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Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law

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> The board of directors . . . is located at two critical corporate interfaces—the interface between the owners of the enterprise and its management, and the interface between the corporation and the larger society. The directors are stewards—stewards of the owners' interest in the enterprise and stewards also of the owners' legal and ethical obligations to other groups affected by corporate activity.[1]

I. INTRODUCTION

For large publicly held corporations,[2] "corporate govern-

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1. THE BUSINESS ROUNDTABLE, THE ROLE AND COMPOSITION OF THE BOARD OF DIRECTORS OF THE LARGE PUBLICLY OWNED CORPORATION, *reprinted in* 33 BUS. LAW. 2083, 2096 (1978) [hereinafter BUSINESS ROUNDTABLE 1978]. In articulating this remarkable definition of the board of directors, the Roundtable adopted the seminal view of the board as a steward for shareholders' interests while serving as an "interface" between shareholders and nonshareholders. Consistent with this definition, the Roundtable recognized that it might be necessary to give shareholders an explicit right to nominate directors. *Id.* at 2095.

2. This Article focuses on large publicly held corporations. The American Law Institute (ALI) defines "publicly held corporation" as a corporation with "both 500 or more record holders of its equity securities and $5 million or more of total assets." *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE, ANALYSIS AND RECOMMENDATIONS § 1.31 (Proposed Final Draft, Mar. 31, 1992) [hereinafter ALI PROJECT]. The ALI defines "large publicly held corporation" as a corporation with two thousand or more shareholders and $100,000,000 or more total assets. *See id.* § 1.24. The Securities and Exchange Commission uses similar classifications. The Securities Exchange Act of 1934 subjects issuers to special regulation if they have total assets exceeding one million dollars and a class of equity securities held of record by five hundred or more persons. 15 U.S.C. §§ 78a-78ll (1988) [hereinafter the "1934 Exchange Act"]. The regulations require that the corporation register that class of shares with the SEC and submit periodic financial information. *See* 1934 Exchange Act § 12(g)(1)(B), 15 U.S.C. § 78l(g)(1)(B). Rule 12g-1 exempts from registration requirements issuers whose total assets do not exceed five million dollars. *See*

ance,"[3] a common term in current law review articles,[4] is an outdated term. It is outdated because it emphasizes the tensions and power struggles between corporate constituencies and implies an inevitable and immutable governance tug-of-war.[5] It is also outdated because it masks the economic reality of the corporate enterprise: that the *raison d'etre* of large publicly held corporations is to maximize "longterm shareholder"[6] and corporate value. Finally, it is outdated because today's globally competitive marketplace requires a corporate focus on long-term per-

id. § 12(g)(1); *see also* FEDERAL SECURITIES CODE § 402(a) (1980) (requiring registration if a corporation has over one million dollars in assets and over five hundred holders of securities).

3. The term "corporate governance" embodies the basic allocation of powers and duties among shareholders and nonshareholders. For purposes of this article, "nonshareholders" includes directors, officers and "stakeholders." *See generally* ROBERT C. CLARK, CORPORATE LAW §§ 3.1 - 3.5 (1986) (outlining the basic allocation of powers and duties of shareholders and nonshareholders).

4. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989); Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REF. 19 (1988); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881; Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982) [hereinafter Fischel, *The Corporate Governance Movement*]; Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982) [hereinafter Fischel, *The "Race to the Bottom"*]; Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991); Donald E. Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511 (1984); Elliott J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CAL. L. REV. 551 (1987); Elliott J. Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1 (1984).

As to the nature and function of corporate law generally, see ALI PROJECT, *supra* note 2; Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865 (1990).

5. Ever since the takeover decade of the 1980s, during which corporate raiders mounted challenges against incumbent management, the concept of "corporate governance" has carried a war-like connotation, suggesting shareholders pitted against nonshareholders.

6. The authors intend to use "longterm" as a term of art when in conjuction with shareholder ("longterm shareholder") and stakeholder ("longterm stakeholder")—thus, the lack of hyphenation. For background of longterm shareholders and longterm stakeholders, see John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313 (1992).

formance rather than on divisive factionalism. Accordingly, this Article suggests steps toward minimizing corporate law's preoccupation with "corporate governance" in favor of a new concept: "corporate cooperation."

Corporate law and contemporary corporate law reform proposals proceed from a fundamentally flawed framework, which depicts management, shareholders, and stakeholders as inherently and inexorably antagonistic. As a result, the United States is in the midst of a corporate law revolution. For the most part, directors of publicly held corporations do not understand their roles and particularly their relationships with large institutional shareholders[7]—despite the fact that institutional shareholders own over fifty percent of all equity securities.[8] For several decades, directors have insulated themselves and management from shareholder accountability, eschewing any real effort to assimilate shareholders into the corporate activity fabric.[9] This anachronistic anti-shareholder attitude will not survive in an era in which shareholders, armed with a revamped proxy system,[10] are determined to be heard.

Shareholder activism is changing. Longterm shareholders now realize the need to focus on long-term value maximization to ensure satisfactory corporate performance. Longterm shareholders[11] invest in a corporation expecting their share ownership to engender more than a mere monetary stake. These shareholders expect to have a relationship with the corporation, its board, its management, and other longterm stakeholders. Just as marriage is more than a "transaction," a longterm shareholder's commitment to a corporation is more than a monetary "transaction"; both envision a long-term relationship.

Corporate law reform must ultimately focus on how to redefine the role of directors[12] to maximize long-term corporate value. Although several proposals purport to resolve this gov-

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7. *See infra* Part II.C.2.b. (discussing institutional shareholders).

8. *See* Dan Cordtz, *Corporate Hangmen*, FIN. WORLD, March 30, 1993, at 24, 25 (noting that institutional investors control "54% of the stock in U.S. corporations").

9. *See infra* text accompanying notes 35-37 (discussing management entrenchment).

10. For a discussion of this new proxy system, see *infra* Part III.A.

11. *See infra* Part IV.E (discussing longterm shareholders).

12. "In the corporate governance debate, all arguments ultimately converge on the role of the board of directors in general, and on the role of outside directors in particular." Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873 (1991).

ernance conundrum,[13] none adequately addresses the role of the board in a world populated by the new species of shareholder, the longterm shareholder. This Article attempts to fill the void.

As the centerpiece of corporate law,[14] boards are fiduciaries for, and are accountable to, the shareholders—the corporation's primary constituency.[15] Contemporary corporate law endows boards with two primary functions: monitoring and management. The law is oblivious, however, to a potentially far more significant board function, the "relationship management" function. This Article posits that an effective corporate cooperation regime requires that contemporary boards undertake this "relationship management" function.

The essence of an effective relationship is communication. Consistent with the role of relationship management, the board of directors, longterm shareholders, and other stakeholders must engage in dialogue—or, more accurately, "trialogue"[16]—to function effectively. This is the trialogical imperative that flows from the board's relationship management role.

