THE POLITICS OF CORPORATE GOVERNANCE

A review of STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE. *By Mark J. Roe.*

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The 1932 publication of Berle and Means's THE MODERN CORPORATION AND PRIVATE PROPERTY began the modern era of corporate governance scholarship.[1] Berle and Means demonstrated that public corporations were characterized by a separation of ownership and control: the firm's nominal owners, the shareholders, exercised virtually no control over either day-to-day operations or long-term policy. Instead, control was vested

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1. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

in the hands of professional managers, who typically owned only a small portion of the firm's shares.[2]

Separation of ownership and control occurred, according to Berle and Means, because stock ownership was dispersed amongst many shareholders, no one of whom owned enough shares to materially affect the corporation's management.[3] Berle and Means believed that dispersed ownership was "inherent in the corporate system."[4] Important technological changes during the decades preceding publication of their work, especially the development of modern mass production techniques, gave great advantages to firms large enough to achieve economies of scale, which in turn gave rise to giant industrial corporations.[5] These firms required enormous amounts of capital, far exceeding the resources of any single individual or family.[6] Only the aggregation of many smaller investments, accomplished by selling shares to investors, could finance these industrial giants.[7]

Virtually all post-Berle and Means scholarship assumed the separation of ownership and control to be an inevitable feature of public corporations. Until quite recently, little serious attention was paid to the prospect of reuniting ownership and control. Instead, the academy focused on the consequences of their separation. Modern scholars refer to the consequences of the separation of control from ownership as agency costs,[8] but Berle and Means had identified the basic problem over forty years before the current terminology was invented: "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge."[9] Preventing such divergence, or at least minimizing its effects, has been the primary concern.

In his important new book, STRONG MANAGERS, WEAK OWNERS,[10] Professor Mark Roe strikes out in a new direction by attacking the origins of the agency cost problem, rather than

2. *Id.* at 2-5.
3. *Id.* at 47.
4. *Id.*
5. *Id.* at 24-26.
6. BERLE & MEANS, *supra* note 1, at 5.
7. *Id.* at 59.
8. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).
9. BERLE & MEANS, *supra* note 1, at 6. .
10. MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

merely seeking to treat its symptoms. The question Roe poses is whether Berle and Means were correct in assuming that the separation of ownership and control is an inherent aspect of large public corporations. Roe contends that dispersed ownership was not the inevitable consequence of impersonal economic forces, but rather the result of a series of political decisions motivated by a fear of concentrated economic power. If the legal rules flowing from those decisions had not existed, Roe opines, ownership might not have fragmented and thus might not have separated from control. The implication of this thesis, of course, is that while economic forces shaped modern corporate governance, they did so within parameters set by law. Therefore, the governance structure of U.S. public corporations may not be optimal in an absolute sense, but only relative to the set of possibilities defined by our legal system.[11]

Roe focuses on legal rules preventing institutional investors from acting as financial intermediaries between the investing public and the management of public corporations. The first third of STRONG MANAGERS is devoted to a historical review of the rules precluding institutions from playing a significant role in corporate governance. In the second section he reviews recent developments, which have perpetuated the legal obstacles to institutional activism in corporate governance. Finally, he addresses the essential policy question arising from his analysis: should the legal system encourage institutions to take a more active governance role?

Although the first two sections of STRONG MANAGERS are notable in their own right, the book takes on importance mainly because of the significance of the policy questions to which the final section is addressed. Institutional investors increasingly dominate the equity markets. They are also beginning to play a somewhat more active role in corporate governance than they had in earlier periods. All of this makes Roe's work of far more than mere historical interest, because the historical and political forces he examines continue to shape corporate governance.

In this article, I explore some of the more interesting facets of Roe's analysis, elaborating upon some areas of agreement, while highlighting some areas of disagreement. Part I of this article briefly reviews the standard economic theory of the modern

11. *Id.* at 24.

large public corporation—what we might fairly term the Berle-Means corporation. In part II, I explore the historical evidence Roe marshals in support of his thesis, principally to suggest that certain aspects of the story prove less than satisfying. Finally, in part III, I examine Roe's policy proposals.

I. The Berle-Means Corporation

Insofar as statutory corporate law is concerned, separation of ownership and control is in fact an inherent feature of the corporate governance system. Under all corporation statutes, the key players in the formal decision-making structure are the members of the board of directors. As the Delaware Code puts it, the corporation's business and affairs "shall be managed by or under the direction of a board of directors."[12] The vast majority of corporate decisions accordingly are made by the board of directors or their delegees acting alone. Shareholders essentially have no power to initiate corporate action and, moreover, are entitled to approve or disapprove very few board actions.[13] The statutory decision-making model thus is one in which the board acts and shareholders, at most, react.

To be sure, the shareholders' right to elect the board of directors can give the former de facto control even though the statute assigns de jure control to the latter. Indeed, Berle and Means found that relatively small blocks of stock could give their owners effective control of the enterprise. Berle and Means identified such firms as minority controlled corporations. These firms exhibit a partial separation of ownership and control. The dominant shareholder controls the firm, despite owning less than 50% of the outstanding voting shares, leaving the other minority shareholders without significant control power.[14] Where no such control block exists, however, Berle and Means found that con-

12. Del. Code Ann. tit. 8, § 141(a) (1988).

13. Under the Delaware Code, shareholder voting rights are essentially limited to the election of directors and approval of charter or by-law amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolutions. As a formal matter, only the election of directors and amending the by-laws do not require board approval before shareholder action is possible. *See* Del. Code Ann. tit. 8, §§ 109, 211 (1988). In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board.

14. Berle & Means, *supra* note 1, at 80-84. Majority controlled firms, in which a dominant shareholder (or group of shareholders acting together) owns more than 50% of the outstanding voting shares, likewise exhibit a partial separation of ownership and control. *Id.* at 70-72.

trol passes from the firm's shareholders to its managers.[15] Although shareholders of such firms retain the right to elect directors, management controls the election process, and thus the firm.[16] At the time they wrote, about half of the two-hundred largest U.S. corporations exhibited total separation of ownership and control.[17]

Berle and Means believed that this separation of ownership and control was both a departure from historical norms and a serious economic problem.[18] In fact, however, separation of ownership and control is a highly efficient solution to the decision-making problems faced by large corporations. The economic basis for this claim rests on Kenneth Arrow's seminal work on organizational decision-making, which described two basic decision-making structures: "consensus" and "authority."[19] Consensus is utilized where each member of the organization has identical information and interests, which permits relatively easy collective decision-making. In contrast, authority-based decision-making structures arise where team members have different interests and amounts of information. Because collective decision-making is impracticable in such settings, authority-based structures are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.

Decision-making systems in small business firms typically resemble Arrow's consensus model.[20] As firms grow in size, however, consensus-based decision-making systems become less practical. By the time we reach the Berle-Means corporation, their use becomes essentially impractical. Consider the problems faced by shareholders, who are usually assumed to be the corporate constituency with the best claim on control of the decision-making apparatus. The sheer mechanics of achieving consensus amongst thousands of decision makers preclude an active role for shareholders. Even if those mechanical obstacles could be overcome, active shareholder participation in corporate decision-

15. *Id.* at 84-90.
16. *Id.* at 86-87.
17. *Id.* at 94.
18. *See id.* at 6-7.
19. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68-70 (1974). For the seminal application of Arrow's work to corporate governance, which strongly influenced the following analysis, see Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992) [hereinafter *Two Models*].
20. *Id.* at 466-67.

making still would be precluded by the shareholders' widely divergent interests and different levels of information. True, most shareholders presumably come to the corporation with profit-making as their principal goal. Their investment time horizons, however, are likely to vary from short-term speculation to long-term buy-and-hold strategies, which in turn is likely to result in disagreements about corporate strategy.

A more important factor is the shareholders' lack of incentives to actively participate in decision-making. A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits of doing so outweigh its costs.[21] Given the length and complexity of corporate disclosure documents, the opportunity cost entailed in making informed decisions is both high and apparent. In contrast, the expected benefits of becoming informed are quite low, as most shareholders' holdings are too small to have significant effect on the vote's outcome. Shareholders of Berle-Means corporations thus are rationally apathetic.[22] Instead of exercising their voting rights, disgruntled shareholders typically adopt the so-called "Wall Street rule"—it's easier to switch than fight—and sell out. The same would be true of other corporate constituents on whose behalf claims to control of the decision-making apparatus might be made, such as employees or creditors.

The modern public corporation precisely fits Arrow's model of an authority-based decision-making structure.[23] Neither shareholders nor any other constituency have the information or the incentives necessary to make sound decisions on either operational or policy questions. Overcoming the collective action problems that prevent meaningful shareholder involvement would be difficult and costly. Rather, as Arrow predicts, shareholders will prefer to irrevocably delegate decision-making authority to some smaller group. Separating ownership and control by vesting decision-making authority in a centralized entity distinct from the shareholders is what makes the large public corporation feasible.

Unfortunately, as Berle and Means recognized, management's interests sometimes diverge from those of the firm's sharehold-

21. *See* ROBERT C. CLARK, CORPORATE LAW 391 (1986).

22. *See id.* at 390-92. The problem is compounded by the likelihood that a substantial number of shareholders will attempt to free ride on their fellow shareholders. *See id.* at 392-93; *see also infra* notes 133-36 and accompanying text.

23. *Two Models, supra* note 19, at 467-68.

ers.[24] In modern agency cost terminology, shirking by the firm's agents is an inherent consequence of organizing productive activity within a firm.[25] A sole proprietorship with no agents will internalize all costs of shirking, because the proprietor's optimal trade-off between labor and leisure is by definition the same as the firm's optimal trade-off. Agents of a firm, however, will not internalize all of the costs of shirking: the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking. The classic example is two workers who jointly lift heavy boxes into a truck.[26] The marginal productivity of each worker is very difficult to measure and their joint output cannot be easily separated into individual components. In such situations, obtaining information about a team member's productivity and appropriately rewarding each team member are very difficult and costly. In the absence of such information, however, the disutility of labor gives each team member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness.

Accordingly, an essential economic function of management is monitoring the various inputs into the team effort: management meters the marginal productivity of each team member and then takes steps to reduce shirking.[27] The question then arises: who will monitor the monitors?[28] Put another way, because managers are themselves team members, a mechanism to monitor their productivity and reduce their incentive to shirk must also be created or one ends up with a never-ending series of monitors monitoring lower level monitors. In their classic article, Professors Alchian and Demsetz solved this dilemma by consolidating the roles of ultimate monitor and residual claimant.[29] If the constituent entitled to the firm's residual income is given final monitoring authority, he is encouraged to detect and punish shirking by the firm's other inputs because his reward will vary exactly with his success as a monitor.

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24. BERLE & MEANS, *supra* note 1, at 6.

25. While the text focuses on shirking in the form of culpable cheating, the concept also refers more generally to negligence, non-negligent errors of judgment, and plain incapacity.

26. Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organizations*, 62 AM. ECON. REV. 777 (1972).

27. *Id.* at 794.

28. *Id.* at 782.

29. *Id.* at 781-83.

Unfortunately, this elegant theory breaks down precisely where it would be most useful. Because of the separation of ownership and control, it simply does not describe the modern publicly-held corporation. As the corporation's residual claimants, the shareholders should act as the firm's ultimate monitors. But while the law provides shareholders with some enforcement and electoral rights, these are reserved for fairly extraordinary situations.[30] In sum, shareholders of a public corporation have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents.

Does this mean that there is no mechanism to control management shirking in the modern corporation? No. Important constraints are provided by a variety of market forces. In addition, corporate law responded to the ineffectiveness of shareholder monitoring by establishing alternative accountability structures to punish and deter wrongdoing by firm agents. It remains true, however, that because of the separation of ownership and control the economic actors with the most at stake in the corporation's success—the residual claimants—are effectively removed from any meaningful role in assuring management accountability.

II. The Historical Evidence

Most corporate governance scholarship starts from some variant on the basic themes just recounted. Roe does not dispute that the Berle-Means corporation is an efficient response to dispersed stock ownership. Roe likewise does not dispute the importance of developing adaptive mechanisms to constrain the temptation for managerial shirking inherent in the Berle-Means corporation. What Roe does dispute is the proposition that economic production must be organized within Berle-Means corporations.

Recall that ownership and control fully separate only where stock ownership is widely dispersed. According to Strong Managers's version of economic history, dispersed ownership is a

30. Derivative suits and proxy contests, for example, constrain managerial behavior to some extent. These remedies are so costly and their outcome so uncertain that they are invoked only episodically. Moreover, many aspects of the legal rules governing these devices (such as the derivative suit demand requirement, the federal proxy regulations, and state rules governing reimbursement of expenses) seem calculated to discourage frequent recourse to them. *See Two Models, supra* note 19, at 525.

consequence of the development of large capital-intensive industrial corporations during the late-19th Century.[31] These firms, which required investments far larger than a single entrepreneur or family could provide,[32] could obtain financing only by attracting funds from many investors. Because small investors needed diversification, even very wealthy individuals limited the amount they would put at risk in any particular firm, further fragmenting share ownership. The Berle-Means corporation was the direct result of these forces.

Roe accepts this historical account, but contends that dispersed ownership was not inevitable.[33] Investments could have been channeled to the new industrial enterprises through large financial intermediaries; that is, institutional investors, such as banks, insurance companies, and mutual and pension funds.[34] Put another way, while it was necessary to aggregate and tap the savings of large numbers of individual investors to fund major industrial corporations, such aggregation could have taken place in financial institutions specifically designed to provide savings opportunities. In turn, it would have been those institutions that invested in industrial corporations.

If large financial intermediaries had arisen along side the large industrial corporations, ownership and control might not have separated or at least not to the degree present in the Berle-Means corporation. Rather, industrial corporations might have been owned by a few professional investors. Such investors might have behaved very differently than did individual investors. Because they would have owned very large blocks of shares, and would have had specialized expertise in making and monitoring investments, they likely would have had both the ability and perhaps the incentive to play a far more active role in corporate governance than do the dispersed shareholders of the Berle-Means corporation. Corporations with large blocks of stock held by institutional investors thus might have more closely resembled Alchian and Demsetz's firm, in which the residual claimants act as

31. ROE, *supra* note 10, at 3-5. As discussed below, however, there is reason to doubt the accuracy of this account. *See infra* part II.B. Roe's reliance on this economic model, moreover, causes him to underestmiate the principal risk posed by his policy recommendations. *See infra* notes 238-51 and accompanying text.

32. As Berle and Means put it, "even a Rockefeller would think twice before endeavoring to purchase a majority interest of the Standard Oil Company of Indiana." BERLE & MEANS, *supra* note 1, at 81.

33. ROE, *supra* note 10, at xiii.

34. *Id.* at xiv.

the ultimate monitor of the firm's agents, than does the classic Berle-Means corporation.

The purpose of STRONG MANAGERS is to ask why this did not happen. Roe contends that the Berle-Means corporation cannot be explained on purely economic grounds; it is not simply a Darwinian survivor of economic competition.[35] Rather, the Berle-Means corporation arose in large part because of political forces that prevented the formation of large financial intermediaries capable of exercising significant control over industrial corporations.[36]

The heart of Roe's argument is found in chapters 5 through 9 of STRONG MANAGERS, which marshal the historical evidence for his thesis.[37] It is an impressive effort, demonstrating a detailed command of a wide array of primary materials. In brief, Roe argues that politics intervened whenever it seemed likely that financial institutions would gain significant control over industrial enterprises, leading to legal rules that impeded those institutions from playing an intermediary role. Banks were kept small and localized by laws prohibiting branching and interstate banking.[38] The lack of a central bank throughout most of the 19th Century further limited the potential for bank financing of large corporations,[39] as did the New Deal banking legislation.[40] Insurers were barred from owning corporate common stock.[41] Mutual funds were unimportant until well into the 20th Century and were deterred from holding large blocks of stock in any particular firm by securities and tax regulations.[42] Private pension funds were

35. *Id.* at xiii.

36. *Id.* at xiii-xv.

37. In addition to the historical evidence, Roe uses evidence from a variety of contemporary sources to support his thesis that separation of ownership and control is a creature of politics as well of economics. One of the more intriguing examples he cites is a comparison of American corporate governance structures to those of Germany and Japan. In both of the latter, large financial intermediaries play a much more important role than they do in this country. Both have also enjoyed dramatic economic success in the post-World War II era. *See* ROE, *supra* note 10, at 169-86.

