investments only equal the market in long-run return.[260]

This record suggests some obvious problems with the negotiated relationship investing model. For starters, the model is predicated on the injection of one or two new investor-board members and does not significantly expand the number of perspectives that are brought to bear on corporate decisions, as does the political model. By potentially locking up control, it may in fact guarantee that other views, which may predominate in the market, will not be heard in the boardroom.[261] Second, the friendly, cozy relations between the relationship investor and the corporation means that, over time, it may be that the relationship investor will exhibit the same convergence of views that is found on the corporate board.[262]

A third problem with the relationship investing model is the potential for conflicts of interest. These range from preferential treatment in the conduct of business to preferential treatment in the investment deal itself. A number of observers have criticized some of Warren Buffett's recent investments because they involved preferred instruments that

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258 See, e.g., Michael Porter, Remarks at the Securities and Exchange Commission Conference on Corporate Governance and American Competitiveness (Mar. 20, 1992). Porter argued that the American stock markets undervalue long-term research and that American executives must essentially find ways to ignore the signals sent by capital markets. This view is inconsistent with market valuation of long-term oriented companies such as Microsoft, as well as with the available empirical research on market response to long-term oriented projects such as research and development expenditures. See, e.g., Office of the Chief Economist, SEC, Institutional Ownership, Tender Offers, and Long Term Investments (Apr. 19, 1985) (showing stock-price increase in response to announcements of increased research and development spending).

259 See generally Gordon & Pound, supra note 118, at 3.

260 See id. at 4.

261 Indeed, many relationship investments appear to be made primarily to protect management. Such was rumored to be the motive surrounding Warren Buffett's investment in USAir. See Scott Kilman, USAir Sells Shares Equaling 12% Stake to Berkshire Hathaway for $358 Million, Wall St. J., Aug. 8, 1989, at A3.

262 See text accompanying note 244 supra.

guaranteed a healthy return regardless of monitoring or the treatment of common shareholders.[263]

The relative dearth of negotiated relationship investments may reflect the seriousness of these problems, and the resulting truth is that the relationship investing model has not been demonstrated to pass the market test. The economic failure of tightly drawn, negotiated relationship investing would also explain the series of regulations that has arisen to prevent various financial intermediaries (such as banks, who are particularly likely to be conflicted) from pursuing such investments.[264]

Why the predominance and apparent success of relationship investing elsewhere if it is a failure in this market? One interesting possibility that has been advanced by several authors is that relationship investing in Japan and Germany has been misinterpreted. In one view, the German and Japanese structures have been the products of small economies, underdeveloped capital markets, and a lack of free cash flow, and therefore have not experienced the kind of problems that occur with relationship investing in the United States.[265] A second, complementary view is that relationship investing patterns in these countries were not provoked by and do not accomplish the job of monitoring, but rather are the result of a different concept of industrial structure.[266] It is thus incorrect to tie the success of these economies to these apparent patterns because they do not have the same meaning that U.S. analysts would attach to them.[267]

In any event, the political process offers the benefits of relationship investing without its overly cozy long-term relationships and its potential for self-dealing. It is possible to pursue relationship investing predicated on expert involvement with portfolio companies and long-term investments but not predicated exclusively on friendliness with incumbent management. Such close ties to management may not be appropriate for

263 See, e.g., Linda Sandler, Buffett's Savior Role Lands Him Deals Other Holders Can't Get, Wall St. J., Aug. 14, 1989, at C1 (documenting suspicions of favorable treatment with respect to Buffett's investments).

264 See Jensen, supra note 5, at 65-66; Roe, A Political Theory, supra note 84, at 16-31. Of course, in and of themselves these regulations do not seem to provide a convincing explanation for the paucity of relationship investing. The argument that other factors are involved has been made by, among others, Jensen, supra note 5, at 66, Roe, A Political Theory, supra note 84, at 32, and Grundfest, supra note 84, at 90-92. If relationship investing offered the promise of great long-term profits, other mechanisms could be found. Expert entrepreneurs committed to relationship investing could pursue their activities through other organizational forms that were not subject to regulatory and legal restrictions. This is indeed what Warren Buffett, America's premier relationship investor, has done, working through Berkshire Hathaway. See Jensen, supra note 5, at 65.