This Article sets forth a legal paradigm designed to facilitate a cooperative corporate law regime that will maximize longterm corporate value. This new paradigm comprises three key players: the board of directors, longterm shareholders, and longterm stakeholders, including senior management. In contrast to the old governance paradigm characterized by atomized ownership, pervasive investor apathy, and hostile control battles, this new legal paradigm emphasizes ongoing communication and cooperation among the key players.

This Article argues that, of the three key players, the board is the appropriate organ for mediating between the other longterm players to set a course for maximizing the long-term welfare of the corporation, its shareholders, and its constituencies.

13. See *infra* Part IV.B (discussing the major governance reform proposal proffered this decade).

14. Corporate law generally decrees that "[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors." MODEL BUSINESS CORP. ACT § 8.01(b) (1991).

15. *See, e.g.*, Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 STETSON L. REV. 197, 199 (1991) (noting that "[t]he fiduciary duty of directors is perhaps the most powerful and important concept underlying the corporate system. The reason is our belief that those who exercise power should be accountable to those who are affected by it.").

16. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2440 (unabridged, 1986) (defining "trialogue" as a "discourse[ ] or colloquy in which three persons share").

To implement this proposal successfully, the board, or a committee of the board, will mediate among competing factions. As the master controller of the enterprise, the board will serve as the central information processor between longterm shareholders and stakeholders. Meanwhile, the longterm shareholders and longterm stakeholders, if given appropriate access, will ensure that the board possesses the requisite expertise, authority, and resources to make informed decisions that optimize the players' mutual long-term interests. In this sense, the board will become a significantly more important and powerful element in synthesizing and coalescing the goals of a corporation.

Institutional investors promise to become an integral element of the proposed board-centered governance regime. To monitor and mediate fundamental finance and governance issues effectively, the board needs a great deal of information, much of which institutional investors can supply. Who better to provide information on longterm shareholders' interests than those shareholders themselves? As one commentator notes, "[i]nstitutional investors are perhaps the strongest force for reform ever to emerge in the history of boards."[17]

Part II of this Article sets forth the contemporary corporate governance landscape. It outlines the three key players in the corporate governance triad. It describes the central importance of the board of directors in corporate governance, explaining why the board continues to be the master controller of the corporate machine. This Part analyzes the promise and limits of independent outside directors and concludes that they are a necessary but insufficient element of effective corporate reform. It also describes the roles of shareholders and stakeholders, the remaining two elements of the corporate governance triad.

Part III explores rays of hope on the current "corporate governance" horizon. It suggests that reforms giving shareholders greater voice, although aimed in the right direction, suffer from the same shortcomings as other reform proposals. That is, they continue to rely on the "corporate governance" framework of ages past and ignore the potent and inevitable forces of a "corporate cooperation" regime.

Part IV proposes a "corporate cooperation" regime in which the board's function is "relationship management." This Part articulates the need for a trialogue between the board, longterm shareholders, and longterm stakeholders.

17. Leslie Levy, *The Debate Over Corporate Governance: Past, Present and Future*, INSIGHTS, Dec. 1991, at 27, 27.

II. "CORPORATE GOVERNANCE" AND THE TRADITIONAL LEGAL FRAMEWORK FOR CORPORATE LAW

"[U]nloved and unlamented, the corporate form now languishes, bleeding and dying . . . ."[18]

For more than two centuries, scholars and commentators have predicted the demise of the publicly held corporation. In his *Wealth of Nations*, Adam Smith questioned the viability of the corporation,[19] implying that the conflict of interest between managers and scattered, absentee shareholders would fatally undermine the development of the corporation.[20] In 1932, Adolf Berle and Gardiner Means cautioned that the "separation of ownership and control" insulated corporate managers from the discipline of competitive markets.[21] Ultimately, this would render the corporate form extinct. Similarly, the logical conclusion of John Kenneth Galbraith's social reform arguments is that America's unconstrained managers would devastate our unregulated, free-exchange economy.[22] Today's law and economics scholars also predict the demise of the corporate form.[23] The common conclusion of these commentators is that the "agency costs"[24] arising from the ownership and control dichotomy[25] inherent in the corporate form may cause the demise of the public corporation.

Various corporate governance reform efforts attempt to avert the fatality these commentators foresee. Corporate governance reform approaches based on the "legal constraint theory" seek to transcend the dichotomy between ownership and

18. Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 Nw. U. L. REV. 148, 148 (1992).

19. *See* ADAM SMITH, THE WEALTH OF NATIONS 741-58 (R.H. Campbell et al. eds., Clarendon Press 1976) (1776).

20. *Id.* at 741.

21. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 2-6 (1932). Berle and Means also believed that the proxy system was fatally flawed in that it provided no constraints upon management. *Id.* at 139.

22. *See* JOHN K. GALBRAITH, THE ANATOMY OF POWER 132-33 (1983); JOHN K. GALBRAITH, ECONOMIES AND THE PUBLIC PURPOSE 84-87 (1973); JOHN K. GALBRAITH, THE NEW INDUSTRIAL STATE 72-85 (1971).

23. *See, e.g.*, Presser, *supra* note 18, at 148.

24. Michael Jensen and William Meckling originated and defined the term "agency costs." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

25. For a discussion of this dichotomy, see *infra* text accompanying notes 29-37.

control by minimizing "agency costs."[26] These reformers seek to impose legal restraints on managers to better conform their behavior to more economically efficient outcomes. A second approach to corporate reform, based on the "stakeholder theory," contrasts sharply with the "legal constraint model." The "stakeholder theory" is a "contractarian" theory because it posits that market forces align managers' self-interests with shareholders' interests, enabling the corporation to transcend the dichotomy between ownership and control. In other words, it says that market forces adequately discipline managers by compelling them to align their interests with those of the shareholders.[27] Adherents to this theory assert that public policy should facilitate contracting among self-interested individuals and that legal rules hampering the contracting process disadvantage all corporate stakeholders.[28]

A. The Dialectical Underpinning of Corporate Law

Contemporary corporate law doctrine proceeds from the assumption that corporate governance is dialectical.[29] The best

26. The most comprehensive and self-contained reform proposal is the titanic *American Law Institute Principles of Corporate Governance: Analysis and Recommendations*. ALI PROJECT, *supra* note 2. This proposal fully embraces the "agency cost" model. The ALI Project argues that agency costs are minimized through constraints imposed by strengthening the role of liability rules and judicial review. *See id.*

27. This is alternatively called the "market constraint theory" or the "contractarian theory." These theories share the same goal: minimizing legal constraints imposed on the free-market so stakeholders can contract freely with the corporation.

28. *See, e.g.*, Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 777, 778 (1972); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980).