Despite the considerable attention he pays to comparative corporate governance, Roe ultimately uses his evidence in this area to make a very simple point: different politics and different histories can result in different governance systems becoming dominant. If political forces are favorable, fragmentation of financial intermediaries need not occur. *Id.* at 198-99. This merely provides additional evidence that the Berle-Means corporation is not the inevitable consequence of economic forces, and even on this score Roe acknowledges that one should not make too much of dissimilarities in governance structures. *Id.* at 169.

38. *Id.* at 54-59.

39. *Id.* at 57-59.

40. *Id.* at 94-101.

41. ROE, *supra* note 10, at 60-64, 78-91.

42. *Id.* at 102-10.

not an important source of equity capital until quite recently and are regulated in ways that give their managers little incentive to play an active corporate governance role.[43] All institutional investors were subject to securities laws that deterred the formation of large blocks of stock and precluded communication between holders of small blocks.[44] As a consequence of these rules, institutions were prevented from functioning as Alchian and Demsetz's residual claimants-ultimate monitors. Instead, individual investors were the most readily available source of financing for large industrial corporations, resulting in the dispersed stock ownership of the classic Berle-Means corporation.

A. *Is Politics Trivial?*

Throughout STRONG MANAGERS, but especially in its early chapters, there is a strong implication that Roe's so-called political paradigm is the antithesis of a prevailing conventional wisdom, which he refers to as the economic paradigm. According to Roe, the economic paradigm contends that the Berle-Means corporation would have evolved irrespective of the political and legal constraints imposed upon the market for business structures.[45] Unfortunately, this argument is a straw-man.

The point becomes abundantly clear in Roe's description of the contractarian theory of the corporation. The prevailing theory of the firm treats corporations not as an entities but as aggregates of various inputs acting together to produce goods or services.[46] Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and theoretically monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The firm is simply a legal fiction representing the complex set of contractual relationships between these inputs. In other words, the firm is not a thing, but rather a nexus or web of explicit and

43. *Id.* at 124-27, 138-43.

44. *Id.* at 273-75.

45. *See, e.g., id.* at xiii, 22-25, 53. To be sure, Roe does not deny the importance of economic factors. On the contrary, he concedes that they were "more important" to the development of the Berle-Means corporation than the political forces. *Id.* at xv. Despite these early concessions, however, the thrust of his argument sets up two conflicting paradigms, with Roe's support thrown behind the political paradigm.

46. The best introduction to nexus of contracts theory remains Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

implicit contracts establishing rights and obligations among the various inputs making up the firm.

Contractarian theory can take both normative and positive forms. As a normative matter, contractarians argue that corporate law should be comprised of default rules, from which shareholders are free to depart, rather than mandatory rules.[47] As a positive matter, contractarians contend that corporate law in fact generally is comprised of default rules. The straw-man element of Roe's description arises in his pushing the positive component of contractarian much further than even its most ardent proponents are prepared to go. According to Roe, contractarian theory fails to take into account the political forces that constrain the relationship between firms and investors,[48] because it contends that firms adjust to legal restrictions by contracting around them.[49] In response to these arguments, Roe contends that such contracts are not costless and may not provide perfect substitutes for the outlawed alternative.[50] Strikingly, however, Roe fails to cite any examples of such contractarian arguments.[51] In fact,

47. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15 (1992).

48. ROE, *supra* note 10, at 23.

49. *Id.* at 24, 208-09.

50. *Id.* at 209.

51. A variant of this argument has been made by Roe's Columbia University colleague Bernard Black. In his provocatively entitled article, *Is Corporate Law Trivial?*, from whence I borrowed the title to this section, Black argued that even though corporate law includes many mandatory rules, those laws are trivial because they are either unimportant—rules that everyone would adopt in a scheme of purely private contracting—or subject to ready evasion. Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990). Whatever the merits of his thesis, which is an issue beyond the scope of this article, Black's argument is limited to corporate law rules and, as such, says nothing about the other legal regimes with which Roe is concerned. Indeed, with respect to those regimes, Black advances a political paradigm quite similar to Roe's: "American [financial] institutions are kept passive by a complex web of federal and state rules." Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1, 5 (1992) [hereinafter *Next Steps*].

Roberta Romano has advanced an argument somewhat similar to Black's. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 90 (1993) [hereinafter GENIUS]. She concludes that "private parties are persistent in devising institutions that circumvent or minimize the effect of political constraints on economic development." *Id.* at 147. Again, however, she does not press the point so far as Roe's description of contractarian theory might lead one to expect. Among other things, she recognizes that mandatory federal laws substantially affect corporate governance. *Id.* at 91. Indeed, she elsewhere states that "the strength of banks in Germany and Japan is equally a function of their political processes as of economics." Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2030 (1993) [hereinafter *Cautionary Note*]. Much the same could also be said of Larry Ribstein, who is yet another proponent of the argument that mandatory corporate law rules are subject to evasion, but who also points out that legal rules can drive such issues as choice of organizational form. *See* Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 1019 (1993).

even strong proponents of the positive component of contractarian theory concede that "[t]he impracticality and illegality of an important contractual device may mean that the contracts actually adopted are not optimal."[52]

Not only does the dichotomy between the economic and political paradigms turn out to be a straw-man, it also turns out that a political interpretation of the origins of the separation of ownership and control is not new. Berle and Means themselves explained the phenomenon they observed as having evolved in large part through a shift in the legal rules governing stock ownership. To be sure, they focused on a different set of legal rules than does Roe, who makes a valuable contribution by drawing our attention to the role of rules governing financial institutions, but the critical point is that Berle and Means also saw politics and law as being just as critical to the development of the Berle-Means corporation as were economic forces.[53] In sum, Roe oversells the distinction between his political paradigm and the economic paradigm which he assigns to the rest of us.

B. *The Chicken and the Egg*

Seminal though their work undoubtedly was,[54] there has always been something of a chicken and egg quality to Berle and Means's thesis. The question is which came first: legal or economic separation of ownership or control. According to the Berle-Means version of history, there was a time when the corporation "behaved as it was supposed to:"[55]

> The shareholders who owned the corporation controlled it. They elected a board of directors to whom they delegated management powers, but they retained residual control, uniting control and ownership. In the nation's early years the states created corporations sparingly and regulated them strictly. The first corporations, run by their proprietors and constrained by law, exercised state-granted privileges to fur-

52. EASTERBROOK & FISCHEL, *supra* note 47, at 27.

53. In the critical chapters, Berle and Means focus on corporate law rules directly affecting shareholder rights. BERLE & MEANS, *supra* note 1, at 127-287.

54. In fact, however, Berle and Means were not the first to document the phenomenon of separation of ownership and control. HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW: 1836-1937, at 357 (1991). Alfred Marshall had made the same point in 1890, *id.*, as did William W. Cook in 1891. *Id.* at 16. Note that this inferentially supports the argument, made below, that ownership and control had separated well before the legal rules on which either Berle and Means or Roe blamed the separation.

55. Walter Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1612 (1981).

> ther the public interest. The states then curtailed regulation, shareholders abdicated control, and this Eden ended. The corporation expanded into a huge concentrate of resources. Its operations vitally affected society, but it was run by managers who were accountable only to themselves and could blink at obligations to shareholders and society.[56]

Walter Werner aptly named this version of corporate history the "erosion doctrine."[57] Werner demonstrated that the erosion doctrine is a false account of the history of corporations. Economic separation of ownership and control in fact was a feature of American corporations almost from the beginning of the nation:

> Banks, and the other public-issue corporations of the [antebellum] period, contained the essential elements of big corporations today: a tripartite internal government structure, a share market that dispersed shareholdings and divided ownership and control, and tendencies to centralize management in full-time administrators and to diminish participation of outside directors in management.[58]

The legal rules upon which Berle and Means laid most of the blame for the separation of ownership and control came along much later, however, presumably as an adaptive response to the economic forces that caused ownership and control to separate.

Roe does not explicitly embrace the erosion doctrine, but it lurks just under the surface of Roe's analysis, and his historical account echoes that of the erosion doctrine's proponents, giving STRONG MANAGERS an analogous chicken and egg problem. In recounting the standard theory described above, Roe relies principally on Alfred Chandler's version of corporate history, which he reads as asserting that ownership and control separated because of technological changes at the end of the 19th Century.[59] This historical account is critical to his project, because it permits him to claim that "[t]he regular prohibition on financial institutions' taking large stock positions was crucial to the development of the Berle-Means corporation, with its fragmented share ownership."[60]

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56. *Id.*

57. *Id.* at 1613.

58. *Id.* at 1637; *see generally id.* at 1629-44 (suggesting that corporations have inherent characteristics that are constant over time).

59. ROE, *supra* note 10, at 3 (citing ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 87 (1977)).

60. *Id.* at 93.

In contrast, Werner suggests that the critical economic factor was not technological change, but rather the early presence of well-developed secondary trading markets. Such markets existed in New York and Philadelphia by the beginning of the 19th Century.[61] The resulting liquidity of corporate stock made it an especially attractive investment, which in turn made selling stock to the public an attractive financing mechanism. Stocks were purchased by a "diversified, geographically scattered group of public customers," including both institutions and individuals.[62] The national taste for speculation also played a part in the early growth of the secondary trading markets and, in turn, to dispersal of stock ownership.[63] As a result of these economic forces, ownership and control separated not at the end of the 19th Century, but at its beginning.

A slightly different version of this story is told by Herbert Hovenkamp, who argues that separation of ownership and control is less a function of firm size than of firm complexity. Under this model, neither technological change nor corporate financing was the dispositive factor. Rather, ownership and control separated when, because of a high degree of vertical integration, firms became sufficiently complex to require professional managers.[64] Notice the close fit between this interpretation and the economic model advanced in part I of this article. Under both, the unique attribute of modern public corporations is the hierarchical decision-making structure adopted as an adaptive response to organizational complexity. In any case, as to the chicken and egg problem at hand, Hovenkamp affirms that "the phenomenon [Berle and Means] described was prominent by the middle of the nineteenth century, particularly in American railroads."[65]

If either Werner's or Hovenkamp's version of corporate history is correct, and Roe offers no evidence to disprove either,[66] ownership and control had separated long before most of the rules Roe blames for the separation were formalized.[67] Even

61. Werner, *supra* note 55, at 1631-32.
62. *Id.* at 1633.
63. *See id.* at 1631-34.
64. HOVENKAMP, *supra* note 54, at 360.
65. *Id.* at 357.
66. Indeed, neither source is cited by Roe.
67. To be sure, large publicly-held industrial corporations exhibiting separation of ownership and control did not appear in great numbers until the latter decades of the 19th Century. Werner, *supra* note 55, at 1641. But the transition of manufacturing enter-

under Chandler's version, ownership and control of some large corporations had separated by the middle of the 19th Century.[68] In contrast, most of the prohibitory rules with which Roe is concerned came into existence only after the turn of the century. To be sure, banks had been fragmented since the first third of the 18th Century, a factor of unquestioned importance, but a number of critical restrictions did not come into play until the New Deal.[69] Insurers were largely unregulated until after 1906.[70] Mutual funds, albeit long of little importance, likewise essentially were unregulated until the New Deal.[71] Given this free market environment, why did these or other financial intermediaries not step into the economic niche opened when ownership and control separated during the early and mid-1800s? Roe's political and historical accounts offer no convincing answer.

If the economic egg in fact preceded the political chicken, what are the implications for Roe's project? In the first place, without a good deal more historical evidence relating to the early part of the 19th Century, Roe cannot prove that politics created the Berle-Means corporation.[72] In other words, he cannot prove that the Berle-Means corporation would not have evolved in the absence of the constraints on financial intermediaries he describes. But perhaps we ask too much if we ask Roe to prove this point. The historical account of STRONG MANAGERS still can tell a useful story about the role of politics in shaping the modern system of corporate governance. At a minimum, Roe demonstrates that politics did nothing to impede the development of the Berle-Means corporation, perhaps facilitated its evolution, and eventually helped sustain it by preventing financial intermediaries from taking active governance roles. In and of itself,

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prises from closely-held corporations to public corporations with dispersed ownership, "though drastic for such firms, represented merely an extension to industrial enterprise of elements that had existed in earlier public corporations engaged in finance and railroading." *Id.* at 1641-42.

68. According to Chandler's account, the railroads were the first of the modern corporations. Their financial structure had largely taken shape before the Civil War. CHANDLER, *supra* note 59, at 92.

69. ROE, *supra* note 10, at 94. Romano reports that at least in New England "the divorce of private bankers and industrialists began long before it was required by federal statute." GENIUS, *supra* note 51, at 146.

70. ROE, *supra* note 10, at 62.

71. *Id.* at 102.

72. In fairness, recall that Roe does not explicitly claim that the economic paradigm is irrelevant, but rather acknowledges that economic forces played a role in the formation of the Berle-Means corporation. *See supra* note 45.

that showing is a formidable accomplishment and a valuable contribution to the literature.

C. *Interest Groups, Unintended Consequences, and Ideology*

For those of us accustomed to thinking about the politics of corporate governance from a public choice perspective, one of the most striking aspects of STRONG MANAGERS is the lack of a coherent interest group theory for much of the legislation it reviews. At first blush, it may seem somewhat surprising that Roe finds little evidence indicating corporate managers provided interest group support for laws that precluded institutional investors from playing an active corporate governance role. As we saw in part I, the separation of ownership and control essentially eliminates any form of direct managerial accountability to shareholders. Making the not implausible assumption that managers prefer this state of affairs to one in which they are subject to vigilant monitoring by activist shareholders, we would expect managers to strongly favor laws that encourage dispersed share ownership. Why then does management in fact appear on the political stage only after the relevant laws have been in place for many years?[73]

Upon reflection, however, this is not a particularly surprising finding. The law of unintended consequences pervades Roe's historical account. Although Roe claims that the Berle-Means corporation is the inevitable result of the process of breaking up large financial intermediaries, I do not understand him to be claiming that it was an intended consequence. Put another way, the political establishment did not set out to separate ownership and control of industrial corporations; rather, such separation was an unintended consequence of unrelated political decisions and forces.[74] Once laws impeding the formation of large financial intermediaries were on the books, however, managers' self-interest helped sustain them against reforms that might have encouraged the unification of ownership and control.

Insurance law provides a good example of this phenomenon. The prohibition of insurance company ownership of corporate stock is one of the key developments in Roe's story of how poli-

73. *See* ROE, *supra* note 10, at 42-43; *see, e.g., id.* at 74 (discussing rules barring insurers from holding common stock).

74. Roe makes this point explicitly in connection with his discussion of insurance regulation. *See id.* at 93.

tics fragmented large financial intermediaries. The prohibition grew out of a turn of the century scandal in the insurance industry.[75] Roe relates some evidence that contemporary observers were aware of the insurance industry's growing involvement in the affairs of their portfolio corporations.[76] In fact, however, the concerns they expressed do not relate to the possibility that insurers might take an active role in monitoring the management of those firms. Instead, the concern seems to have been concentration of economic power.[77]

Similarly, although Roe finds evidence that banks supported the prohibition, and speculates that this may have reflected the desire of bank managers to prevent insurers from becoming active bank shareholders,[78] this evidence again more clearly relates to competition and concentration than to managerial accountability. Insurers threatened banks' competitive position in the financial services industry. Bank support for the prohibition thus could be explained as an effort to rid themselves of competitors, rather than as an effort to rid themselves of active shareholders.

While the lack of a management-centered public choice theory thus is not too disturbing, the absence of any persuasive interest group-based rationale for several of the most important laws Roe cites is truly surprising.[79] For example, with respect to regulation of mutual funds in the Investment Company Act of 1940, Roe contends that there was little interest group activity.[80] Instead, "politicians were operating at the symbolic level, *creating* via regulation and taxation a framework in accord with their concept of what a mutual fund ought to be."[81] Similarly, Roe fails to find a "clear political motivation" for the ERISA rules that preclude pension funds from taking an active corporate governance role.[82] This failure is especially curious, because ERISA both was

75. *See id.* at 63-64.

76. *Id.* at 74.

77. *See id.*

78. ROE, *supra* note 10, at 76.

79. In some cases, the legislation benefited groups that on first blush appear to have been adversely affected. This seems to have been true of some mutual funds. *See id.* at 114. In other cases, it simply may be that with the passage of time it is no longer possible to identify the interest groups that drove the legislation. Because naked self-interest is unattractive, interest groups usually cloak their motives with public regarding arguments. As such, it can be difficult to identify the private benefits reaped by decades-old laws.