265 See Jensen, supra note 5, at 73-74.

266 See Ronald J. Gilson & Mark J. Roe, Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization, 102 Yale L.J. 871, 880-81 (1993).

267 See id. at 880.

a true monitor. Nonnegotiated investments can be friendly and lead to long-term dialogue and constructive engagement about corporate strategy. Many investors can, through the political process, pursue variants of the relationship investing ideal along the evolutionary lines advocated by Millstein.[268] In contrast, economic reasoning suggests that few benefits are to be gained from the strict, standstill contracts that give management the freedom to disregard broad market signals completely.

Conclusion

For the first time in approximately thirty-five years, the debate over corporate governance no longer revolves around the hostile tender offer. Rather, the debate has shifted to focus on how best to monitor and improve corporate performance over the long term. It hardly bears emphasizing that this shift is a healthy one from the viewpoint of economics, rhetoric, and policy. The move away from tender offers has been prompted by a profound change in the corporate governance landscape. Hostile takeovers have diminished in number; new laws have made full-control challenges difficult and expensive. Concurrently, a rising concentration of institutional ownership has profoundly altered the incentives for participants in the corporate governance arena.

This Article has argued that what is transpiring in the corporate governance arena can be understood in terms of a simple paradigm. The market- and transactions-based approach to governance is being supplanted, and to a significant degree replaced, by a process that I have termed "political." This political model of governance revolves around voting power—the ability of shareholders to bring limited voting challenges, particularly for board representation, through the proxy process. But the political process is a much broader and more organic form of governance than is suggested by shareholders' limited statutory voting rights. Like oversight in public-sector democratic politics, the political approach to corporate oversight involves a wide range of activities through which corporate constituents can influence their elected representatives and lobby for change. The rise of institutional investors makes this political approach possible by concentrating the shareholder base into a core group of informed actors who are willing and able to play the role of active lobbyists.

I have argued that the political process is not an arid prediction but rather an emergent reality. Empirical evidence illustrates that corporations and investors are quickly developing political approaches to communication and oversight through which long-term constituents make their views known and through which their elected representatives can

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268 See generally Millstein, supra note 11.

change policy when necessary. The remarkable increase in political activity in the recent proxy seasons suggests that a critical mass of momentum in favor of the political system has been reached, and that change will occur with remarkable speed in the next few years.

Ultimately, the new process offers an opportunity to establish a corporate governance system that embodies the best hopes of scholars and experts in the history of the American market. The system can provide large, informed shareholders with new means to bring limited pressure to bear on corporate boards and thereby empower board members to represent their constituents. The process offers a sustainable solution to a set of problems that are themselves political, as well as economic. In doing so it promises an approach to governance that is in keeping, perhaps for the first time, with the basic dictates of American political norms and cultural values.

In order for the process to move forward, one important facet of the political process needs to evolve. That is a renewed tolerance for insurgency in the corporate sector. The takeover movement of the past several decades created a pervasive backlash against insurgency—and indeed a deep suspicion of anyone playing the role of the insurgent. Yet insurgency, contention, and debate are fundamental to effective corporate governance, just as they are to governance in the public sector. If the political model is to mature to dominance in the corporate sector, a similar understanding of the benefits of insurgency must reemerge.

Such tolerance—and indeed, enthusiasm—for insurgency was present throughout most of American corporate history prior to the peak of hostile tender offers in the 1980s. With the disappearance of takeovers and the rise of substantive, issue-based governance, it is likely that the benefits of insurgency will once again be recognized, providing the necessary backdrop for a vigorous, pluralistic approach to corporate oversight.