29. The principal basis of the corporate form is the limited liability afforded capital providers (shareholders), whose primary incentive is to maximize corporate profitability irrespective of adverse consequences to other stakeholders. "I weigh my words when I say that in my judgment, the limited liability corporation is the greatest single discovery of modern times." Nicolas M. Butler, President of Columbia University, Address at the 143d Annual Banquet of the Chamber of Commerce of the State of New York (Nov. 16, 1911), *in* WILLIAM M. FLETCHER, CYLCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 21 (1917). *See generally* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS §§ 73-76 (3d ed. 1983) (discussing advantages and disadvantages of corporate organization). Commentators have defined limited liability as "the rule that shareholders are not liable for the obligations of the corporation beyond their capital investment." PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS, SUBSTANTIVE LAW § 1.02, at 7 (1987). Corporations thus allow shareholders to reap profits and dividends without personal responsibility for the consequences of

economic explanation of the dialectical nature of corporate form is agency cost theory,[30] which emphasizes the dichotomy between discretion and accountability. This dichotomy stems from the separation of ownership and control,[31] as articulated by Adolf Berle and Gardiner Means in their classic work, *The Modern Corporation and Private Property*.[32] Berle and Means claimed that shareholders are merely passive owners and that managers provide the true locus of control amid pervasive shareholder passivity. They predicted that the separation of ownership and control would ultimately cause the demise of the corporation as a form of private enterprise.[33] Tensions between

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failure. Stakeholders—including, employees, customers, suppliers, and even communities—have no such long-term protection. They seek guarantees by the corporation of an ongoing commitment to their welfare. In a fundamental sense, the current governance framework pits shareholders against nonshareholders.

30. See the seminal article by Jensen and Meckling. Jensen & Meckling, *supra* note 24, at 310-11.

31. Berle and Means are the most frequently cited authority on the role of the separation of ownership and control in corporate governance. *See* BERLE & MEANS, *supra* note 21. Adam Smith was an early commentator on the same subject:

> The directors of [corporations], however, being the managers rather of other people's money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co[-]partner[ship] frequently watch over their own. . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of [a corporation].

SMITH, *supra* note 19, at 741.

32. BERLE & MEANS, *supra* note 21.

33. *Id.* at 355-56. Because of this separation of ownership and control, directors lack incentives to maximize efficiency and shareholder welfare. Instead, they are saddled with interests that often diverge from those of shareholders. Conflicts of interest between shareholders and nonshareholders are thus the inevitable result of separation of ownership and control.

The lack of a meaningful mechanism for shareholders to select management aggravates the conflicts of interest inherent in the corporate form. Indeed, management is a self-perpetuating oligarchy. *See* Dent, *supra* note 4, at 881, 907. Management controls the director nomination process and the proxy machinery. *Id.* at 882 ("So long as management controls proxies, corporate governance reform efforts are doomed."). "Proxy disclosure has not led to shareholder control; management still runs the proxy machinery and shareholders still lack any plausible alternative to supporting management." *Id.* at 896.

> If the shareholders are supposed to select directors, it is incongruous to vest proxy control in incumbents seeking re-election. This is like letting legislators fund their re-election campaigns from the public treasury while requiring challengers to pay their own way. This system makes the board a self-perpetuating oligarchy and, once management controls the board, the tool for managerial control of the firm. In short, the system generates the separation of ownership and control.

shareholders and management are inherent in corporate governance.[34]

The dialectical nature of corporate governance appears to have compelled the dialectical evolution of corporate law.[35] In modern corporate law's infancy, shareholder primacy predominated.[36] Shareholders had the right and power to control operation of the corporation. As corporations grew and capital markets expanded, shareholders lacked incentives to participate actively in management. As shareholders became more passive, they increasingly relied on corporate management

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Id. at 906-07 (footnote omitted); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 419-20 (1983) ("Shareholders' involvement in the voting process has not increased with the adoption of the proxy rules."). Shareholder passivity and the concomitant ability of managers to control the proxy process leave owners unable to communicate or negotiate effectively with management. The inefficiencies stemming from shareholders' passive roles become part of the "agency costs" of the current governance regime. *See, e.g.*, Jensen & Meckling, *supra* note 24.

34. The ALI Project describes the dialectical nature as follows:

> The challenge for corporate law is to facilitate the development of a corporate structure that allows management the discretion to utilize its expertise on behalf of shareholders, but at the same time establish safeguards in situations in which management might utilize that discretion to favor itself at the expense of shareholders.

ALI PROJECT, *supra* note 2, introductory note to part VI, at 519; *see also id.* introductory note to parts III & III-A, at 99 (noting that there are "two highly important social needs regarding [publicly held] corporations[:] the need to permit a corporation to be highly flexible in structuring its operational management [and] the need for processes that ensure managerial accountability to shareholders"). Building upon this dichotomy, Professor Lyman Johnson asserts:

> [The function of corporate law should be to] confer a sufficiently wide berth of discretion to enable management to operate creatively and flexibly but should not be so broad that management can subvert the ultimate objective of shareholder welfare. These dual strands of management discretion and shareholder welfare are in constant tension, and each is poised on any given issue to check, if not negate and overwhelm, the other.

Johnson, *supra* note 4, at 880.

Professor Clark writes:

> [T]he role or function of the manager is to act on behalf of other persons' interests. Yet power corrupts. It can be turned to [a manager's] personal use . . . in ways that hurt the other persons having claims on the organization. The problem, then, is how to keep managers accountable to their other-directed duties while nonetheless allowing them great discretionary power over appropriate matters. This is the major problem dealt with by corporate law.

CLARK, *supra* note 3, at 33-34.

35. *See* Matheson & Olson, *supra* note 6, at 1323-53.

36. *See infra* Part II.C.2.a (describing the traditional shareholder primacy norm).

to run the business, supposedly in the shareholders' best interests.

As the chasm separating shareholders from stakeholders expanded, shareholders placed paramount importance on means of effectively monitoring management. Corporations adopted monitoring devices, such as the independent director. The market for corporate control also evolved as a monitoring device. Tender offers allowed suitors to go directly to shareholders to determine the target corporation's fate. Nonshareholders responded dialectically by aggressively developing anti-takeover weaponry. Their efforts culminated in the current "insulated mangerialism" stage of corporate law.[37] A chasm that grew over decades thus separates today's shareholders from effective communication with management.

B. THE ECONOMIC AND LEGAL RESPONSE TO THE DIALECTICAL GOVERNANCE NATURE

The past decade has witnessed marked instability and unrest surrounding the current governance framework. The 1980s takeover bonanza caused havoc in corporations. Proliferation of state-adopted and corporate-imposed anti-takeover and anti-shareholder mechanisms, including the poison pill,[38] and anti-takeover legislation,[39] similarly caused havoc with shareholders. As a result, corporate governance is undergoing a major

37. *See* Matheson & Olson, *supra* note 6, at 1319-23.