80. *Id.* at 110.

81. *Id.*

82. *Id.* at 140. To the extent Roe finds glimmers of an interest group theory of ERISA, his analysis relates more to management fear of unions than to management fear of shareholders. *See id.* at 127-32.

adopted quite recently and had an enormous economic impact on business and labor.

Holes in the interest group component of his story do not particularly trouble Roe. Throughout STRONG MANAGERS, Roe couples ideology and interest group theory, contending that neither is fully explanatory standing alone.[83] Indeed, he goes so far as to claim that "[p]oliticians do not always respond to interest groups, because some politicians seek the public interest, or fear association with special interests."[84]

This claim is not inconsistent with public choice theory. Public choice theory has enormous explanatory power, but it has difficulty accounting "for ideological politicians like Reagan and Thatcher."[85] Any sensible theory of the relationship between politics and corporate governance thus must consider not only naked self-interest, but also the possibility that ideology matters, even in the halls of Congress. Granted, ideology sometimes serves as cover for self-interest.[86] Yet, as James Q. Wilson observes, "something in us makes it all but impossible to justify our acts as mere self-interest whenever those acts are seen by others as violating a moral principle."[87] Rather, "[w]e want our actions to be seen by others—and by ourselves—as arising out of appropriate motives."[88] Hence, legislators may choose to act consistently with their ideological principles, even when doing so puts them at odds with important interest groups.

Having established that ideology matters, Roe finds a critical ideological force in turn-of-the-century populism.[89] At about the same time as the large industrial corporations were beginning to evolve in the latter half of the 19th Century, populism was be-

83. *See, e.g.*, ROE, *supra* note 10, at 27.

84. *Id.* at 153.

85. DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION 24 (1991).

86. It is likely that some populist reformers used popular disdain for Wall Street to advance their personal political influence and power. We see this possibility in figures like Roosevelt, Hughes, Coughlin, and Long, all of whom manipulated anti-Wall Street sentiment for personal political advantage.

87. James Q. Wilson, *What is Moral and How Do We Know It?*, COMMENTARY, June 1993, at 37, 39.

88. *Id.*

89. Of only slightly less importance to Roe's story is the role of federalism. Roe believes that during the 19th Century federalism helped small financial institutions resist large financial intermediaries. *See* ROE, *supra* note 10, at 27, 45-46. As we shall see below, even though federalism in our post-New Deal world must be numbered among the walking wounded of American political principles, it remains a potential obstacle to institutional investor corporate governance activism even today. *See infra* notes 176-93 and accompanying text.

coming a major force in American political life. One of its chief characteristics was fear of concentrated economic power. As Roe puts it, "Main Street did not want to be controlled by Wall Street."[90] The bulk of the first third of STRONG MANAGERS is devoted to exploring in considerable detail the impact this ideology had on the development of the legal regime governing institutional investors. Doing justice to a description of Roe's analysis would require a work of nearly book length in itself. Suffice it then to say that he makes an impressive and persuasive case for the proposition that most of the legal rules precluding institutional investors from taking on a major intermediary role can be linked to this ideological impulse.

One aspect of Roe's thesis is worth exploring in some detail, however, if only because he gives it somewhat less attention than it arguably deserves. If we stipulate the validity of his argument about the role of populist ideology, a further question logically arises: Granting that Main Street did not want to be controlled by Wall Street tycoons, why was Main Street content to be controlled by the company presidents who lived in the big houses at the top of the hill? Put less colloquially, why was the populist fear of concentrated economic power directed at financial intermediaries, rather than at managers of large corporations?

The point becomes even more puzzling when one considers Roe's belief that senior managers of large corporations are among the least accountable people in our society.[91] This is a point of view that widely was held during the periods relevant to Roe's story. In fact, it is fair to say that Main Street was not content to be ruled either by Wall Street or by corporate presidents.

Roe essentially concedes this point, but argues that the antitrust laws were the vehicle by which populist ideology made itself felt on big business.[92] Granting that some view antitrust law as having a number of non-economic goals, including a "Madisonian" dispersion of economic power,[93] why did the populists stop with the antitrust laws? Why did populist ideology not spill over into regulation of corporate governance as well?

Roe contends that fragmentation of big business was not politically practical. As we shall see below, because business leaders are

90. ROE, *supra* note 10, at 22.
91. *Id.* at 9.
92. *See id.* at 29, 32, 207.
93. STEPHEN F. ROSS, PRINCIPLES OF ANTITRUST LAW 8 (1993).

both geographically dispersed and well-organized, they wield enormous political power. In contrast, because large financial intermediaries are concentrated geographically, they are more vulnerable to being broken up.[94]

Roe here has made an interesting argument, but it ultimately misses the point. Populist fear of concentrated economic power did not have to play out in an attempt to break up large industrial corporations. Instead, it could have taken shape as a corporate governance reform movement. Indeed, it arguably did so. As I have recounted in detail elsewhere, reformers repeatedly have directed their fire at corporate governance.[95] At several points during this century, their efforts very nearly resulted in a federal law of corporations.[96] Roe does not attempt to explain why federal corporate governance reform consistently failed, even though reforms directed at institutional investors succeeded during the same time frame. The answer is certainly an interest-group story comparable to the one he tells, but that makes it a story all the more worth telling.

III. Roe's Policy Proposals

Business historians will find much to debate within Strong Managers, but corporate lawyers will find it of interest principally because the historical and contemporary evidence Roe supplies is relevant to the present debate over the role of institutional investors in corporate governance. As I argue in this part, the future of that role is likely to be determined by its past.

To begin at the beginning, two dominant lines of corporate governance thought emerged from Berle and Means's work. One treats corporate governance as a species of public law, such that the separation of ownership and control becomes principally a justification for regulating corporate governance so as to achieve social goals unrelated to corporate profitability. The other treats corporate governance as a species of private law, such that the separation of ownership and control does not in and of itself justify state intervention in corporate governance. In this article I ignore the former line of corporate governance scholarship,

94. Roe, *supra* note 10, at 208.

95. *See generally* Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 Wash. U. L.Q. 565, 598-616 (1991) [hereinafter *Rule 19c-4*] (describing reform efforts that sought "fair corporate suffrage" to prevent the disenfranchisement of existing shareholders).

96. *Id.* at 602-03.

both because I am an avowed proponent of the latter conceptual framework[97] and because Roe's public policy proposals are directed at the same set of problems with which the private law theory of corporate governance is concerned.

Since Berle and Means, managerial accountability to shareholders has been the chief concern of most corporate legal scholarship. Several decades after Henry Manne's seminal work on mergers, conventional academic wisdom decided that Manne had pointed them in the right direction: it settled on hostile takeovers, that is, the market for corporate control, as the accountability mechanism that made Berle-Means corporations practicable. Unfortunately, no sooner had the academic community reached consensus than a variety of legal and economic developments effectively shut down the market for corporate control.[98] After a suitable mourning period, the academic community began casting about for a new accountability mechanism. Some of them found it in institutional investors. The academic fad for institutional investors coincided with the emergence of (i) a number of activist institutional investors, (ii) politicians who saw institutional investors as a useful vehicle for achieving political goals, and (iii) consultants who saw the phenomenon as a potentially profitable opportunity. The corporate governance role of institutional investors thus quickly took on political and regulatory, as well as academic, significance.

Institutionalization of ownership in the equity markets appears inevitable. As long as a decade ago, institutions already controlled almost half of all NYSE-listed securities,[99] with the trend clearly towards increasing control. Indeed, it is estimated that by the year 2000, pension funds alone will control fifty percent of all corporate stocks.[100] Such control provides a relatively small number of institutions with enormous economic clout. In 1989, for example, the fifty largest institutions collectively owned twenty-seven percent of all public U.S. equities; the thirteen larg-

97. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993) [hereinafter *In Defense*].

98. *See* Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1084-88 [hereinafter *Proxy Contests*].

99. *Id.* at 1088.

100. SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE, 99TH CONG., 2D SESS., CORPORATE TAKEOVERS: PUBLIC POLICY IMPLICATIONS FOR THE ECONOMY AND CORPORATE GOVERNANCE 112 (Comm. Print 1986).

est each owned over one percent of the stock market.[101] A given institution usually owns only two to three percent of a given firm's stock, but stakes exceeding ten percent sometimes exist.[102] As a result, institutions dominate many firms' shareholder lists.[103]

Institutional activism in the corporate governance area, however, is neither inevitable nor necessarily desirable. As I argue in this section, there are a number of forces that discourage institutional activism. Moreover, even if those obstacles are overcome institutional activism is likely to prove a mixed blessing at best.

A. *The Future, If Any, of Institutional Activism*

Roe sees evidence that institutional investors are becoming more active players in corporate governance,[104] and there is some truth to this observation. Institutions probably are becoming more active, "taking their voting rights more seriously and using the proxy system to defend and promote their interests."[105] Increasingly, they vote against takeover defenses proposed by management and in favor of shareholder proposals recommending removal of existing defenses.[106] Many institutions also no longer routinely vote to reelect incumbent directors.[107] Less visibly, institutions have influenced business policy and board composition through negotiations with management.[108] While there thus seems little doubt that institutional investor activism will have effects at the margins,[109] the question remains whether the impact will be more than merely marginal.

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101. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 567-68 (1990) [hereinafter *Shareholder Passivity*].

102. *Id.* at 568.

103. Total institutional ownership often exceeds 60 percent in large firms. *Id.* at 567.

104. ROE, *supra* note 10, at 223-24.

105. PAUL BERGIN, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1988 PROXY SEASON 1 (1988); *see also* Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1140-47 (1991) (describing broad trends among institutional investors).

106. For example, only four percent of the institutions responding to one industry survey favored dual class capital structure proposals, while nearly two-thirds vote against them as a matter of policy. BERGIN, *supra* note 105, at 25.

107. LAWRENCE KRASNOW, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES IN THE 1989 PROXY SEASON 50 (1989); BERGIN, *supra* note 105, at 54-57.

108. John Pound, *After Takeovers, Quiet Diplomacy*, WALL ST. J., June 8, 1992, at A10.

109. The impact of increased institutional investor activism is described by MICHAEL USEEM, EXECUTIVE DEFENSE: SHAREHOLDER POWER AND CORPORATE REORGANIZATION 51-55 (1993). Useem puts a pro-activism spin on his data, but it is generally consistent with the view that institutional activism will have marginal, but no more than that, effects on corporate governance.

1. *The Cost of Activism*

Because institutional investors generally are profit maximizers, they will not engage in an activity whose costs exceed its benefits. If the governance function of institutional investors is to act as Alchian and Demsetz's residual claimants-ultimate monitors, they will find activism to be a high cost, low benefit task. Even ardent proponents of institutional investor activism concede that institutions are unlikely to be involved in day-to-day corporate matters. Instead, they are likely to step in only where there are serious long-term problems.[110] Because it is impossible to predict ex ante which corporations are likely to experience such problems, activist institutions will be obliged to monitor all of their portfolio firms.[111] At the bare minimum, activist institutions will be obliged to closely scrutinize corporate disclosures for signs of impending trouble. The length and complexity of corporate disclosure documents makes this an expensive proposition both in terms of time invested and the need for specialized expertise. More important, because corporate disclosures rarely give one a full picture of the corporation's prospects, additional and more costly monitoring mechanisms must be established.

Monitoring costs are only the beginning, of course. Once the problem firm is identified, the activist institution must take steps to address the problem. In some cases, it may suffice for the activist institution to raise the problem with management. Less tractable problems will necessitate more extreme remedial measures, such as removal of the incumbent board of directors.

Outside the unlikely limiting case in which the activist institution controls a majority of the stock, such measures necessarily require the support of other shareholders, which makes a shareholder insurrection against inefficient but entrenched managers a costly and difficult undertaking. Consider the comparison Roe

110. *See infra* pp. 717-18.

111. It is for this reason that Professor Black's economies of scale arguments fail. Black contends that activist investors will find that monitoring issues cut across a wide range of companies, which permits them to make use of economies of scale by developing standard responses to managerial derelictions, *see Shareholder Passivity*, *supra* note 101, at 580-84, while non-activist investors can obtain economies of scale by developing standardized voting procedures. *Id.* at 589-91. If institutional activism is more likely to take the form of crisis intervention, however, such economies of scale are unlikely to obtain because different crises will necessitate differing responses. At most, we might expect institutions to adopt standard voting practices on issues such as takeover defenses, which is a low-cost technique consistent with observed institutional behavior. It is also consistent with the thesis that only marginal effects should be expected from institutional activism.

likes to draw between American corporate governance and that of Germany and Japan. In both of the latter, a large percentage of the stock of large industrial corporations tends to be owned by a few institutional investors each owning fairly large blocks of stock.[112] These large shareholders play a far more active corporate governance role than do their American counterparts. There is reason, however, to doubt that the comparison is a useful one. In Germany and Japan, financial intermediaries are much larger than their American counterparts, while corporations are smaller.[113] Despite the increasing institutionalization of U.S. equity markets, stock ownership of domestic corporations remains far less concentrated than is the case in Germany or Japan.[114] Unlike Germany or Japan, where a small group of investors can exercise effective control, a shareholder insurrection in a domestic corporation requires support from a relatively large number of investors.

Putting together a winning coalition will require, among other things, ready mechanisms for communicating with other investors. Unfortunately, SEC rules on proxy solicitations, stock ownership disclosure, and controlling shareholder liabilities long have impeded communication and collective action. Recent SEC rule amendments have lowered somewhat the barriers to collective action, but important impediments remain.[115]

Yet even if there is further erosion in the barriers to shareholder communication, coordinating shareholder activism may remain a game not worth playing. Individual investors doubtless will remain passive. Institutions likewise have an incentive to remain passive. Many institutional investors will prefer liquidity to activism.[116] For fully-diversified institutions even the total failure of a particular firm will not have a significant effect on their port-

112. ROE, *supra* note 10, at 172, 177-78.

113. *Id.* at 171-72, 182 (describing, respectively, Germany and Japan).

114. *Id.* at 223. To be sure, if increased institutional investor activism is cost-efficient, we can expect further concentration of stock ownership. It may be doubted both whether sufficient concentration is likely to occur and, if it does, whether that would be desirable. *See infra* p. 729.

115. *See Next Steps*, *supra* note 51, at 49-52.

116. For such investors, some of Roe's proposals would prove particularly unpalatable. Holding a block above 10 percent would subject them to the reporting and short-swing profits rules of § 16 of the Securities Exchange Act, which would substantially reduce their liquidity. Roe further suggests that institutions could play an activist role by analyzing information that management cannot disclose to the markets. *See infra* pp. 711-13. Access to such information, however, would bring an institution within the confines of the insider trading rules even if it held less than 10 percent, which would again reduce their liquidity.

folio, and may indeed benefit them to the extent they also hold stock in competing firms.[117] Such investors may prove less likely to join the insurgent coalition than simply to use the activist's call for action as a signal to follow the "Wall Street rule" and switch to a different investment before conditions further deteriorate. As we shall see below, others may have conflicts of interest that prevent them from supporting the activist institution.

Historical inertia—so-called path dependence—also plays a role in limiting the scope of institutional activism. Consider the example of insurance companies. Roe offers no evidence that insurers were moving towards a financial intermediary role prior to the turn of the century imposition of the prohibition against stock ownership by insurers. He simply speculates that they might have done so.[118] The principal basis for that speculation is a series of statements by Charles Evan Hughes, which more plausibly relate to a fear of concentration—a concern that insurers would run companies, not that they would watchdog them.[119] Given that insurance companies were large and essentially unregulated prior to 1906,[120] their failure to develop into the role played by large financial intermediaries in Germany or Japan is curious. In any case, as Roe himself admits,[121] the many decades in which insurance companies were barred from stock ownership have left them ill-prepared to assume a financial intermediary role at this late date. Path dependence and inertia thus serve as formidable obstacles to activism.

Activism is also inconsistent with prevailing financial theories about investing, a point that Roe all too briefly acknowledges. Efficient capital markets theory and portfolio theory, which have become reasonably well-accepted in the investment community, argue strongly for a highly passive approach to investing. Indeed, their logical implication is that the best investment approach is passive indexing, a strategy now widely followed by individual and institutional investors.[122] Because expense minimization is an important aspect of passive indexing strategies, investors following this approach are unlikely to become active governance

117. *See Two Models*, *supra* note 19, at 526.