38. Poison pills are stock warrants or rights that allow the holder to buy a suitor's stock at low prices ("flip-overs") or to sell target stock to the target itself ("flip-ins"). *See, e.g.*, P. John Kozyris, *Corporate Takeovers at the Jurisdictional Crossroads: Preserving State Authority Over Internal Affairs While Protecting the Transferability of Interstate Stock Through Federal Law*, 36 UCLA L. REV. 1109, 1156-57 (1989). "If the recent trends continue, virtually all major corporations will be transformed into fortresses in the near future." *Id.* at 1125 n.59. The Investor Responsibility Research Center, an independent non-profit research group, found that 51% of large American companies are armored with poison pills as of August 1990. *Majority of Large U.S. Corporations Have Adopted Poison Pills, IRRC Finds*, Sec. Reg. & L. Rep. (BNA) No. 47, at 1659 (Nov. 30, 1990); *see also* John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1430 n.17 (1991) (describing the purpose of "poison pills").

39. This "extraordinary ferment of activity in the field of corporate governance" includes increased involvement by the Securities and Exchange Commission, institutional investors, major corporate stakeholders, legislators, boards, commentators, executives, and scholars. Roswell B. Perkins, *The President's Letter*, 4 A.L.I. 1 (1982), REP. 1 *quoted in* Melvin A. Eisenberg, *An Introduction to the ALI Corporate Governance Project*, 52 GEO. WASH. L. REV. 495, 496 (1984).

transformation. Shareholders and even some outside directors have become increasingly impatient with languishing corporate performance. One sign is that outside directors of *Fortune* companies have ousted chief executive officers as never before. Examples include General Motors, Compaq Computer, Chrysler, and Allied-Signal.[40]

The unequaled economic and social impact of the modern corporation[41] helps explain why the controversy and criticism surrounding corporate governance are intensifying. Inquiries into methods of improving corporate governance come on the heels of an economic recession, at a time in which the country is experiencing heightened competition from abroad and an increasing awareness that most boards ineffectively monitor management. Indeed, society's long-term welfare is at stake.[42]

In part because of increased shareholder activism, corporate governance has emerged as a ripe subject for reform. As one scholar notes:

> The intensity of the corporate governance debate in the United States . . . reflects a deep-seated concern with the present system. Virtually all participants in the debate recognize that the present system will not meet our needs in the 1990s and beyond. We cannot afford to repeat the financial chaos of the 1980s or the crises that inevitably follow such a speculative frenzy. *While corporate governance is only one factor in determining the success of our business corporations, it is a key factor.* It is imperative that we rebuild the corporate governance system to promote the long-term health of the corporations that form the backbone of our free-market economy.[43]

40. Joel Chernoff, *Investors Cheer GM Shake-up; Directors "have a job to do,"* PENSIONS & INVESTMENTS, Apr. 13, 1992, at 1.

41. "Today, . . . the corporation is the dominant form of business organization, . . . account[ing] for about 89 percent of business receipts. . . . [O]verall, the business corporation is the principal form for carrying out business activities in this country." CLARK, *supra* note 3, at 1-2. Few governance issues impact as broadly and intensely on society as corporate takeovers. As such, "[n]o current corporate issue has attracted more attention from legal and economic scholars than takeover defensive moves by corporate managers." Larry E. Ribstein, *Takeover Defenses and the Corporate Contract,* 78 GEO. L.J. 71, 72 (1989).

42. *See* Martin Lipton, *A Proposal for a New System of Corporate Governance: Quinquennial Election of Directors, in* INSTITUTIONAL INVESTORS: PASSIVE FIDUCIARIES TO ACTIVIST OWNERS 61, 63-65 (PLI Corp. Law & Practice Course Handbook Series No. 704, 1990) [hereinafter INSTITUTIONAL INVESTORS] ("The stakes are large. Indeed, I believe that the health and vitality of our entire economy is at risk.").

43. Lipton & Rosenblum, *supra* note 4, at 253 (emphasis added).

An issue of growing importance is the role of increasingly active, sophisticated, and expert institutional shareholders.[44] An effective corporate governance strategy must harness the valuable input of major, longterm shareholders in order to maximize economic efficiency for society's benefit. To harness this input, a dramatically new corporate board structure must replace the traditional board structure in which directors' primary function seems to be one of following the lead of management.

Although "the 1980s witnessed an unprecedented development in the law surrounding corporate governance,"[45] the 1990s may prove to be even more ground-breaking. The unveiling of the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations* (hereinafter ALI Project)[46] ranks among the major governance developments of this decade; its fifteen-year gestation yielded an impressive treatise on corporate law and governance.[47]

A decade ago, when most regarded shareholder passivity as an immutable characteristic of dispersed stock ownership, few believed that shareholders had the ability or desire to challenge

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44. "The past decade witnessed a staggering rise of institutional share ownership with an equally dramatic increase in the concentration of shareholdings." Matheson & Olson, *supra* note 6, at 1354.

> By 1988, institutional assets had exploded to five trillion dollars, or 18.7% of total financial assets in the United States. In 1989, institutions held forty-three percent of all equities and fifty percent of the fifty largest companies' equity. The fifty largest institutions owned $925 billion in stocks, or twenty-seven percent of the stock market. By 1990, institutional investors owned forty-five percent of outstanding corporate equity.... Controlling more that $2.5 trillion in assets, pension funds alone currently own more than twenty-five percent of all publicly traded equity in U.S. companies.

Id. at 1354-55.

Numerous factors compel institutional shareholders to seek to expand their active involvement in corporate governance issues, including the increased size and concentration of institutional shareholders, their enhanced sophistication, and the marked down-turn in takeovers as a means of monitoring and disciplining management. *Id.* at 1354.

45. D. BLOCK, N. BARTON & S. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 1 (3d ed. 1989). The authors further note that "[t]he early 1990s will likely prove an equally active period...." *Id.* at 41.

46. *See* ALI PROJECT, *supra* note 2.

47. In addition, commentators advanced three significant corporate governance proposals during this decade. The Lipton/Rosenblum proposal recommends extending board terms to five years. Lipton & Rosenblum, *supra* note 4, at 224-30. The Gilson/Kraakman proposal recommends the infusion of "professional directors." Gilson & Kraakman, *supra* note 12, at 883-92. The Matheson/Olson proposal advocates implementing a "longterm shareholder" regime. Matheson & Olson, *supra* note 6, at 1375-81.

corporate governance. Although shareholders of decades past were admittedly passive and powerless, today's shareholder activism foretells a shareholder uprising, fueled largely by the ascendancy of the institutional investor.[48] Indeed, never has the need for shareholder activism been more critical. The pronounced downturn in takeovers this decade[49] limits the disciplinary force that the threat of takeovers has on management.[50]

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48. Commentators have explained:

> [We] are now witnessing the reagglomeration of ownership of the largest corporations, so that long-term shareholders are well on the way to majority ownership of America's companies. They are, of course, the institutional shareholders, who invest collections of individuals' assets through pension funds, trusts, insurance companies, and other entities.

ROBERT A. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 18 (1991).