118. *See* ROE, *supra* note 10, at 62-63.

119. *See id.* at 74.

120. *Id.* at 65.

121. *Id.* at 276.

122. BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 360-63 (5th ed. 1990)

players.[123] Taken together with the factors mentioned above, all of this will make assembling a winning coalition a difficult and expensive task.

Turning from the cost to the benefit side of the equation, corporate governance activism is unattractive in the first instance because activism is unlikely to produce frequent gains. As we have seen, because many companies must be monitored, and because careful monitoring of an individual firm is expensive, institutional activism is likely to focus on crisis management. In many crises, however, institutional activism is unlikely to be availing. In some cases, intervention will come too late. In others, the problem may prove intractable, as where technological changes undercut the firm's competitive position. Most importantly, management resistance may prevent necessary changes.

A useful analogy may be drawn between a corporation with activist institutional shareholders and the Berle-Means minority controlled corporation. In both, a small group of investors "hold a sufficient stock interest to be in a position to dominate a corporation through their stock interest."[124] In both, the dominant shareholders' "control rests upon their ability to attract from scattered owners proxies sufficient to control a majority of the votes."[125] As Berle and Means recognized over sixty years ago, this form of control has substantial limitations. In particular, there is "the possibility that the management may be antagonistic."[126] As was the case in their day, management's control of the proxy system makes it very hard for even large stockholders to dislodge recalcitrant managers.[127]

To be sure, STRONG MANAGERS identifies a number of cases in which the threat of institutional investor unrest led to changes in corporate personnel and policy: GM, IBM, and Westinghouse be-

123. Two factors are important. First, because index funds hold stock in hundreds or even thousands of firms, monitoring every firm in their portfolio would chew up most of the transaction costs saved by an indexing strategy. Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163, 182 (1991). Second, as just explained, well-diversified institutions have little reason to be concerned about the fate of individual firms. Indeed, for an indexed firm, the failure of one firm in its portfolio may lead to profits if the stock of competing firms rises. *Id.* Indexed funds are thus unlikely to see the costs of activism as worth bearing.

124. BERLE & MEANS, *supra* note 1, at 80 (emphasis deleted).

125. *Id.*

126. *Id.* at 81.

127. *See generally Proxy Contests*, *supra* note 98, at 1075-80 (describing obstacles to using the proxy system to unseat incumbent directors).

ing the examples cited.[128] These examples, however, do not necessarily portend the future of most firms. Consider the comparison between Roe's modern-day examples and Berle and Means's account of John D. Rockefeller, Jr.'s struggle to oust the chairman of the board of Standard Oil of Indiana. Rockefeller controlled 14.9 percent of Standard Oil's stock,[129] a considerably larger stake than is typical of modern institutional holdings. The contest proved to be a long and difficult one.[130] Rockefeller ultimately prevailed "partly because the public in general sided with him in his view of the [issues] and still more, perhaps, because Mr. Rockefeller's own standing in the community commanded the confidence of a large body of stockholders."[131] It seems reasonable to speculate that comparable factors were at work in Roe's modern-day examples. This is less likely to be true in the vast majority of smaller firms, which simply will not attract the kind of public attention that was important in Standard Oil several decades ago and in GM several years ago. In such firms, as Berle and Means remarked,

> The difficulty and cost of dislodging the management . . . emphasizes the precarious nature of control resting on the ownership of a minority of the voting stock . . . and further emphasizes the importance of the management to any effective minority control.[132]

In the absence of management support, institutional activism thus often will be hard-pressed to yield gains.

Activism is problematic, in the second instance, because on those occasions in which gains might arise from activism, only a portion of them would accrue to the activist institutions. Suppose that the troubled company has 110 outstanding shares, currently trading at $10 per share, of which the potential activist institution owns ten. The institution correctly believes that the firm's shares would rise in value to $20 if the firm's problems are solved. If the institution is able to effect a change in corporate policy, its ten shares will produce a $100 paper gain when the stock price rises to reflect the company's new value. All the other shareholders, however, will automatically receive a pro rata share of the

128. ROE, *supra* note 10, at 284-85.
129. BERLE & MEANS, *supra* note 1, at 82.
130. *Id.* at 82-83.
131. *Id.*
132. *Id.*

gains.[133] As a result, the activist institution confers a gratuitous $1,000 benefit on the other shareholders.

All of this makes institutional activism a classic example of a situation in which free riding is highly likely. In a very real sense, the gains resulting from institutional activism are a species of public goods. They are costly to produce, but because other shareholders cannot be excluded from taking a pro rata share, they are subject to a form of non-rivalrous consumption. As with any other public good, the temptation arises for shareholders to free ride on the efforts of those who produce the good. To be sure, as stock concentrates in the hands of large institutional investors, there will be marginal increases in the gains to be had from activism and a marginal decrease in its costs.[134] A substantial increase in activism seems unlikely, however. Consider that most institutional investors are competing with one another to attract either the savings of small investors or the patronage of large sponsors, such as corporate pension plans. Competition in this context is generally concerned with relative performance rates.[135] This makes institutions and money managers highly cost-conscious.[136] Given that activism only rarely will produce gains, and that when such gains occur they will be dispensed upon both the active and the passive, it makes little sense for cost-conscious money managers to incur the expense entailed in shareholder activism. Instead, they will remain passive in hopes of free riding on someone else's activism. As in other free riding situations, because everyone is subject to and likely to yield to this temptation, the probability is that the good in question—here shareholder activism—will be underproduced.

2. *Continuing Political Constraints: Populism is not Dead*

Despite my doubts, let us suppose that Roe is right: the Berle-Means corporation is not inevitable and, further, investor passivity is not inevitable. If Roe's basic thesis is correct political change will be an important component of any evolution away

133. One could plausibly expect institutions to surmount this problem by engaging in self-dealing transactions, which raises the conflict of interest problems described below. *See infra* part III.B.2.b. In addition, there are a variety of perfectly legitimate private benefits that might accrue to activist institutions, which will provide some encouragement for activism. *See* Edward Rock, *The Logic and Uncertain Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 460 (1991) [hereinafter *Uncertain Significance*].

134. *See Uncertain Significance, supra* note 133, at 460-63.

135. *Id.* at 473-74.

136. *Id.*

from the Berle-Means corporation, if not a necessary precondition for it to transpire. Hence, it is not surprising that the standard move for proponents of institutional activism is to argue for legal reforms designed to shift the incentives of institutional investors. Some of these proposals have been quite dramatic. To take but one example, Robert Monks and Nell Minow's reform program included eight major points and sixteen sub-points.[137] Among the items proposed were a "minimum standards" federal corporation law, preemption of state laws governing public pension funds, sweeping reform of the proxy rules, and the like.[138] This was hardly a conservative reform agenda, which is somewhat surprising given that Monks was, according to his book jacket biographical blurb, a two-time Republican senatorial candidate and held "top positions in the Reagan administration."[139] As Russell Kirk aptly put it, conservatives are supposed to recognize that "change may not be salutary reform: hasty innovation may be a devouring conflagration, rather than a torch of progress."[140]

From this perspective, STRONG MANAGERS arguably represents the most conservative take on institutional investors yet to emerge from the proponents of shareholder activism. Roe acknowledges both that legal change might not change economic behavior[141] and, more importantly, that sweeping reform might have deleterious effects.[142] As a result, his proposed reforms are admirably modest in scope.

At the outset, Roe concedes that there is not enough evidence to justify policies that would force greater institutional concentration or mandate activism, but he claims there is enough to justify loosening existing restrictions.[143] As a result, his proposals are not designed to replace the Berle-Means corporation with a German- or Japanese-like system in which large institutions play an activist role. Doing so would require sweeping reforms of banking, pension, tax, and securities law, a task Roe concedes to be neither desirable nor practicable.[144] Instead, Roe believes that re-

137. ROBERT A. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 264-66 (1991).
138. *Id.*
139. *Id.* at *book jacket.*
140. RUSSELL KIRK, THE CONSERVATIVE MIND: FROM BURKE TO ELIOT 9 (7th ed. 1986).
141. ROE, *supra* note 10, at 275.
142. In discussing reforms of the banking laws, for example, Roe acknowledges that significant reforms designed to encourage banks to hold large blocks of stock might have deleterious effects on the banking system. *Id.* at 264-65.
143. *Id.* at 233.
144. *See id.* at 264-67, 271-73 (discussing banks and pension funds, respectively).

forms should merely "ease up on the least useful [existing] restrictions and let economic evolution and private contracting take their course."[145] The goal of this limited reform program is to create a level playing field in which Berle-Means corporations and corporations with activist shareholders would compete.[146]

As the means towards this modest end, Roe focuses on rules limiting shareholder coordination.[147] As a result, although he proposes some minor tinkering with the banking and pension laws, his reform agenda mainly contemplates changes in the securities laws. Roe would do away with or revise the various securities laws that deter investors from holding large blocks of stock and from communicating with one another.[148]

One reasonably may doubt whether amending the securities laws will work a sufficient change in the incentive scheme facing institutional investors to have a significant impact on corporate governance. Deferring that question for the moment, however, it is worth asking whether one can reasonably expect this or any other serious reform proposal to be effected in the near term. A negative answer is likely.

If only by process of elimination, the Securities and Exchange Commission is the forum most likely to be friendly towards reform.[149] Unfortunately for the reformers, however, there are both legal and political limits on the SEC's ability to effect significant reform of the corporate governance system. Although the SEC has authority to regulate the procedural aspects of shareholder voting and the disclosures that must be made in connection with proxy solicitations, it lacks authority to regulate substantive aspects of shareholder voting and, more generally, other aspects of corporate governance.[150] To be sure, most of Roe's specific proposals arguably fall on the procedure and dis-

145. *Id.* at 284.

146. *See* ROE, *supra* note 10, at 12.

147. *Id.* at 263.

148. *See id.* at 273-75. Roe would also substantially deregulate the mutual fund industry. *See infra* note 286.

149. Something more than mere elimination also might point towards this conclusion: "The predictable phenomenon of agency 'capture' by special interest groups has led to subsidies to favored constituencies," including institutional investors. Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 922 (1994). *But see* John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 876 (1994) (arguing that the SEC is caught in the middle between managers and institutions and remains in play). As discussed below, however, managerial pressure can have countervailing effects, as in the case of management resistance to proxy reform. *See infra* p. 702.

150. *See Rule 19c-4*, *supra* note 95, at 598-616.

closure side of the line, but the scope of the SEC's regulatory authority remains an important limitation on the SEC's ability to unilaterally mandate reforms.

Politics may prove an even more important limitation. As mentioned above, the SEC already has loosened the rules governing shareholder communications. A prominent proponent of proxy reform opines that the rules adopted by the SEC adopted were "weaker (less *de*-regulatory)" than those the SEC proposed when it initiated the regulatory proceeding.[151] As he explains,

> [The SEC] was subjected to heavy political pressure from corporate managers to withdraw or weaken the proposal. The Business Roundtable and other corporate groups made full use of their political contacts in the SEC and the Bush administration to fight the reforms. The SEC is an independent agency, but the corporate lobbying effort had its effect. In 1992, the SEC published a revised and in some respects weaker (less *de*-regulatory) proposal. And the political counterattack may have stalled reexamination of other proxy rules, such as the shareholder proposal rule, or the full set of rules governing director elections.[152]

In other words, the SEC's modest reforms already may be the maximum possible without political cover from Congress.

Turning to the legislative arena, interest group politics are again likely to impede significant changes in the corporate governance system. As their opposition to the SEC's proxy changes illustrates, corporate managers are unlikely to support changes in existing law that weaken their position vis-à-vis shareholders.[153]

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151. *Next Steps*, *supra* note 51, at 3 (original emphasis).

152. *Id.* The Business Roundtable's arguments against proxy reform were summarized by its counsel in Rosenbaum, *supra* note 123.

153. Although Roe implicitly acknowledges that managers are unlikely under current conditions to support corporate governance reforms that undermine the basic structure of the Berle-Means corporation, he suggests they might do so under certain conditions. *See* ROE, *supra* note 10, at 145, 226-30. As one possible scenario, he suggests that if managers had not won political protection from hostile takeovers they would have turned to institutions for protection. *Id.* at 226-27. This strikes me as highly speculative, illustrating just how far one must stretch to imagine political conditions that might lend themselves to management support for institutional activism. Consider, in the first instance, that managers in fact won the political protections they needed. *See Proxy Contests*, *supra* note 98, at 1086-88. In the second, corporate managers sought political protection precisely because they did not trust institutions. Managers perceived institutions as short-term speculators who would willingly support any takeover bid at a premium. *See* USEEM, *supra* note 109, at 141-44; *cf.* KEVIN PHILLIPS, ARROGANT CAPITAL 86 (1994) ("Firms once committed to long-term thinking now faced money managers and speculators little concerned about existence beyond the life of a futures contract"). So it is highly unlikely that corporate managers routinely would have turned to institutions as a takeover shield. To be sure, as Roe points out, managers did rely on employee stock ownership plans as a takeover defense, but they did so precisely because management effectively controls ESOPs. *See* ROE,

Corporate managers are also well-organized.[154] Interest groups such as the National Association of Manufacturers and the Chamber of Commerce have been active in corporate governance reform matters ranging from such highly visible issues as litigation reform and takeovers to such obscure ventures as the American Law Institute's corporate governance project.

Legal change aimed at strengthening the hand of profit-maximizing institutional investors is also likely to be resisted by unions and, perhaps, the various interest groups that support workers rights and broader social responsibility concerns. Although shareholder wealth maximization and social responsibility are often congruent, there are occasions in which managers cannot advance simultaneously both shareholder and social interests.[155] Reforms that make management more directly accountable to shareholders increase the pressure on management to promote shareholder wealth at the expense of employees and other social responsibility concerns.[156] As such, employees and related interest groups are unlikely to favor such changes.[157]

In contrast, institutions are less well-organized, especially when considered across industry segments, and have less experience in governance politics, especially at the state level. Indeed, some institutions actually might oppose legal change that facilitates shareholder activism.[158] Although the various legal impediments

supra note 10, at 227; *see also infra* note 279 (citing examples of cases in which relational investors provided management with protection against takeovers). Given Roe's fascination with the German and Japanese systems, it is also informative to note that German managers are attempting to oust the large banks from their supervisory board positions. *Id.* at 211. If managers who are accustomed to shareholder activism are resisting it, is it realistic to expect managers who are unused to such activism to support it?

154. It is also possible that important securities industry players with large retail brokerage operations may be inclined to resist anything that furthers the institutionalization of the securities markets.

155. *See In Defense*, *supra* note 97, at 1435.

156. The business judgment rule allows managers considerable leeway to deviate from short-term shareholder wealth maximization to make decisions that benefit non-shareholder constituencies. *Id.* This leeway can be justified on various grounds, including the hope that it will lead these constituencies to make commitments to the firm that will produce long-run gains for the shareholders.

157. "Labor's interest is to loosen managers' ties to capital. Capital could seek profits by getting highly motivated managers who sweat the labor force. When law creates gaps in the responsiveness of managers to capital, then managers have less incentive to squeeze every penny of production out of labor." ROE, *supra* note 10, at 44.

158. Roe acknowledges this possibility. *See id.* at 278. An equally important possibility is that even those institutions which favor reforms may fail to act effectively within the political arena. In general, "individuals are more likely to coordinate their actions to avoid losses than to achieve gains because of risk aversion." GENIUS, *supra* note 51, at 76. Because management stands to lose from reforms that create more direct accountability to shareholders, they are more likely to act collectively.

to corporate governance activism diminish the potential returns from activism for any given institution, the industry as a whole may benefit from eliminating a costly and uncertain form of competition.[159]

Roe believes that a "persuasive case for reform, backed by good data, can defeat political interest groups that would want to maintain the status quo."[160] This is consistent with his more general belief that ideology matters in politics. In the present political climate, however, ideological forces are likely to cut against reforms designed to bolster the size and power of institutional investors. The populist fear of concentrated economic power has been one of the true constants in American politics[161] and, as the 1994 political season illustrated, populism is not dead as an ideological force in American politics.[162]

According to Roe, modern-day populism is directed "more at Washington than at Wall Street."[163] Perhaps so, but anti-finance populism remains a formidable force. A good example, taken from the left, is the class warfare then-Governor Bill Clinton waged during his presidential campaign: "We need to give people incentives to make long-term investments in America and reward people who produce goods and services, not those who speculate with other people's money."[164] Another good example, this time more or less from the right, is Kevin Phillips's attack on

159. Because institutional managers are evaluated against one another and against market indices, managers of well-diversified funds have no incentive to engage in activity that improves the performance of the market as a whole: "A change that benefits all will benefit none." *Uncertain Significance*, *supra* note 133, at 473-74. As a collective action problem, this encourages passivity; as a political problem, it discourages support for reform and even may encourage opposition thereto.

160. ROE, *supra* note 10, at 278. In light of his views on this issue, it is ironic that Roe's policy prescriptions are so modest. Although I admire that modesty, it is true that one of the chief lessons of the Reagan era is that major reform is often easier to pass than minor changes: "A genuinely ambitious plan can get Main Street talking, whereas mere tinkering leaves things in the hands of the interest groups, whose strong point lies in blocking action." Walter Olson, *And Now for Tort Reform*, WALL ST. J., Nov. 16, 1994, at A29.

161. As Roe points out, for example, it played an important role in the antebellum political conflicts over the Bank of the United States. ROE, *supra* note 10, at 54-59.

162. Political analyst William Schneider observes that the United States has become "ideologically populist, and operationally libertarian." *See* John H. Fund, *Editorial*, PITTSBURGH POST-GAZETTE, Oct. 23, 1994, at F1.

163. ROE, *supra* note 10, at 283; *see also id.* at 285 ("Anti-finance 'populism' is not what it once was as a political force").

164. BILL CLINTON & AL GORE, PUTTING PEOPLE FIRST: HOW WE CAN ALL CHANGE AMERICA 192 (1992). The quote in the text is taken from Clinton's October 3, 1991 announcement that he would run for president. About a year later, he again argued: "The corrupt do-nothing values of the 1980s must never mislead us again. Never again should Washington reward those who speculate in paper, instead of those who put people first." *Id.* at 8.

the "massive, revolutionized, and largely unregulated financial sector armed with the latest high-tech weaponry and pursuing profits on any battlefield, straining the stock and bond markets, plucking loot from any debacle, shooting the economic wounded, and outgunning the 'real economy' by huge ratios."[165] Large bore anti-finance populism, indeed.

We have good recent evidence for the proposition that this sort of anti-finance populism provides powerful political cover for corporate managers facing a corporate governance crisis: the takeover politics of the 1980s. The takeover wave of that era obviously implicated the self-interest of corporate managers. At the same time, despite the pro-takeover consensus within the academy, the public overwhelmingly opposed hostile takeovers.[166] Legislative fall-out was inevitable. To be sure, little of note happened at the Congressional level, but that is itself quite telling. Congress held hearings on takeover reform legislation in virtually every session during the 1980s. Each time the legislation went nowhere, mostly because of interest group objections.

The political power of large financial institutions within Congress tends to be concentrated geographically and jurisdictionally. They wield considerable influence with representatives of important financial centers and within the committees that oversee the banking, pension, and securities laws. In contrast, corporate managers wield great influence throughout Congress as a whole.[167] At the federal level, the result was gridlock. Congress simply was unable to muster the political will to advance in the face of cross-fire between Wall Street and Main Street.

Roe correctly observes that federal takeover legislation came closest to passing in 1987,[168] but his characterization of the 1987

165. PHILLIPS, *supra* note 153, at 80. The visibility of financial populists on both sides of the political spectrum was raised substantially by the recent political battles over NAFTA and GATT. These battles may have "open[ed] the way for forces of the political left and right to merge into some new, populist, anti-Wall Street, protectionist third force in American politics." Gerald F. Seib, *New Isolationism: A Slow Drift the Wrong Way*, WALL ST. J., Nov. 30, 1994, at A20.

166. *See* Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457 (1988).

167. Roe concurs: managers "have money and status and are spread throughout the states; dispersion with local power makes Congress responsive to their needs. Wall Street is geographically concentrated, less likely to have the ear of many members of Congress." ROE, *supra* note 10, at 44. This view is supported by Romano's finding that sponsors of federal takeover legislation tend to come from districts in which a hostile takeover bid has been located. GENIUS, *supra* note 51, at 76.

168. *See* Tender Offer Disclosure and Fairness Act of 1987, S.R. 1323, 100th Cong., 1st Sess. (1987); Tender Offer Reform Act of 1987, H.R. 2172, 100th Cong., 1st Sess. (1987).

reform effort errs in an important respect. Citing the failure of the 1987 legislation to pass, Roe claims that "managerial pressure on Congress failed."[169] As someone who was involved in the 1987 legislative process, however, I believe it is fairer to say that management allowed the bill to die. Just as the 1987 legislative process was coming to a head, the Supreme Court handed down its decision in *CTS Corp. v. Dynamics Corp. of America.*[170] As discussed below, state takeover legislation is overwhelming pro-target management. By validating state takeover laws, *CTS* reopened a legislative environment far more friendly to managers than Congress. Management interest groups thus faced a whole new ball game. Although most of the bills Congress considered during 1987 favored management,[171] all contained unpalatable provisions and some were particularly objectionable because they included restrictions on management takeover defenses. Accordingly, management interest groups switched venues from Congress to the States. Managerial pressure on Congress simply faded away.[172]

Roe spins this history as a story of weak management political power,[173] which he must do to argue that his reform proposals are politically viable, but his story does not ring true. It is far more accurate to say that the takeover story demonstrates that Congress is institutionally incapable of serious corporate governance reforms. Despite the numerous takeover bills proposed during the 1980s, Congress failed to address even those issues upon which there is virtually unanimous agreement, such as closing the "ten-day window" for reporting stock accumulations.[174] Ultimately, competing interest group pressure from management and pro-takeover forces precluded any legislation from going forward. Although the 1994 Congressional election makes this state-

169. ROE, *supra* note 10, at 160.

170. 481 U.S. 69 (1987).

171. For that matter, virtually all federal takeover bills introduced during the 1980s had a strong pro-management tilt. GENIUS, *supra* note 51, at 76-80.

172. Congress did change the tax treatment of certain aspects of corporate acquisitions, which favored management over raiders. *See id.* at 76 n.52.

173. *See* ROE, *supra* note 10, at 160. In fact, it is fairer to say that it was the raiders and the securities industry whose lobbying effort truly failed, because they were unable to use the 1987 legislation to achieve their goal of obtaining federal preemption of state anti-takeover legislation.

174. The SEC's Advisory Committee on Tender Offers in 1983 found "[t]he 10-day window between the acquisition of more than a 5% interest and the required filing of a Schedule 13D . . . present[s] a substantial opportunity for abuse" and recommended "that the ten-day window be closed." SEC. AND EXCH. COMM'N ADVISORY COMM. ON TENDER OFFERS, REPORT OF RECOMMENDATIONS 22 (1983). Despite numerous proposals to implement that recommendation, the 10 day window remains intact.

ment somewhat like shooting at a moving target, at least on this issue I see no sign that the collective Congressional backbone has stiffened in any meaningful way. Given Congress's history of paralysis on even minor issues, it is difficult indeed to imagine that Congress could muster the political will to adopt the bolder reforms Roe envisions.[175]

Because the legal regimes with which Roe is concerned are predominately federal, Congressional gridlock likely dooms significant reforms. To the extent state law reform matters, the prospects for legislative action are even worse than at the federal level. Recent history teaches that States are likely to favor corporate managers against activist shareholders. Absent federal preemption, legislative change in the near future is likely to impede, rather than promote, institutional investor activism.

Simultaneously with Congress's adoption of the Williams Act, the States began adopting what are now known as first generation state takeover laws.[176] Like the Williams Act, the first generation state laws were mainly disclosure statutes. Unlike the Williams Act, the first generation statutes also imposed certain procedural and substantive requirements creating substantial obstacles for takeover bidders.[177] The Supreme Court invalidated one of these laws in *Edgar v. MITE Corp.*[178] Although the *MITE* court was badly fractured, with only a very narrow Commerce Clause rationale commanding a majority, lower federal courts quickly expanded *MITE* by invalidating first generation statutes as a matter of course.[179]

Undaunted, the States began adopting a second generation of anti-takeover statutes. The various *MITE* opinions had left open a narrow window of opportunity for States to regulate takeovers: the internal affairs doctrine, pursuant to which the State of incor-

175. As we shall see below, the States have proven quite hospitable to management. In turn, Professor Jonathan Macey has demonstrated that Congress obtains political benefits from leaving takeover regulation and, more generally, corporate governance issues in the States' hands. *See* Jonathan R. Macey, *State and Federal Regulation of Corporate Takeovers: A View From the Demand Side*, 69 WASH. U. L.Q. 383 (1991). This benefit further strengthens management's hand and thereby further undermines the prospects for Roe's reforms.

176. Indeed, Virginia's first generation statute was adopted several months prior to the William Act's passage. Stephen Bainbridge, *State Takeover and Tender Offer Regulations Post-MITE: The Maryland, Ohio, and Pennsylvania Attempts*, 90 DICK. L. REV. 731, 736 (1986) [hereinafter *State Regulations*].

177. *Id.* at 737-38.

178. 457 U.S. 624 (1982).

179. *Proxy Contests*, *supra* note 98, at 1120-22.

poration's law controls questions of corporate governance.[180] The second generation state takeover statutes were designed to fit this loophole. Specifically, they relied on the States' traditional power to regulate such matters as mergers and voting rights as a justification for regulating back-end mergers and the bidder's right to vote shares acquired in a control transaction.[181] Although these statutes avoided direct regulation of tender offers, they deterred tender offers by regulating ancillary aspects of takeovers.

After the Supreme Court upheld one of the second generation laws in *CTS Corp. v. Dynamics Corp.*,[182] a veritable flood of state anti-takeover laws resulted. By 1992, over two-thirds of the States had anti-takeover laws on the books.[183] Since *CTS*, moreover, those laws routinely have withstood constitutional challenge.[184] Most important for our purposes, these statutes generally were adopted at the behest of corporate managers, many being emergency legislation designed to fend off a pending takeover bid for an in-state company.[185]

The undoubted pro-management tilt of state takeover legislation finds ready explanation from both interest group and ideological perspectives.[186] As we have seen, the political power of large financial institutions is limited to a handful of major financial centers. Individual shareholders form precisely the sort of dispersed and poorly-organized mass that public choice theory predicts interest group politics will harm. In contrast, corporate managers are widely dispersed geographically, but also are the sort of well-organized interest group that wields considerable political power. As a result, state legislatures can be expected to favor managers over either institutional or individual inves-

180. *Id.* at 1122.

181. *See State Regulations*, *supra* note 176, at 743-50.

182. 481 U.S. 69 (1987).

183. *Proxy Contests*, *supra* note 98, at 1096.

184. *Id.*

185. *Id.*

186. I have written several articles in which I argued that States should have primary responsibility for corporate governance matters, including takeovers and proxy contests. *See, e.g.*, *Proxy Contests*, *supra* note 98; *Rule 19c-4*, *supra* note 95. To be clear, my position on this matter is not dependent upon a belief that state regulation is balanced or even sensible. Indeed, I have acknowledged that States can and often do tilt their legislation in favor of management. *See, e.g.*, *Proxy Contests*, *supra* note 98, at 1141 n.327. Rather, my position on the allocation of power between the States and federal government is based on a doctrinal analysis of the relevant legislation, *see id.* at 1107-20, and my belief that the benefits of federalism outweigh the costs occasioned by bad state laws. *See id.* at 1138-44.

tors.[187] At the same time, given the public opposition to takeovers, legislators who supported anti-takeover laws paid no serious political price for doing so, and probably benefited from doing so.

There is no reason this history would not repeat itself with respect to institutional investor challenges to incumbent managers. In telling his story of how politics fragmented the corporate ownership structure, Roe repeatedly emphasizes the impact our federal system had on the development of financial intermediaries. Although federal law is dominant today, in many cases it was state law that initially fragmented financial institutions.[188] State takeover laws were merely a continuation of this pattern. If activist institutions threaten management's position, we may expect state legislatures again to step in to protect management.

Indeed, there are already flashes on the horizon. Beginning in the late 1980s there was an apparent rise in the frequency of proxy contests as a takeover vehicle, which appears to be partially attributable to an uptick in institutional investor activism.[189] Several States responded to the risk that shareholders might begin routinely voting out incumbent directors by passing legislation designed to deter proxy contests.[190] If the trend toward proxy contests continues, other States may be expected to follow.[191] This pattern confirms my belief that state legislatures will crack down on activist institutional investors.[192]

In sum, the takeover wars are an excellent example of a political situation in which anti-finance populism combined with the

187. Institutional investors have had some success in pressuring corporate managers to opt out of state takeover laws. *See* USEEM, *supra* note 109, at 177-80. It seems likely, however, that firms choosing to opt out were already fairly immune to takeovers. *See id.* at 179 (stating that firms that chose to opt out already had takeover defenses in place and had never been put in play).

188. *See* ROE, *supra* note 10, at 45-46, 78-79.

189. *See Proxy Contests*, *supra* note 98, at 1085-90.

190. *Id.* at 1090-96.

191. *Id.* at 1096.

192. It is possible, of course, that if institutional investors continue to grow in importance, their managers will achieve the same sort of interest group power now wielded by corporate managers. At that point, however, a new concern rises to the fore; namely, that large financial intermediaries would use their control of large public corporations to dominate the political process. Fear of this phenomenon was the theoretical underpinning of anti-finance populism during much of our economic history. Roe ably describes the ideological underpinnings of anti-finance populism, with a heavy emphasis on the fear of concentrated economic power. ROE, *supra* note 10, at 34-36. Nor was this fear unfounded. Institutional investors were not always paragons of virtue. The scandals that led to the prohibition of stock ownership by insurers, for example, included widespread political corruption. *See id.* at 67.

private interests of corporate management to produce legislation that insulated management from an external threat. Roe admits as much.[193] Why then would we not expect populist, anti-Wall Street sentiment likewise to combine with management's private interests to shield managers from activist investors? As was the case during the 1980s, the present political environment does not lend itself to change, significant or otherwise, in the legal rules that sustain the Berle-Means corporation. Anti-finance populism remains an important ideological force. Powerful interest groups are likely to oppose change, while institutions may not speak with a strong unified force in support of change. Roe acknowledges these forces,[194] but cannot bring himself to conclude with a political prediction.[195] In contrast, I feel confident in predicting that the takeover politics of the recent past foreshadow the near-term future politics of institutional investor activism.

Strikingly, Roe himself provides comparative evidence that supports this thesis. He reports that political pressure has caused German banks to become circumspect in using the power their large blocks gives them,[196] and he mentions that interest group in-fighting is weakening the power of Japanese financial intermediaries.[197] It is interesting, to say the least, that the two countries Roe holds up as examples of how institutional activism might evolve are currently seeing a weakening of institutions as financial intermediaries.

B. *The Promise, If Any, of Institutional Activism*

Roe is not unaware of the arguments recounted in the preceding section; indeed, he appears to know both that major reforms are necessary if institutions are to become active and that the necessary reforms are unlikely to be implemented anytime soon. His reluctance to admit the force of these arguments may stem in large part from his hope that institutional investors can play a significant and beneficial role in promoting management accountability. Despite my belief that institutional investor activism has a limited future, let us hold that belief in abeyance for the

193. *Id.* at 152-53.
194. *Id.* at 278-80.
195. *See id.* at 285.
196. *Id.* at 210-12.
197. ROE, *supra* note 10, at 216-19.

moment and consider whether Roe correctly assesses the promise of institutional activism.

1. *The Benefits*

STRONG MANAGERS suggests three ways in which institutional investor activism might benefit corporations: (1) by monitoring management; (2) by helping management convey soft information to shareholders; and (3) by aiding inter-firm organization. I am skeptical that either of the latter two should be taken very seriously.

Roe's second suggestion assumes that the absence of large block holders skews management's incentives in favor of short-term gains, in large part because management finds it difficult to convey soft information about long-term prospects to the market. This not only runs counter to the more frequently asserted claim that pressure from institutional investors skews management's incentives towards the short-term, but according to Roe also "challenge[s] faith in the informational efficiency of the American securities markets" by suggesting that those markets do not "accurately process soft, technological, and proprietary information not out there in public markets."[198] The trouble with this argument is that only the strong form of the efficient capital markets hypothesis claims that information "not out there in public markets" is reflected in a stock's market price.[199] This form of market efficiency has been thoroughly refuted.[200] Hence, while Roe is correct to assert that the market cannot process such information, this hardly challenges our faith in the efficiency of U.S. capital markets.