"Notwithstanding major differences among them, institutional investors, as a group, have vastly expanded their economic sphere of influence in a number of important ways. Moreover, while they may be diverse, a high concentration of economic power resides among a relatively small and extraordinarily stable group of institutions." Carolyn K. Brancato, *The Pivotal Role of Institutional Investors in Capital Markets: A Summary of Research at the Columbia Institutional Investor Project*, *in* INSTITUTIONAL INVESTORS, *supra* note 42, at 406-07.

49. *See Mergers, Acquisition Activity Fell 18% in 1st Quarter, Hitting an 11-Year Low*, WALL ST. J., Apr. 16, 1991, at A2 ("Merger and acquisition activity plummeted to an 11-year low in the first quarter [of 1991], with the number of transactions off 18% from a year earlier. . . . continuing the decline that appeared in 1990 when potential deals fell 12% from 1989."); *see also Mergers at an 11-year Low*, N.Y. TIMES, Apr. 18, 1991, at D10 (describing the same drop in merger and acquisition activity).

No governance issue has received more attention than the impact of takeovers and anti-takeover weaponry upon shareholders and nonshareholders. *See generally* ALAN J. AUERBACH, CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (1988) (collecting articles about takeovers and their impact upon corporate boards and management); HOSTILE TAKEOVERS: ISSUES IN PUBLIC AND CORPORATE POLICY (David L. McKee ed., 1989) (same); KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER (John C. Coffee, Jr. et al. eds., 1988) (same).

50. "It is impossible to overstate how deeply the market for corporate control has changed the attitudes and practices of U.S. managers. . . . [That market] represents the most effective check on management autonomy ever devised." Alfred Rappaport, *The Staying Power of the Public Corporation*, HARV. BUS. REV., Jan.-Feb. 1990, at 96, 100; *see, e.g.*, James A. White, *Shareholder-Rights Movement Sways a Number of Big Companies*, WALL ST. J., Apr. 4, 1991, at C1 (describing corporate concessions to shareholder demands).

Nell Minow of Institutional Shareholder Services Inc., a Washington proxy consultant, believes that "this year['s shareholder activism] is unusual because the takeover activity that fueled momentum for [corporate governance] proposals in other years hasn't been there." *Id. Compare* Lipton & Rosenblum, *supra* note 4, at 198 ("the hostile takeover is not a particularly effective or efficient means of motivating or disciplining managers") *with* Gilson & Kraakman, *supra* note 12, at 870-71 ("Given the contribution of hostile takeovers to portfo-

As a result of increased shareholder activism, current corporate doctrine and practice border on obsolescence. Corporate law reform is both necessary and inevitable.

C. The Corporate Governance Triad

Contemporary corporate law is not a simple dichotomy of management and shareholders; rather, it is a complex set of relationships between the corporation's board of directors and various constituencies, primarily the shareholders and stakeholders. These three groups constitute the corporate governance triad.[51]

1. The Board of Directors

> There is one thing all boards have in common[:] they do not function.[52]

a. *The Nature of Board Authority*

The most salient legal and economic characteristic of corporate governance is the concentration of decision-making authority in the board. The corporate board is the focal point of the corporation: management's role is derivative of the board's—the

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lio values during the 1980s, institutional investors were quite right to target defensive tactics in their initial foray into the corporate governance debate.... [Nevertheless, t]he hostile takeover has proved to be an expensive and inexact monitoring device. . . .").

51. Consistent with its dialectical nature, corporate governance has a dialectical structure: shareholders provide capital but lack control; managers wield control but bear no risk exposure. Directors provide oversight. From management's perspective, authority must have independence and discretion to function effectively and creatively—the more the better. Moreover, as discussed below, centralizing authority is necessary to maximize the efficient processing of information. If, however, authority is not held accountable to the asset owners (i.e., shareholders), the exercise of discretion may run contrary to the shareholders' wishes. Furthermore, reducing discretion by increasing responsibility diminishes the value of authority. This leads to an analogous paradox: the dichotomy between authority and responsibility. While the dichotomy between ownership and control focuses on the shareholder, with dispersed share ownership causing an inevitable shareholder passivity, the paradox between authority and responsibility focuses on the board. When it focuses on the board, corporate law seeks to centralize authority for efficiency reasons; centralized authority is not a mere by-product of shareholder passivity.

52. PETER F. DRUCKER, MANAGEMENT, TASKS, RESPONSIBILITIES, PRACTICES 628 (1974), *quoted in* Judith H. Dobrzynski, *Taking Charge: Corporate Directors Start to Flex Their Muscle*, BUS. WK., July 3, 1989, at 66 (emphasis omitted).

shareholders' role is reactive.[53] In centralizing corporate authority and information processing in the board while granting shareholders merely a passive, reactive role, corporate law seeks to minimize the costs of corporate decision making.

Even when statutes require shareholder approval of certain board actions, such as amendments to the articles of incorporation or fundamental corporate reorganizations, usually the board must first approve the proposal.[54] Shareholders may only vote when directors present them with matters; they may not amend board proposals. Indeed, the only significant source of shareholder power over the board is the right to replace board members. Shareholders, however, rarely exercise this option.

Both competitive forces and monitoring forces limit board discretion. Competitive forces include the product market, the internal and external markets for managers, and, ultimately, the market for corporate control. These forces tend to align the interests of managers with the corporation and its shareholders.[55] Supporters of this model heavily emphasize the invisible hand of the marketplace, which they believe compels managers to align their conduct with shareholders' interests, lest the value of the corporate enterprise diminish.[56] Corporations that per-

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53. This board-centered corporate governance system accords well with Kenneth Arrow's "authority" model. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974). Arrow's model has twin foci: individuals' incentives and individuals' control over information. *Id.* at 69-70. Given identical information and incentives, each member of an organization will reach decisions by "consensus" because each member voting in her own self-interest will be motivated to select the outcome preferred by others. *Id.* at 69. Given divergent information and incentives, it is infeasible for all members to partake actively in the decision making process; individual members lack both the information and incentives to arrive at optimal group decisions. *Id.* at 70. It is thus cheaper and more efficient to process information centrally. *Id.*

54. *E.g.*, Model Business Corp. Act §§ 10.03(b) (1991) (prior board approval for amendments to the articles of incorporation); § 11.03(b) (same for mergers); § 12.02(b) (same for sale of substantially all corporate assets); § 14.02(b) (same for voluntary dissolution of corporation).

55. Some scholars claim that managerial discretion is adequately checked by three forces: capital market discipline caused by managers' incentive to sell stock for maximum value, labor market discipline involving *ex post* evaluation of managers, and product market discipline. *See, e.g.*, Fama, *supra* note 28, at 292-97. These "contractarians" further argue that corporate law need not be mandatory because these competitive forces align shareholder and nonshareholder interests optimally, in effect "uniting" ownership and control. *See* Black, *supra* note 4, at 579 (presenting the contractarian arguments and offering rebuttal arguments).

56. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract* 89 COL. L. REV. 1416, 1419 (1989) ("Managers may do their best to take advantage of their investors, but they find that the dynamics of the market

suade shareholders they offer the highest return garner the largest investments. Thus, only corporations that make investor-friendly choices prosper relative to others.[57]

Monitoring forces are rules that constrain managerial discretion. They include the rules the law imposes on corporate actors that attempt to hold them accountable to shareholders. The most familiar manifestations of monitoring forces are independent auditors and outside directors.[58] The derivative suit, another monitoring device, is a method by which corporate law imposes liability for breaches of fiduciary duties. Free market proponents claim that these rules are unnecessary to the extent that market forces adequately curb managerial discretion.[59]

A wealth of scholarship[60] and case law[61] addresses this monitoring model, which arguably limits managerial discretion by conforming managerial conduct to shareholders' wishes. According to the monitoring model, corporate governance provides mechanisms that minimize agency costs by guaranteeing that management conduct is directed toward maximizing shareholder value.

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drive them to act as if they had investors' interests at heart. It is almost as if there were an invisible hand.").

57. *See id.* at 1421.

58. Outside directors, independent of management, will monitor management activities for the benefit of shareholders.

59. *See* Black, *supra* note 4, at 578-79 ("Manager constraining rules will be unimportant if market forces are adequate to curb managerial discretion.").

60. *See, e.g.*, Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 878-79 (1981) (proposing a rule that constrains management's ability to interfere with shareholders' tender offer decisions); LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 209-18 (1988) (proposing that institutional shareholders nominate roughly 25% of the board in order to maximize shareholder participation in corporate governance). *Compare* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1191, 1201 (1981) (advocating managerial passivity amid takeovers to maximize shareholder value) *with* Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) (advocating an auctioneering model, rather than a passivity model, wherein target managers seek to solicit competing bids).

61. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986) (primary criterion for adjudging the legality of poison pills is "the goal of stockholder wealth maximization"), *rev'd on other grounds*, 481 U.S. 69 (1987); Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182, 184 n.16 (Del. 1986) (interests of shareholders become directors' sole concern when company is for sale); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders.").

b. *Role of Outside Directors*

The independent outside director is a cornerstone of current corporate governance polemic. As of 1987, seventy-four percent of the directors of publicly held corporations were not company employees.[62] Ideally, independent directors function as shareholder surrogates to ensure that the corporation pursues the long-term best interests of its owners.

Support for independent directors is widespread. Courts stress the importance of outside directors in providing objective oversight and reasoned business judgment.[63] The Council of Corporate Law Section of the Delaware Bar Association also emphasizes the central role of outside directors.[64] In addition, the Business Roundtable advises that outside directors constitute no less than a "critical mass."[65] The Corporate Director's Guidebook of the American Bar Association recommends "non-management" directors in any committees of the board.[66] Since its inception, the ALI Project has recommended that boards of large public corporations include specified proportions of directors who are "free of any significant relationships with the corporation's senior executives."[67] Institutional investors recently filed proxy resolutions with many firms demanding that a majority of

62. *See* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 17 (1989).

63. *E.g.*, Moran v. Golter, 500 A.2d 1346, 1356 (Del. 1985); Unocal Corp. v. MESA Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985).

64. *See* E. Norman Veasey & Jesse A. Finkelstein, *New Delaware Statute Allows Limits on Director Liability and Modernizes Indemnification Protection*, BUS. LAW. UPDATE July-Aug. 1986, at 1, 2-3.

65. BUSINESS ROUNDTABLE 1978, *supra* note 1, at 2108.

66. COMMITTEE ON CORPORATE LAWS, ABA, CORPORATE DIRECTOR'S GUIDEBOOK, *reprinted* in 33 BUS. LAW. 1595, 1625-27 (1978).

67. ALI PROJECT, *supra* note 2, § 3A.01 (cross-references omitted). The first draft required that large, publicly held corporations have boards with a majority of such directors. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03 (Tentative Draft No. 1) (1982). In 1984, this requirement was changed to a "recommendation of [good] corporate practice." AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 3.04 (TENTATIVE DRAFT No. 2) (1984).

directors be independent of management.[68] Louis Lowenstein would allow shareholders to control some directorships.[69]

Although independent directors are an essential component of an optimal governance structure, installing independent directors is but a first step. The facial "independence" of directors resolves only part of the conflict of interest between management and shareholders. Managers "can easily find directors who are neither subordinates, relatives, nor suppliers, who will support almost anything that the executives propose, and who will resign in extreme cases rather than oppose the executives who have invited them to the board."[70]

Even with nominating committees composed of independent directors, management controls the selection of directors. Management generally may also veto candidates. Even more troubling, most outside directors, aware of management's ability to influence board composition, naturally mesh their decision making with that of management.[71] Indeed, because approximately two-thirds of outside directors are CEOs,[72] they are unlikely to monitor the CEO more energetically than they believe their own boards should monitor them. Finally, outside directors are not socially independent. One scholar writes, "[n]o definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose [performance] he is asked to assess."[73]

One often-cited example of independent outside directors' inability to constrain self-interested behavior is the use of "Special Litigation Committees." These committees, which consist of independent directors, determine whether corporations should consummate a shareholder derivative suit against their officers

68. Hillary Durgin, *Fighting For Independence*, PENSIONS & INVESTMENTS, Feb. 18, 1991, at 1, 38 (noting that the issue of insider boards tops the corporate governance agenda). Similarly, in an effort to garner support in its proxy fight with Carl Icahn, Texaco's management agreed to select one board member from a slate of directors provided by the California Public Employees Retirement System (CalPERS). *See, e.g.*, James Flanigan, *Texaco Stresses the "Share" in "Shareholders"*, L.A. TIMES, Jan. 25, 1989, at D1.

69. LOWENSTEIN, *supra* note 60, at 209-18.

70. Alfred A. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117, 129 (1988) (citation omitted).

71. "All too often . . . [independent directors] turn out to be more independent of shareholders than they are of management." Gilson & Kraakman, *supra* note 12, at 873.

72. LORSCH, *supra* note 62, at 18.

73. Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?* 95 HARV. L. REV. 597, 613 (1982).

or directors. One study noted that "although there have been more than a score of special litigation committee cases . . ., in all but one the committee concluded that the suit in question was not in the corporation's best interest."[74]

Today, even totally independent directors face many obstacles to the decision-making process. First, outside directors "lack an affirmative incentive to monitor effectively."[75] One study suggests that boards react, rather than manage; they render advice when solicited and replace the chief executive officer only in dire emergencies.[76] In addition, the recent development of the multiconstituency concept leaves directors uncertain when faced with an issue that potentially affects different constituencies differently. Finally, under current statutes and case law, directors lack incentives to seek shareholder input. The modern corporate framework envisions that directors, not shareholders, control policy decisions. Shareholder input is not required and therefore does not factor significantly into the decision-making process. In short, even the most independent of directors shun shareholder input. For these reasons, independent directors are an insufficient remedy to the current ills of corporate governance.