Our faith in market efficiency would be challenged only if the market was unable to evaluate soft information that has been made public, which Roe also claims to be true.[201] This claim is inconsistent with the semi-strong form of the efficient capital markets hypothesis, which conventional academic wisdom takes as well-established.[202] To the extent Roe is willing to question the semi-strong form of the hypothesis, I am not wholly unsympathetic. But while I am willing to harbor some doubts about the

198. *Id.* at 241.
199. JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY 37 (1991).
200. *Id.* at 41.
201. *See* ROE, *supra* note 10, at 240-41.
202. Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 96 (1978).

extent to which markets are both relatively and absolutely efficient, I seriously doubt that markets are as inefficient as Roe suggests. In my view, the sensible position on the question of market efficiency is to begin by asking not whether the market is or is not efficient, but rather to what degree it is efficient. If approached from that direction, one can acknowledge that the market sometimes fails to value information accurately, while still believing that such failures are rare and temporary.[203] As a result, I doubt that the market systematically fails to accurately process soft information.

If my analysis is correct, the only case in which large block holders might solve an informational problem is that in which management is unwilling or unable to disclose proprietary information to the markets. In such a case, large block holders could get access to the information by virtue of board representation.[204] In turn, Roe suggests, large block holders with access to such information would give management credit for developing it and, as a result, would both "protect secrets *and* protect managers from outsiders who would second-guess truly profitable long-run investments."[205] One objection to this line of reasoning is that the jury is still out on the issue of whether institutional investors are likely to take long-term views.[206] Another objection has to do with the clash of cultures inherent in the institution-corporation relationship. An empirical study of institutional investors and corporate managers reports that the latter believe the former are "impervious to almost any message."[207] Symptomatic of the former's regard for the latter is the comment of one buyout fund president that investor relations managers are "all brain dead."[208] The report concludes, with considerable understatement: "Some of the gap between companies and investors would prove unyielding to any educational effort."[209] Finally, and most seriously, selective disclosure of information to large block share-

203. This view is generally consistent with state-of-the-art financial theory. *See* RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 181-82 (1993); MALKIEL, *supra* note 122, at 210-11.

204. ROE, *supra* note 10, at 240.

205. *Id.* at 241 (original emphasis).

206. *See supra* note 153. If institutions in fact skew management's incentives towards a short-term view, the underlying premise of this line of reasoning fails in any event.

207. USEEM, *supra* note 109, at 145.

208. *Id.* at 146.

209. *Id.*

holders raises serious insider trading concerns.[210] Allowing large financial intermediaries to evolve as a solution to the problem of short-term management horizons thus seems likely to create more problems than it solves.[211]

Roe's suggestion that large financial intermediaries could improve industrial organization by providing a network of interlocking ownership as a supplement to inter-firm contracts,[212] seems equally dubious. Even if such a system arose and proved successful it is precisely this sort of institutional role that is most likely to stimulate populist opposition to the creation of large financial intermediaries. Indeed, this type of ownership as practiced by investment banks was one of the targets of turn-of-the-century anti-finance populists.[213]

In the end, we are left with the central problem posed by the separation of ownership and control: management accountability. As we saw in part I, firm agents always have an incentive to shirk because they do not bear the full pecuniary costs of preferring leisure to work. As a result, the firm incurs agency costs: the firm must monitor its agents to prevent shirking; agents must bond their performance; and even in the presence of active monitoring and bonding, some residual loss will necessarily remain. The rise of the Berle-Means corporation is particularly problematic from this perspective, because it means that the dominant

210. The problem is illustrated by a recent SEC enforcement proceeding against the institutional investor group run by money manager Mario Gabelli. The group owned over 25% of the stock of an industrial corporation of which Gabelli was chief executive. Even though there was no evidence of illegal insider trading, the SEC brought an enforcement proceeding alleging that the investment group had inadequate policies to prevent insider trading by the firm based on information learned by Gabelli through his relationship with the corporation. Mark H. Anderson, *Gabelli Group Settles Charges of Lax Oversight*, WALL ST. J., Dec. 9, 1994, at B2.

This is not the appropriate forum for an extended discourse on the policy basis for regulating insider trading. Suffice it then to say that, in my view, insider trading is subject to regulation solely because it represents a theft of information in which the firm has a proprietary interest. As such, selective disclosure of such information to some but not all shareholders would be a breach of fiduciary duty by the managers who made such disclosures. See Stephen M. Bainbridge, *Insider Trading under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. 1 (1993).

211. Roe acknowledges the insider trading objection, but ducks it. His response to possible abuses of power by large block holders asserts that multiple blocks would check one another and that multiple blocks would behave differently than would a single large shareholder. Neither response goes to the issue of insider trading by large block holders with special access to information. Instead, they appropriately are directed to other conflicts of interest that arise when large block holders come into existence. *See infra* notes 273-80 and accompanying text.

212. ROE, *supra* note 10, at 248-53.

213. *See, e.g.*, WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET 92-93 (1927).

economic actor in our society faces a situation in which those with the most incentive to monitor the firm's agents—the residual claimants—are poorly-positioned to carry out their monitoring task.

In theory, large financial intermediaries could remedy this problem. Institutional investors holding large blocks would have more power to hold management accountable for actions that do not promote shareholder welfare. Their greater access to firm information, coupled with their concentrated voting power, would enable them to monitor more actively the firm's performance and to make changes in the board's composition when performance lagged.[214]

The theory is not implausible, but there is much we do not know. As we have seen, we do not know whether large financial intermediaries would take on an active role. We also do not know whether shifting to a corporate governance structure in which activist shareholders dominated the firm in fact would produce significant economic changes. Roe concedes that governance is a relatively minor component of productivity and competitiveness.[215] Roe further concedes that the lack of large financial intermediaries holding concentrated voting power is not a serious economic problem,[216] and that gains from remedying this lack likely would be modest.[217] Indeed, Roe goes so far as to concede that most firms are probably better off with a Berle-Means structure.[218] In fact, there is good empirical evidence that general economic conditions, changes in specific industry sectors, and

214. ROE, *supra* note 10, at 235-37. Roe suggests two other aspects of the relationship between large block holders and firms that might improve firm performance. First, large block holders would "personify" the shareholder community. Loyalty to real people may be a better motivator than loyalty to an abstract collection of small shareholders. *Id.* at 237-38. The trouble, of course, is that the interests of large and small investors often differ. *Uncertain Significance*, *supra* note 133, at 466-68; Rosenbaum, *supra* note 123, at 176-79. As management becomes more loyal to the interests of large shareholders, it may become less concerned with the welfare of smaller investors. Second, large block holders may improve decisions by providing managers with an additional information network. This is an interesting suggestion that has merit. Such information networks, however, would have to be carefully structured to avoid compounding the informational inefficiencies inherent in the corporate system.

215. ROE, *supra* note 10, at 233.

216. *Id.* at 5.

217. *Id.* at 171. A survey of the empirical literature by a leading proponent of institutional investor activism found only "modest but not conclusive support for the proposition that institutional monitoring *in fact* adds value." Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 917 (1992) (original emphasis).

218. ROE, *supra* note 10, at 16.

changes in company size are far more predictive of company performance than is senior management turnover.[219] Taken together with Roe's concessions, this confirms our prior conclusion that monitoring for purposes of crisis intervention is not a program likely to have significant favorable results.

Where then is the evidence to support the theory? Because German and Japanese corporations have ownership structures dominated by large financial intermediaries,[220] proponents of institutional investor activism inevitably are tempted to point to the economic success of Germany and Japan in recent decades as evidence of the superiority of their corporate governance systems. Roe very nearly succumbs to this temptation, opining that the German and Japanese success stories pique our interest.[221] To his credit, however, Roe ultimately resists the temptation.

It is important to be skeptical of arguments attempting to link governance with competitiveness. In particular, it is vital to be skeptical of comparative arguments based on U.S. competitiveness vis-à-vis that of Japan or Germany.[222] American enterprise long prevailed in world economic competition.[223] Moreover, despite German and Japanese successes, American enterprise is still winning the competitiveness war.[224] Does this mean that the U.S. system of corporate governance is superior? Roe says this is at best a debater's argument,[225] which is a fair point, but is not the converse argument equally just a debater's argument? In any case, as Roe admits, the impact of corporate governance rules on

219. USEEM, *supra* note 109, at 216-17.

220. A prominent American student of Japanese law and finance argues that the large stockholdings of Japanese banks cannot be explained on corporate governance grounds. Banks take such positions not to monitor corporate management, but as a mechanism for realizing the value of inside information learned during the lending process. J. Mark Ramseyer, *Columbian Cartel Launches Bid for Japanese Firms*, 102 YALE L.J. 2005, 2005, 2013-14 (1993). If true, this may suggest that the risks of institutional investor activism are greater than Roe anticipates, while little in the way of enhanced management accountability can be expected on the benefit side.

221. ROE, *supra* note 10, at 254.

222. At the outset, it should be noted that Japanese firms do not operate under rules analogous to those proposed by most proponents of institutional investor activism. *See* Ramseyer, *supra* note 220, at 2019. Accordingly, even if recent Japanese economic success has causal links to corporate governance, the Japanese analogy cannot justify the more extreme reform proposals of American academics and institutional investors. *See also* Rosenbaum, *supra* note 123, at 179-82 (noting the substantial structural differences between U.S. institutional investors and German or Japanese financial intermediaries, which preclude the former from playing a corporate governance role comparable to the latter).

223. ROE, *supra* note 10, at 254.

224. *See* Hobart Rowen, *Challenging Convention on Productivity*, WASH. POST, Nov. 22, 1992, at H1.

225. ROE, *supra* note 10, at 254.

productivity and competitiveness is likely to be swamped by other factors.[226] As a result, one ultimately cannot make very much of comparative data. Indeed, Roe goes so far as to concede that there is no clear evidence that German or Japanese governance models are superior to the Berle-Means corporation.[227]

2. *The Risks*

Like most students of corporate governance, Roe believes that managers of U.S. firms generally are not accountable to anyone and, accordingly, that enhanced accountability mechanisms are desirable, if not essential.[228] While direct accountability is not wholly unimportant, American managers already function within a pervasive web of indirect accountability mechanisms. Both our legal system and our markets have adapted to minimize the agency costs inherent in the Berle-Means governance structure. Among the relevant legal constraints are shareholder derivative suits, mandatory disclosure, state and stock exchange governance requirements, anti-fraud laws, and the like. The economic constraints include outside directors, independent accountants, takeovers, proxy contents, and competition in the product, capital, and managerial services markets.

Roe concedes that these market mechanisms substitute for shareholder activism, but calls their effectiveness partial and imperfect.[229] Setting aside the trivial point that no accountability mechanism, including institutional investor monitoring, is perfect, where is the evidence that existing constraints are imperfect in any meaningful sense? Indeed, this claim would seem to run counter to Roe's concessions that institutional activism would produce only modest gains and that most firms are better off in the Berle-Means framework.

A better argument might be that institutional activism would provide a useful redundant control on management agency

226. *Id.* at 254-56. Romano persuasively argues that perceived disparities between U.S. and Japanese or German productivity incorrectly are overstated in favor of the latter and that there is no evidence to support the claim that any such disparities are causally linked to corporate governance arrangements. *Cautionary Note, supra* note 51, at 2023-26.

227. *See* ROE, *supra* note 10, at 15.

228. *See id.* at 235 ("American managers have often not been held accountable for their performance").

229. *Id.* at 275-76. Roe identifies three factors that counterbalance the agency costs created by the separation of ownership and control: (1) its benefits (in terms of economies of scale) outweigh its drawbacks; (2) competition in various markets constrain management from severe derelictions; and (3) various other legal and extra-legal control mechanisms arise to constrain management's behavior. *See id.* at 7-8.

costs. An analogy to engineering concepts may be useful. If a mechanical system is likely to fail, and its failure likely to entail high costs, basic engineering theory calls for redundant controls to prevent failure.[230] As just mentioned, no accountability mechanism is perfect. Neither markets nor legal regimes eliminate management misbehavior. Why then would activist institutional investors not be an appropriate redundant control?

At this point the theory of the second best comes into play: in a complex, interdependent system, inefficiencies in one part of the system should be tolerated if correcting them would create even greater inefficiencies in the system as a whole.[231] Even if facilitating the creation of large financial intermediaries would increase management accountability, such a change would still be inappropriate if it imposes costs in other parts of the corporate governance system. Put another way, although one almost never encounters arguments against enhancing management accountability within corporate law scholarship, the theory of the second best provides such an argument if enhanced institutional activism gives rise to serious risks.

Various potential risks associated with institutional investor activism can be identified. Roe concedes, for example, that bank control of the securities markets harms Japan and Germany by impeding the development of new businesses.[232] Given the importance of individual investors to the American market in new issues, the increasing institutionalization of the markets may cause similar problems here. The main concerns, however, remain institutional over-reaching and the question of who will monitor the monitors. These risks are well-known, of course, but are reviewed briefly here to evaluate Roe's appraisal of them.

a. *Institutional Overreaching*

Even the most fervent proponents of institutional investor activism concede that institutions should not try to operate the firm; they "do not have the expertise, the resources, or the right to become involved in matters of day-to-day management."[233]

230. *See* T.A. Kletz, *Process Industry Safety*, *in* ENGINEERING SAFETY 347, 348 (David Blochley ed., 1992) ("[N]ot all hazards can be avoided and many have to be controlled. The principle followed is defense in depth: if one line of defense fails there are others in reserve.").

231. *Two Models*, *supra* note 19, at 525.

232. *See* ROE, *supra* note 10, at 194-96.

233. MONKS & MINOW, *supra* note 137, at 255.

Roe admits that institutions should not run firms, but rather simply should monitor management's performance and step in if performance falters.[234] Given this consensus on the need for institutional restraint, the more interesting question is whether institutional investors would seek to overstep their bounds. Roe treats this problem in some detail in connection with his discussion of insurers. Roe asserts that "they would probably not *immediately* seek to direct their portfolio firm's management and policies. Indeed, they might never seek tight direction, because activity *without* control could ordinarily be their best policy, since the institution is unlikely to run the firm better than the firm's own managers."[235] Assuming that insurers overcome the various forces that incline them towards passivity, however, this scenario is refuted by Roe's own historical account.

Recall that limits on stock ownership by insurance companies were imposed precisely because insurers were taking control of corporations. At the turn of the century, Charles Evan Hughes remarked that insurers holding large blocks "frequently found it advisable to increase [their ownership interest] until a substantial control is effected, and the insurance corporation is not only engaged in a different enterprise, but directly undertakes its management."[236] Although we have suggested that Hughes was mainly concerned with the resulting concentration of economic power, that merely confirms the hazard: what begins as institutional monitoring may soon become institutional managing. As Roe admits, this danger remains a viable concern: "if an insurer wanted influential blocks, multiple crises could lead it to direct the management and policies of a few firms in its portfolio."[237]

Once the likelihood of institutional over-reaching is acknowledged, the rising power of institutional investors becomes most troubling. As we have seen, the economic model of the corporation embraced by Roe, which views the corporation as a child of technological change and a vehicle for aggregating capital investment, misses the point. The chief economic virtue of the Berle-Means corporation is not that it permits the aggregation of large

234. *See* ROE, *supra* note 10, at 12.

235. *Id.* at 89.

236. *Id.* at 74.

237. *Id.* at 89. Useem argues that such a shift has already taken place, at least for some firms. *See* USEEM, *supra* note 109, at 19-48. Given that many of these changes were undertaken before shareholders pressured management in the early 1990s, *id.* at 221, however, it seems fair to speculate that the threat of hostile takeovers had more to do with the phenomenon Unseem describes than did institutional investor activism.

capital pools, but rather that it provides a hierarchical decision-making structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs.[238] In such a firm, someone must be in charge: "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."[239] As we saw in part I, the Berle-Means corporation responds to this necessity by vesting ultimate decision-making authority in the board and its subordinate managers.

Roe might concede the point, but respond by asking why I object to shifting ultimate decision-making authority to the firm's owners. One answer to this question begins by observing that ownership is not a particularly meaningful concept as applied to modern public corporations.[240] Recall that contractarians view the corporation as merely a nexus of contracts between the firm's various inputs. Each input is owned by someone, but no one input owns the totality—not even shareholders, who from this perspective are simply one of the inputs bound together by the web of voluntary agreements.

This insight implicates the provocative question Michael Dooley asked in a somewhat different context: "Why have we assumed that it is the shareholders . . . who must act as monitors and disciplinarians of the board and the management team?"[241] Given that shareholders do not own the corporation in any meaningful sense, they have no inherent right to exercise the oversight and control powers of owners of private property. Instead, the very limited ownership-like rights granted shareholders by the corporate contract exist solely to help constrain managerial misconduct.[242] Consistent with the theory of the second best, expanding the role of institutional investors within the corporation can be justified only if doing so reduces managerial shirking without imposing countervailing costs elsewhere in the corporate decision-making structure. Such costs, however, appear to be a necessary consequence of shareholder activism. Large-scale institutional involvement in corporate decision-making seems likely

238. *See supra* part I.

239. ARROW, *supra* note 19, at 69.

240. Another answer to this question is that it raises the problem of who will monitor the monitors, which is taken up in the next section.

241. *Two Models*, *supra* note 19, at 525.

242. *See id.* at 468.

to disrupt the very mechanism that makes the Berle-Means corporation practicable; namely, the centralization of decision-making authority in the board of directors.

Arrow's organizational theories suggest that the Berle-Means corporation's hierarchical structure is a highly efficient response to the conditions of divergent interests and information created by dispersed stock ownership. Neither further institutionalization of the market nor increased institutional investor activism would eliminate dispersed ownership. Instead, such measures likely would result only in a slight decrease in the degree of dispersal. As a result, successful institutional activism still will require coordinated action by a coalition of investors. Even assuming that institutions can overcome the serious collective action problems that impede coalition formation, continuing divergence in the interests of the coalition members and in their ability to make informed decisions still will impede their ability to make or review corporate policy. Indeed, as we shall see in the following section, individual institutions might pursue their own self-interest at the expense of the firm's best interests.

Yet, even assuming that these hurdles can be overcome, there is still no guarantee that transferring decision-making authority from the board to institutional investors would result in better decisions. To the contrary, even if we grant Roe all the necessary assumptions to reach this stage of the argument, we might reasonably still expect that institutions would make worse decisions than a firm's managers. As we have seen, a fully diversified institutional portfolio will suffer little from the failure of any particular firm. Indeed, if the firm's failure benefits competing firms that are also part of the institution's portfolio, the institution conceivably could come out ahead of the game. In contrast, as Michael Dooley points out, managers are not only part of an efficient authority-based decision-making structure, but also have a strong stake in their firm's success: much of their wealth is tied up in firm-specific human capital.[243] Between managers and shareholders, managers have the greatest incentive to ensure the firm's success.

In sum, the conditions that gave rise to the Berle-Means corporation—and the concomitant legal superiority of the board of directors—will continue to obtain under any set of plausible as-

243. *See id.* at 526.

sumptions about the near term future of institutional investors and the corporations in which they invest. As such, Berle and Means correctly believed that the separation of ownership and control inhere in the concept of corporate governance. This is so not simply because of the exigencies of size, technology, or capital formation, but also because of the unavoidable need for authoritarian decision-making structures in complex organizations. As a result, concerns about institutional over-reaching must take center stage in any debate over the role of institutional investors. Legal reforms designed to make managers more directly accountable to institutional investors necessarily will shift some aliquot of the board's decision-making authority to that class of shareholders,[244] with adverse consequences for corporate decision-making the most likely result.[245]

Trying to preserve the distinction between management and monitoring is not an adequate response to this concern, because that distinction is far easier to state than to make in practice. While Roe argues that "power *sharing* differs, at least in form,

244. *Cf. id.* at 470 (describing this shift in the context of the proposed reforms of the business judgment rule). Especially troubling are proposals for a shareholder advisory committee, which would play a role comparable to that of the supervisory board in German corporations (but without the counter-weight of employee representation). *See generally* Barnard, *supra* note 105, at 1138-40, 1147-49. At best, such committees will likely duplicate the functions of the board of directors. *See id.* at 1166-67. At worst, they would usurp those functions entirely.

The controversy last year between Chrysler Corporation and Kirk Kerkorian, its largest shareholder, offers a useful anecdotal example of the mischief that might result from an enhanced shareholder role in corporate decision-making. Chrysler's management had decided to build up large cash reserves as a buffer against future cyclical down-turns in the automotive market. Kerkorian wanted those funds used to fund a large stock buy-back program. Ira Millstein, the lawyer who advised GM's independent directors in their 1992 board room coup, argued that Chrysler's board would make "a big mistake" by allowing "Kerkorian to take the company away from the strategic plan management ha[d] adopted." Paul Ingrassia, *Memo to the Board: Management Isn't Always Wrong*, WALL ST. J., Nov. 23, 1994, at A14. Millstein further accused Kerkorian of pursuing short-term gain at the expense of the long-term health of the company. *See id.* Paul Ingrassia, a prominent automobile industry analyst, likewise argued that Kerkorian's efforts to overturn management's plans gave Chrysler's board "the chance to show that board room activism means standing up for management when it's on the right track." *Id.* Kerkorian subsequently launched a takeover bid and proxy contest for Chrysler, activities which led one institutional investor to opine that "Kerkorian is just trying to stir the pot." *Kerkorian Ready for Chrysler Proxy Fight*, N.Y. TIMES, April 29, 1995, at 36. As this article went to press, the situation remained in flux.

245. In addition to threatening the efficiency of corporate decision making, institutional opportunism also may discourage investments in firm-specific human capital by managers and other non-shareholder constituencies of the firm. Part of the economic function of firms is to provide a mechanism for preventing opportunistic behavior, such as the expropriation of firm-specific investments. *See generally* Jonathan R. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74 CORNELL L. REV. 43 (1988).

from completely *shifting* authority from managers to" institutions,[246] it must in fact be a difference in form only. Roe's model necessarily contemplates that institutions will review management decisions, step in when management performance falters, and exercise voting control to effect a change in policy or personnel.[247] In a very real sense, giving institutions this power of review differs little from giving them the power to make management decisions in the first place: "If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem" of allocating control under conditions of divergent interests and differing levels of information.[248] The same is true even if only major decisions of A are reviewed by B. The board directors of General Motors, after all, does not micromanage the company, but it is still in charge.[249] Just so, even though a coalition of institutional investors probably would not micromanage a corporation, vesting them with the power to review major decisions would shift some portion of the board's authority to them.

From this perspective, the evidence that Germany and Japan may be moving away from corporate governance structures in which shareholders play a dominant role becomes particularly striking.[250] By Roe's own account, the smaller size of German and Japanese economies has meant that their corporate managers were less subject to market constraints than were managers of

246. *See* ROE, *supra* note 10, at 184.

247. *See id.* at 235 ("The model institutional overseer would not micromanage the firm from day to day, but be ready to make changes during crisis and hold the managers accountable during the interim").

248. *See* ARROW, *supra* note 19, at 78.

249. General Motors was chosen as the textual example because of its board's unprecedented dismissal of GM's chief executive and two other top executives in 1992. One commentator observed that then-GM CEO Robert Stempel was the first to lose control of the board in over 70 years. *See* USEEM, *supra* note 109, at 234. Institutional investors had been pressing the board to act and strongly supported its decision to do so. *See id.* at 228. This development may prove to be a positive harbinger. Some institutional activists are focusing their reform agenda on plans to enhance not their own power, but rather that of the board of directors. *See id.* at 200-09. Changes designed to enhance the board's position vis-à-vis both shareholders and managers are consistent with the theory of corporate governance presented in the text and, accordingly, may prove to be the most positive result of the fad for institutional investor activism. A word of caution is in order, however, against reform proposals that assume that "one size fits all." The role and composition of boards of directors can and should vary from firm to firm. *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1064-66 (1993) [hereinafter *Independent Directors*].

250. *See supra* notes 196-97 and accompanying text.

U.S. Berle-Means corporations.[251] If large financial institutions actively monitor corporate governance in those countries, their role may be as much an economic necessity as it is a consequence of their political history. In other words, the Berle-Means corporation really may be the most efficient system, and Germany and Japan may have chosen less efficient systems because institutional monitoring was the best available weapon against agency costs.

b. *Who Watches the Watchers?*

Dr. Seuss tells a marvelous tale about the town of Hawtch-Hawtch, whose principal industry is a bee. The Bee-Watcher's job is to watch the bee, because "[a] bee that is watched will work harder, you see."[252] Unfortunately, the bee did not work very hard. The townspeople concluded that this was the fault of the Bee Watcher, so they decided to hire a Bee-Watcher-Watcher. But the latter also failed. So a Watch-Watcher-Watcher was hired. Things progressed as one might expect, with the upshot being that soon all of Hawtch-Hawtch was out in the field watching one another.

Alchian and Demsetz tried to solve this precise problem by introducing the residual claimant as the ultimate monitor. One cuts off the chain of monitors by giving the ultimate monitor the claim on whatever profits are left, thus giving him an economic incentive to maximize productivity.[253] As we have seen, however, this solution does not hold in the public corporation context.[254]

The second problem with reforms designed to enhance monitoring by institutional investors now should be readily apparent: it amounts to hiring a Bee-Watcher-Watcher. The vast majority of large institutional investors manage the pooled savings of small individual investors. From a governance perspective, there is little to distinguish such institutions from corporations. The holders of investment company shares, for example, have no more control over the election of company trustees than they do over the election of corporate directors.[255] Nor do the holders of such

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251. ROE, *supra* note 10, at 15-16. *But see* Ramseyer, *supra* note 220, at 2019 (stating that U.S. and Japanese managers face comparable market incentives).

252. DR. SEUSS, DID I EVER TELL YOU HOW LUCKY YOU ARE? (1973).

253. *See supra* notes 28-29 and accompanying text.

254. *See supra* pp. 677-78.

255. Accordingly, fund shareholders exhibit the same rational apathy as corporate shareholders. Kathryn McGrath, a former SEC mutual fund regulator, observes that "[a] lot of shareholders take ye olde proxy and throw it in the trash." Karen Blumental, *Fidelity Sets Vote on Scope of Investments*, WALL ST. J., Dec. 8, 1994, at C1, C18. The proxy system thus

shares have any greater access to information about their holdings, or ability to monitor those who manage their holdings, than do corporate shareholders.[256] Indeed, until quite recently, most investment companies would not disclose even the name and background of the individual who managed the fund. Worse yet, although an individual investor always can abide by the "Wall Street rule" with respect to corporate stock, he cannot do so with respect to some institutional investments, such as many pension plans. In sum, if separation of ownership and control is a problem in search of a solution, encouraging large financial intermediaries to evolve and to take an active corporate governance role simply moves the problem back a step—it does not solve it.[257] This prospect is troubling not only in its own right, and not only because of the already discussed risk of institutional over-reaching, but also because every major category of institutional investor is subject to serious conflicts of interest.

Corporate law scholars long have been concerned that controlling shareholders will use their position to take a non-pro rata share of the firms assets and earnings.[258] This concern is some-

"costs shareholders money for rights they don't seem interested in exercising." *Id.* Indeed, "Ms. McGrath concedes that she herself often tosses a proxy for a personal investment onto a 'to-do pile' where 'I don't get around to reading it, or when I do, the deadline has passed.'" *Id.*

256. The same can be equally true of other institutions. Amusingly, given his status as a leading proponent of institutional activism, Robert Monks recounts that a bank trust department declined to give him information about the performance of a trust account of which Monk's wife was a beneficiary and, moreover, refused to resign as trustee. MONKS & MINOW, *supra* note 137, at 198-99.

257. For a single example, consider that corporate managers often (and justifiably) are accused of being more risk-averse than a fully diversified shareholder would prefer. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 47, at 99-100. The likelihood that management will base its actions on its own risk preferences rather than those of the shareholders is a form of agency costs. Precisely the same sort of agency costs exists in pension funds. Because of legal liability rules, losses from risky investments may fall on the manager, while gains will go to the investors. The manager is therefore likely to invest more conservatively than would the beneficiaries. *See* ROE, *supra* note 10, at 143. The rise of large financial intermediaries simply shifts this agency cost problem rather than solving it.

258. *See, e.g.*, MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 308-15 (1976) (discussing the analogous problem of majority-owned subsidiaries). Professor Rock offers a skeptical account of so-called relational investors, who function in ways comparable to those proposed by proponents of institutional investor activism and, indeed, are often institutional investors as the term has been used herein. In the course of doing so, Rock offers several examples of situations in which relational investors have used their control over portfolio companies for self-dealing through preferential contracts. *See* Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 995-999 (1994) [hereinafter *Dark Side*]. For a somewhat more optimistic account of relational investing that, however, ultimately fails to reach firm conclusions about its value, see Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033 (1994).

what misplaced, however, because small shareholders can protect themselves from this risk by holding a diversified portfolio. A fully diversified shareholder is just as likely to hold investments in the parent corporation that does the looting as he is to be an investor in the looted subsidiary.[259] If managers of large financial intermediaries use their institution's control of industrial corporations to line their own pockets, however, diversification cannot protect investors. Roe offers historical evidence of this sort of looting from the insurance industry at the turn of the century, when insurance company managers obtained low-interest loans and jobs from portfolio firms.[260]

Conversely, corporate managers are well-positioned to buy off most institutional investors that attempt to act as monitors.[261] The same banks whose trust departments might become activist investors often have or anticipate commercial lending relationships with the firms they purportedly will monitor.[262] Similarly, insurers "as purveyors of insurance products, pension plans, and other financial services to corporations, have reason to mute their corporate governance activities and be bought off."[263]

The potential for conflicts of interest becomes especially obvious in the context of private pension funds. Under current law, private pension funds essentially are barred from corporate governance activism because "corporate managers dominate pension managers, not the other way around."[264] As Roe explains in considerable detail, existing law vests management with control over pension fund activities, including their corporate governance activities.[265] This gives management a great deal of leverage to prevent governance activism by private pension funds. During the takeover binge of the late 1980s, for example, managers of

259. *Cf.* Frank Easterbrook & Daniel Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) (presenting this diversification theory in the context of sales of control of majority-owned subsidiaries).

260. *See* ROE, *supra* note 10, at 67.

261. *See id.* at 15.

262. *See generally Independent Directors*, *supra* note 249, at 1059 (discussing director conflicts of interest).

263. ROE, *supra* note 10, at 62. In addition, a variety of institutional and historical factors leave insurers ill-equipped to be active in governance. *See id.* at 83. Accordingly, they are prime candidates for avoiding the cost of active governance and, as such, prime candidates to support cartel-like rules against activism. Much the same is true of mutual funds. Fund management companies often also provide corporate pension fund management. Their analysts need access to corporate managers for information. By withholding such opportunities, corporate managers easily can punish activist fund managers.

264. *Id.* at 225.

265. *See id.* at 124-38.

target corporations not only pressured their own firm's pension fund managers to oppose hostile raids, but some also enlisted other corporate managers to pressure their pension fund managers to do the same.[266] A variety of other rules, such as the "prudent investor rule," further encourage passivity by pension managers. Is it prudent, for example, to expend resources on governance activities that have an uncertain pay-off?[267] Taken together, these factors render private pension funds an unlikely source of managerial accountability.

Yet even if private pension funds were freed of management control, by vesting their control in unions or individual employees, it is not clear that they immediately would become an important accountability mechanism. Actions that benefit managers at shareholder expense often benefit labor as well.[268] Unless those who control the private pension funds are barred from considering the effect of a decision on workers *qua* workers, they will support management in many cases vis-à-vis other shareholders.

In view of these conflicts, much attention has been focused on public pension funds. State and local government pension funds, however, are relatively small. As of 1993, they controlled slightly more than nine percent of U.S. equities.[269] In contrast, private pension funds controlled twenty-two percent.[270] More important, public pension funds are just as subject to managerial pressure as are private funds. Can it be doubted, for example, that the same state legislators who passed anti-takeover laws at the behest of target managers would fail to rein in activist pension funds pursuing those same managers?[271] As we have seen, corporate managers

266. *See* MONKS & MINOW, *supra* note 137, at 191-93. Black reports, more generally, that corporate managers commonly give pension fund managers voting advice, and that such advice almost always is taken. *Shareholder Passivity*, *supra* note 101, at 597. After 1988, when the Labor Department began scrutinizing plan fiduciary voting practices, such pressures did not dissipate, but merely became less overt. *See id.*

267. *See* ROE, *supra* note 10, at 138-43.

268. *See supra* notes 155-57 and accompanying text.