2. Shareholders

a. *Traditional Shareholder Primacy Model*

The traditional shareholder primacy model of the corporation derives from the concept that, as owners of the corporation, shareholders are entitled to control its destiny, determine its fundamental policies, and decide whether to make fundamental changes in corporate policy and practice. One encapsulation of the shareholder primacy norm has been cited frequently:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes. . . . [I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental bene-

74. James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and The ALI Project*, 1982 DUKE L.J. 959, 963.

75. Gilson & Kraakman, *supra* note 12, at 875.

76. MYLES L. MACE, DIRECTORS: MYTH AND REALITY 13-19, 178-80 (1971).

> fit of shareholders and for the primary purpose of benefiting others . . . .[77]

This governance regime derives from a time when shareholders were "real owners" intimately involved with the operations of the corporation,[78] when institutional investors were scarce and most corporations were owned by individuals who were typically founders or joint owners.[79] Stakeholder interests were recognized only after and to the extent the shareholders so determined.[80]

The viability of the shareholder primacy theory derives from economic theory; it says that shareholders' unfettered pursuit of maximum profits[81] promotes economic efficiency and, collaterally, social welfare.[82] Corporate law accordingly endows shareholders with various rights, including the right to elect the board of directors, to vote on certain corporate transactions, and to rely on the fiduciary duties of directors to manage the corporation in the shareholders' best interests.[83] The shareholder vote traditionally has been the primary mechanism for shareholder control over director decisions.[84] Shareholders vote to re-

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77. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

78. *See* Alfred D. Chandler, The Visible Hand: The Managerial Revolution in American Business 9-10 (1977) (describing the time when "owners managed and managers owned").

79. *See* Lipton, *supra* note 42, at 64.

80. Thus, shareholders may allow the corporation to be bound by contract, to employees, suppliers or creditors. Alternatively, the shareholders may exercise a degree of conscience, or philanthropy, by donating corporate resources to or for the benefit of needy or worthy organizations or individuals.

81. *See* Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property, 299-302 (rev. ed. 1967); *see also* Matheson & Olson, *supra* note 38, at 1470 (describing the nature and role of shareholders in the modern corporation).

82. *See* Clark, *supra* note 3, at 389. Clark justifies shareholder primacy as follows:

> From an economic point of view, there is a strong argument that the power to control a business firm's activities should reside in those who have the right to the firm's residual earnings . . . . The intuition behind this argument is that giving control to the residual claimants will place the power to monitor the performance of participants in the firm and the power to control shirking, waste, and so forth in the hands of those who have the best incentive to use the power.

Id. See generally Alchian & Demsetz, *supra* note 28 (describing managers as agents of investors); Jensen & Meckling, *supra* note 24 (describing generally how principals seek to limit agency costs by limiting divergent interests between principal and agent).

83. *See, e.g.*, Minn. Stat. § 302A (1992).

84. "Voting rights of shareholders are a major element in the structure of corporate law . . . ." Lucian A. Bebchuk & Marcel Kahan, *A Framework for*

move directors[85] and to effect fundamental corporate changes. For example, shareholders must vote on mergers,[86] dissolutions,[87] or sales of substantially all of a corporation's assets.[88] The shareholder-approved board, through its designated officers,[89] is presumed to act as a surrogate for, and in the interests of, the shareholders. Justifications given for shareholders' primary voice in the governance of corporate affairs distill to one concept: shareholders are well suited to guide and discipline directors and managers.

b. *Ascendancy of the Institutional Shareholder*

The 1990s have witnessed a staggering increase in institutional share ownership with an equally dramatic increase in the concentration of shareholdings. In 1990, institutional investors owned 45% of outstanding corporate equity.[90] By 1993, that figure had swelled to beyond 54%.[91] Pension funds, the largest class of institutional investors, owned roughly 44% of all institutional holdings in 1987.[92] Controlling more that $2.5 trillion in assets, pension funds currently own more than 25% of all publicly traded equity in U.S. companies.[93] This is particularly noteworthy because, on average, a pension fund holds any given stock in its portfolios for two and one-half years.[94]

Analyzing Legal Policy Towards Proxy Contests, 78 CAL. L. REV. 1071, 1073 (1990) (citation omitted).

85. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(k) (1991).

86. *See id.* § 251 (c) (1991).

87. *See id.* § 275 (1991).

88. *See id.* § 271 (1991).

89. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 1 (1976).

90. Richard H. Koppes & Kayla J. Gillan, *The Shareholder Advisory Committee*, DIRECTORS & BOARDS, Spring 1991, at 29, 29. By 1988, institutional assets had exploded to five trillion dollars, or 18.7% of total United States financial assets. Clifford L. Whitewall, *Institutional Ownership, in* INSTITUTIONAL INVESTORS, *supra* note 42, at 406-07. In contrast, institutional assets amounted to $107 billion or 8.4% of total U.S. financial assets. In 1989, institutions held 43% of all equities and 50% of the 50 largest companies' equity. Brancato, *supra* note 48, at 406. The fifty largest institutions owned $925 billion in stocks, or 27% of the stock market. *See The Institutional Investor 300: Ranking America's Top Money Managers, in* INSTITUTIONAL INVESTORS *supra* note 42, at 137, 173. Percentages are based on the Wilshire 5000 Index.

91. Cordtz, *supra* note 8, at 25.

92. Koppes & Gillan, *supra* note 90, at 29.

93. *Id.*

94. *See* James A. White, *Pension Funds Try to Retire Idea That They Are Villains*, WALL ST. J., Mar. 20, 1990, at C1.

Investments in common stock by state and local pension systems ballooned from $10.1 billion in 1970 to $150.2 billion in 1986 and to an estimated $240 billion in institutional holdings in 1990. Whitewall, *supra* note 90, at 75, 79.

The primary impetus for increased shareholder activism likely stems from shareholders' increased ownership concentration.[95] Voting power is increasingly concentrated in a small number of major institutions. In 1989, the top twenty funds and top ten money managers controlled 16% of all equity; by the year 2000, they may control between 22% to 29% of the equity in the top ten corporations.[96] The twenty largest pension funds account for more than 25% of all pension assets. The top twenty funds thus control at least 7.7% of the outstanding stock of American's ten largest corporations.[97]

Increasingly concentrated share ownership drives institutional activism in two ways. First, institutions that own a large stake in a corporation are less able to sell their shares and take the "Wall Street walk."[98] As James Martin of College Retirement Equities Fund (CREF) attests, "We're the quintessential long-term investors."[99] In addition, a greater stake means a greater incentive to invest time and resources in improving corporate monitoring and performance.[100] Finally, institutional investors' size and share concentration enhance their ability to monitor and discipline management. The marked increase in management entrenchment that has accompanied the death of the takeover era, however, probably also fuels shareholder activism.