269. ROE, *supra* note 10, at 125.

270. *Id.*

271. "Few state governments have the staying power to challenge a major local corporation." MONKS & MINOW, *supra* note 137, at 216. Anecdotally, Monks and Minow report that "[w]hen the Wisconsin state pension fund wanted to object to General Motors's $742.8 million of greenmail to Ross Perot, it was stopped by the governor, who was trying to get General Motors to build some plants in his state." *Id.* at 186. Not surprisingly given their agenda of pushing institutional activism, Monks and Minow ignore this general rule and focus on the main exception that proves it: California's public pension funds, especially CalPERS. *See id.* at 216-18. California has never been noted as a state with a strong pro-business philosophy. *See West of Eden—California's Economic Fall*, POL. REV., Summer 1993, at 42. Pennsylvania's 1991 adoption of sweeping anti-takeover legislation, which

are a discrete and well-organized interest group. In contrast, public pension fund beneficiaries are dispersed and poorly-organized. Basic public choice theory suggests that conflicts between their interests are likely to be resolved in favor of managers.[272]

Roe acknowledges most of these concerns, but argues they are overstated.[273] While a single controlling shareholder can readily put his own interests ahead of those of other shareholders, an institutional investor cannot. Although institutions increasingly dominate the shareholder demography of large public corporations, individual institutions still hold relatively small blocks in any given firm. Hence, even if institutions hold two-thirds or more of a firm's stock, no single institution is likely to own more than five or ten percent of the stock. Where multiple institutions must act collectively to achieve a particular outcome, they will check one another's conflicted interests. Management could thwart a single opportunistic institution by calling that institution's misbehavior to the attention of other institutions. Formation of a self-dealing cartel amongst multiple opportunistic institutions is unlikely because of collective action problems, the possibility of legal regulation,[274] and the differing interests of the various players.[275] Management under-performance, in contrast,

included protection against proxy contests (despite overwhelming opposition from institutional investors) is a more likely scenario for the future of political action.

272. An equally plausible source of concern is the risk that politically weak institutional investors may be used for the political rather than economic ends of other interest groups. Although all institutional investors are subject to this risk, the government's role in public pension funds may render them especially susceptible to it. Using pension fund investments to support so-called socially responsible investments is particularly popular with politicians and academics of the left. Some have gone so far as to suggest that "the road to socialism, or some substantial socialization of the investment process, might lie through an expanded, publicly regulated system of pension finance." William H. Simon, *The Prospects of Pension Fund Socialism, in* CORPORATE CONTROL AND ACCOUNTABILITY 165, 166 (Joseph McCahery et al. eds., 1993).

273. The following discussion summarizes the discussion at ROE, *supra* note 10, at 244-46. For a more detailed examination of the conflict of interest problems posed by institutional investor activism, see *Uncertain Significance, supra* note 133, at 469-78.

274. Note, however, that existing law provides few barriers to self-dealing by institutional investors. *See Dark Side, supra* note 258, at 1006-21.

275. Where the opportunistic institution is seeking short-term gain at the expense of the firm's long-term health, however, a cartel may form if other institutions take an equally short-sighted view. In the dispute between Chrysler and Kirk Kerkorian, for example, Kerkorian's proposed course of action was supported by institutional money managers. *See* Ingrassia, *supra* note 244, at A14. Indeed, because the costs of creating a cartel are sunk, and the presence of institutional trade associations may make maintenance of the cartel a low-cost venture, cartels may form and remain active much more readily than Roe admits. *See Uncertain Significance, supra* note 133, at 466. For an argument suggesting that cartels may not often form, see Coffee, *supra* note 149, at 847-71. While Coffee doubts that self-dealing cartels are likely, the thrust of his argument cuts against Roe's position

would unite the institutions: all have a common interest in remedying under-performance. Assuming that management cannot make side-payments to all the large institutions within its shareholder community (which seems plausible), conflicts of interest thus would not stop institutions from preventing at least some instances of management under-performance.

I harbor some remaining doubts about this argument. First, Roe seems to ignore the collective action problems discussed above. Even assuming that Roe's proposed legal changes are adopted, which would permit greater shareholder coordination, barriers to collective action remain. Consider first the case of management under-performance. In the situation of multiple small blocks, no one institution alone can take corrective action if management resists change. As in any multiple actor setting, someone must go first: some institution will have to step forward to assemble a coalition that can unseat the incumbent managers.[276] In the event that some institutional activist does step forward, it will face vigorous opposition from the threatened managers, who will try to cut off the flow of information to shareholders, co-opt key institutions,[277] mobilize nonshareholder constituencies that also would be affected adversely by change, and otherwise disrupt the process. As our review of the Standard Oil dispute suggested, management resistance of this sort can pose serious problems for institutional activists.[278] The situation remains a classic free rider problem.

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because Coffee also argues that coalitions will not form in response to management under-performance. *See id.*

276. Because public pension funds are the institutional group arguably least subject to direct conflicts of interest, they may be the group most likely to act as a rallying point around which a coalition could build. However, public pension funds also uniquely are subject to co-option through the political process. Roe concedes this point. *See* ROE, *supra* note 10, at 245.

277. Useem points out that corporate managers have a well-developed set of mechanisms for dealing with external constituencies. Many of these mechanisms involve generic lobbying and public relations skills that carry over to investor relations. *See* USEEM, *supra* note 109, at 130-31. Motivated by the takeover wave of the 1980s and, perhaps, rising institutional investor activism, many firms now have given investor relations a very high priority in terms of both prestige and resources. *See id.* at 131-33. Coupled with the conflicts of interest that pressure some types of institutions to support management, an active investor relations program can give management substantial leverage in pulling the teeth from activist investors. *See id.* at 149-55 (describing successful management resistance to activist investor proposals to redeem poison pills).

278. In 1991, Robert Monks ran as a dissident candidate for election to the Sears board of directors. At that time, he was perhaps the most visible proponent of institutional investor activism. Despite support from several large public pension funds, Monks received only 15 percent of the vote, which fell short of the necessary 25 percent. *See* USEEM, *supra* note 109, at 200. The Monks example provides a more up-to-date version of the Standard

The free rider issue becomes especially acute when collective action is needed to repel an opportunistic institutional investor. Ironically, because institutions have little incentive to monitor one another, collective action against an opportunistic institution usually will depend upon management to assemble the requisite coalition. Obviously, this will not happen in situations in which management is willing to make side payments to the opportunistic institution.[279]

Second, a significant increase in the level of institutional activism seems most probable if preceded by an increased concentration of institutional ownership. With such increased concentration, the result will be fewer, albeit more powerful, institutions. For small- and medium-sized corporations, this could mean that only one or two institutions would have a significant stake. In such firms, institutional conflicts of interest would remain a serious concern. Roe's solution to the conflict of interest problem thus requires economic evolution to essentially stop on a dime (or maybe a quarter): institutions must become large enough to overcome the collective action problems that encourage passivity, but not so large that they become controlling shareholders.[280]

C. *Why not an Enabling Approach?*

As we saw above, institutional investor activism is best justified as a redundant control on management conduct—a backstop that steps in when market and legal constraints fail. Because redundant controls are costly, however, we should not impose them without some showing that they are needed. Throughout this part, I have explained how Roe anticipates many of the objections that might be raised against the use of institutional inves-

Oil story, confirming the continuing disadvantages activism faces even when one activist steps forward as an agent of change.

279. Rock offers several examples of situations in which management was willing to make side payments to relational investors in return for protection against hostile takeover bids. *Dark Side*, *supra* note 258, at 990-95.

280. Roe anticipates this objection and responds that under existing law most institutions are subject to legal limits on the percentage of stock they may own in a given firm. Indeed, most institutions do not approach the legal limit on stock ownership. Perhaps this is because isolated large blocks are subject to being outmaneuvered by management. Roe implies that, assuming the limits on stock ownership remain in place, institutional blocks will remain relatively small because they will need a critical mass of other large block holders. *See* ROE, *supra* note 10, at 245-46. Presumably he believes that holding less than the legal limit would encourage other institutions to buy substantial blocks. Query, however, whether such multiple blocks will be able to overcome the collective action problems inherent in dispersed stock ownership.

tor activism as a redundant control. As the preceding sections relate, however, there remain a number of objections to which Roe either has not responded or, in my judgment, has not responded persuasively.[281]

The remaining task is to gauge the magnitudes of the cost and benefits of institutional activism—concededly a difficult task. As Justice Brennan observed, albeit in a very different context, "the language of . . . cost-benefit analysis, if used indiscriminately, can have a narcotic effect. It creates an illusion of technical precision and ineluctability."[282] Given this warning, our skepticism about the merits of cross-cultural comparative data, and the obvious impracticability of gathering other direct empirical evidence, cost-benefit analysis in this context necessarily must be seen as a series of educated guesses.

Roe essentially admits that the case for change is, at best, weak. Recall his concessions that, among other things, reform faces serious political obstacles, poses important risks, and offers only modest benefits. The question then becomes whether we should embark on major reforms on such a tenuous basis. Here again, however, Roe anticipates the objection and puts forward a intriguing reply. While conceding that there is not enough evidence to justify policies that affirmatively would promote institutional concentration and activism, Roe argues that one cannot justify sticking with the current corporate governance structure simply because the benefits of change are unclear.[283] He further claims there is enough evidence to justify policies that would facilitate further evolution by loosening existing restrictions.[284] Roe therefore advocates creating an enabling regime—a level playing field—in which Berle-Means corporations and corporations with large institutional holders could co-exist and compete.

As someone who embraces the contractarian approach to corporate law, I initially found Roe's enabling approach appealing. Like most contractarians, I have a general preference for enabling rules as opposed to mandatory rules. On closer examina-

281. To say that existing barriers to institutional activism need not be dismantled is not to say that new ones should be erected. Roe makes a convincing case that any new barriers would be motivated more by populist outrage and interest group pressure than by public-minded impulses.

282. *See* United States v. Leon, 468 U.S. 897, 929 (1984) (Brennan, J., dissenting).

283. *See* ROE, *supra* note 10, at 257.

284. *See id.* at 233.

tion, however, I am somewhat dubious of the utility of an enabling approach in this context.

An enabling regime has the advantage of recognizing that different firms have different accountability needs. Managers of a firm with strong takeover defenses are less subject to the constraining influence of the market for corporate control, for example, than are those of a firm with no takeover defenses. The former needs internal monitoring mechanisms far more than the latter does. In theory, an enabling regime would take this into account by allowing firms with a need for strong institutional oversight to develop a shareholder demography dominated by large institutions, while firms needing less active oversight would tend to attract individual investors.

A truly enabling system would require enormous changes in the existing legal system. As Roe himself describes, there are substantial legal barriers under American law that prevent U.S. banks from imitating the corporate governance role of German or Japanese banks.[285] The same would be true of the legal rules governing pension and mutual funds.[286] Repeal or modification of not just these obvious candidates, but also of a host of laws imposing liability or obligations on those who control corporations would be necessary. Among these provisions are the securities law restrictions on controlling shareholders and the bankruptcy implications of control.

Many such laws are more than mere interest group legislation. To the contrary, these rules originally were adopted not for the purpose of fragmenting corporate stock ownership, but to address perceived abuses by financial intermediaries.[287] Roe's historical account suggests that the repeated misbehavior of large financial institutions gave turn of the century populists good reason to be suspicious of such entities. His historical analysis thus

285. *See id.* at 187-97; Coffee, *supra* note 149, at 892-905 (setting forth a lengthy list of laws requiring repeal or modification if institutional investors are to have enhanced incentives for corporate governance activism).

286. Roe's claim that restrictions on mutual funds should be loosened is probably correct. *See* ROE, *supra* note 10, at 267-71. There is good reason, however, to doubt that mutual funds would become major governance players. *See supra* note 263. As for pension funds, Roe concedes that major restructuring of the pension fund system is not economically justified. *See* ROE, *supra* note 10, at 271-72. Roe further concedes that doctrinal changes are unlikely to matter much in terms of pension fund activism. *See id.* at 272. In addition, existing pension laws essentially codify a bargain between management and labor. Changing the pension laws would require reopening that bargain, and the interest groups that support the present bargain are unlikely to allow this to happen.

287. *See supra* part II.

tends to confirm the concerns about institutional behavior identified in the preceding sections. Granted, some of the concerns identified there may prove over-blown. In addition, some of the concerns identified there are mutually exclusive. For example, if the ineffectualness of crisis management leads institutions to remain passive, concerns about over-reaching by those institutions are obviously vitiated. But none of this suggests the absence of risks associated with institutional investor empowerment; to the contrary, divergent possible outcomes are the very nature of risk. Basic finance theory demonstrates that there ought to be a reward for bearing risk. Without prospect for significant returns from reform, is it rational to incur the risks reform entails?[288]

These concerns are perhaps why Roe eschews recommending truly sweeping legal change. Tinkering with the securities laws, however, is unlikely to result in a workable enabling regime. Changes designed to facilitate coordination likely would have only marginal effects absent changes that encourage concentrated ownership. Coordination is by far the most costly form of institutional activism and the one most subject to collective action problems.

Even if sweeping reform were undertaken, moreover, one doubts that it is either legally or economically practicable for fragmented ownership and institutional ownership to coexist, which is a pre-condition to competition between organizational forms. To take but a single example, how would a firm that neither needs nor desires activist shareholders exclude them from buying stock or limit their power once they become shareholders? Institutions that have developed the technology and human resources necessary to undertake an active governance role likely would be unwilling to take inactive roles. At least plausibly, fragmented and unified ownership are antithetical as an economic matter even in a totally free market. Strikingly, by Roe's own evidence and admission, ownership patterns tend to be all or nothing: passive and fragmented, as in the United States, or concentrated and active, as in Germany.[289] Perhaps the

288. To be sure, as Roe argues, past scandals alone should not be enough to bar a class of transactions. *See* ROE, *supra* note 10, at 38. In general, corporate law is consistent with this view: it polices conflict of interest transactions, but rarely prohibits them. *See Independent Directors*, *supra* note 249, at 1075. Where scandals often are repeated, but are also difficult to detect, however, a mandatory prohibition of the suspect class of transactions may become both necessary and appropriate.

289. *See* ROE, *supra* note 10, at 277.

choice between organizational forms must be made by countries rather than by companies.

IV. Conclusion

One of its book-jacket blurbs promises that STRONG MANAGERS will prove "far more influential than Adolf Berle and Gardiner Mean's THE MODERN CORPORATION AND PRIVATE PROPERTY," which is, to put it mildly, more than a bit far-fetched. Sixty years is an awfully long time for one book to dominate a field of law, yet Berle and Mean's classic shows no signs of slowing down. But we would hold STRONG MANAGERS to far too high a standard if we were to require it to displace Berle and Means to earn a place in the history of corporate governance scholarship. Measured by more appropriate standards, STRONG MANAGERS is unquestionably important and useful.

As a work of narrative history, STRONG MANAGERS is unmatched in recent corporate law scholarship. Although one can question some of his premises and doubt some of his conclusions, Roe tells a plausible story about the political forces that helped shape modern corporate governance. As a primer for reform, STRONG MANAGERS is more problematic, but remains quite important. It seems likely that the corporate governance role of large institutional investors will remain a significant political issue. If so, there is little doubt that Roe's analysis will feature prominently in the debate, and deservedly so. At the most basic level, STRONG MANAGERS is far and away the most readable book on corporate governance written by an academic in recent memory. Readability is a virtue all too often ignored within the academy, but by making his arguments accessible to the widest possible audience, Roe is likely to have a far greater impact on policy making than would more arcane theorists.

At a more substantive level, Roe's policy prescriptions have the equally often over-looked virtue of modesty. To be sure, STRONG MANAGERS did not assuage my doubts about either the likelihood or the necessity of substantial legal change in this area. Whatever the flaws of the Berle-Means corporation, U.S. firms have almost two centuries of experience with it. As we have seen, that experience gave rise to a variety of legal and extra-legal forces that limit the agency cost problem created by the separation of ownership and control. I doubt whether this body of experience should or will be cast aside in favor of reformist schemes proposed by aca-

demic lawyers and economists. To his credit, Roe recognizes both the political obstacles to sweeping reforms and the theoretical arguments against such reforms, and therefore does not pursue drastic change. Indeed, the conservative flavor of STRONG MANAGERS is striking. If its recommendations are followed, change will be slow and measured, relying more on economic evolution through private contracting than on government mandates. So if change does come, let it come along the lines Roe proposes.