Although equity holdings of private pension funds have been relatively stable since 1982, state and local government pension holdings have increased markedly; in 1988, they owned a total of $223.7 billion in stocks, or 9.1% of the NYSE's total market value. *See id.*

95. *July Client Advisory Letter, in* INSTITUTIONAL INVESTORS *supra* note 42, at 34.

96. William Taylor, *Can Big Owners Make a Big Difference?*, HARV. BUS. REV., Sept.-Oct. 1990, at 70, 72.

97. Koppes & Gillan, *supra* note 90, at 29.

98. *See* Matheson & Olson, *supra* note 38, at 1477-82 (describing behavior differences between institutional investors and individual investors).

99. David Pauly, *Wall Street's New Musclemen*, NEWSWEEK, June 5, 1989, at 46, 46.

100. Major shareholders thus have begun to unite toward more effectively wielding their immense power. The Council of Institutional Investors serves as a nucleus for institutional activism. Robert D. Rosenbaum & Michael E. Korens, *Trends in Institutional Shareholder Activism: What the Institutions are Doing Today, in* INSTITUTIONAL INVESTORS, *supra* note 42, at 45, 48. Institutional Shareholder Services advises large institutional investors on corporate governance issues. *Id.* at 48. Analysis Group provides economic and financial consulting services to institutional investors. *Id.* Analysis Group has also created the Institutional Voting Research Service to evaluate the governance and economic performance of large corporations. *Id.*

In his comprehensive study of global competition, Michael E. Porter identifies the growth of institutional investors in the United States to a position of dominance over corporations as the most significant factor in the decline of the country's competitiveness:

> Unlike institutional investors in nearly every other advanced nation, who view their shareholdings as nearly permanent and exercise their ownership rights accordingly, American institutions are under pressure to demonstrate quarterly appreciation. . . . With a strong incentive to find companies whose shares will appreciate in the near term and incomplete information about long-term prospects, portfolio managers turn to quarterly earnings performance as perhaps the single biggest influence on buy/sell decisions.[101]

Apparently, no consensus has emerged about the proper role of institutional shareholders in modern corporate governance.

3. Stakeholders

The stakeholder perspective generally posits that managers should seek to maximize long-term corporate health irrespective of effects on short-term shareholder wealth.[102] Accordingly, under case law and developing modern statutes, directors may consider many nonshareholder interests—including the interests of employees, creditors, communities, customers, and suppliers—in arriving at long-term business strategies.[103]

The judicial embrace of the concept of "the best interests of the corporation" has advanced the stakeholder approach.[104]

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101. MICHAEL E. PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS 528 (1990).

102. The chief proponent of this model is Martin Lipton. *See, e.g.*, Lipton & Rosenblum, *supra* note 4, at 187. "[T]he ultimate goal of corporate governance is the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy." *Id.* at 189. For background see, for example, William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180 (1992); Roberta S. Karmel, *Implications of the Stakeholder Model* 61 GEO. WASH. L. REV. 1156 (1993); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70* TEX. L. REV. 759 (1992).

103. Matheson & Olson, *supra* note 38, at 1448.

104. For example, the Delaware Chancery equated "shareholder long-term interests" with "multi-constituency interests":

> The knowledgeable reader will recognize that this particular phrase masks the most fundamental issue: to what interest does the board look in resolving conflicts between interests in the corporation that may be characterized as "shareholder long-term interests" or "corporate entity interests" or "multi-constituency interests" on the one hand, and interests that may be characterized as "shareholder short term interests" or "current share value interests" on the other?

Some commentators have argued that a corporation has an "independent interest in its own long-term business success."[105] Until *Unocal v. Mesa Petroleum*, however, the Delaware judiciary had not directly endorsed directors' consideration of nonshareholder constituencies.[106] *Paramount Communications, Inc. v. Time*, in which the Delaware Supreme Court emphasized that Paramount's offer was a threat to the corporation rather than its shareholders, also vigorously endorsed the stakeholder approach.[107]

One of the strongest recent trends in corporate governance has been the growing insistence that directors recognize stakeholder interests. Indeed, the stakeholder model is the only model that states have enacted into law. No fewer than twenty-nine states have legislated that directors *may* consider stakeholder interests in arriving at business judgments.[108] Termed "stakeholder constituency statutes," most of these statutes explicitly empower directors to consider stakeholder interests in conjunction with shareholder interests.[109] Minnesota's stakeholder statute, a typical one, states that directors "may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers,

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TW Servs., Inc. v. SWT Acquisition Corp., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,178 n.5 (Del. Ch. Mar. 2, 1989). "[D]irectors . . . may find it prudent (and are authorized) to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected." *Id.* at 92,178; *see* Paramount Communications v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989) (finding that time frame is a relevant factor in responding to a takeover).

105. *See* Lipton & Rosenblum, *supra* note 4, at 202.

> The greater the amount of goods or services the enterprise can sell, and the greater the difference between what the consumer is willing to pay and what the goods or services cost to produce, the greater the profit that inures to the enterprise. Viewed in this light, the corporate enterprise has an independent interest of its own in the successful operation of its business, with success measured in terms of present and expected profit.

Id. at 203.

106. 493 A.2d 946 (Del. 1985). A director may consider "the impact [of a takeover] on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally). . . ." *Id.* at 955.

By allowing the target board to consider a takeover's "impact on constituencies other than shareholders," *Unocal* illustrates the degree to which the business judgment rule may be wielded to expand the already broad scope of director's discretion to bypass shareholder input. The business judgment rule in the takeover context thus may allow advancement of stakeholder interests at the expense of shareholder interests.

107. 571 A.2d 1140 (Del. 1989).

108. *See* Matheson & Olson, *supra* note 6, at 1352 n.177.

109. *See id.*

and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders. . . ."[110] In contrast to the traditional view of the corporation based on the economic perspective of the corporate entity as an aggregation of shareholder interests for the purpose of maximizing wealth, the stakeholder model exhorts much broader objectives. Under the stakeholder model, shareholders are but one constituency of the corporation; employees, consumers, suppliers, and the general public are also sufficiently affected by a corporation's activities to warrant consideration.

Allowing boards to equate or even subordinate shareholders' interests to stakeholders' interests runs counter to a long-standing, fundamental principle of corporate management: the principle that the directors' duty is to maximize shareholder wealth. Minnesota law, for example, says that a director's standard of conduct encompasses the duty to "discharge the duties of the position of director in good faith, in a manner the director reasonably believes to be in the best interests of the corporation. . . ."[111]

The pivotal question is how directors can satisfy stakeholder constituencies consistent with their fiduciary duty to shareholders.[112] Some argue that, if directors focus primarily

110. MINN. STAT. § 302A.251, subd.5 (1992).

111. MINN. STAT. § 302A.251, subd.1 (1992).

112. Until a takeover becomes imminent, directors may consider nonshareholder constituencies in deploying takeover defenses as long as they also benefit the shareholders. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del.1986). *Revlon* provides guidance about the directors' responsibility to the shareholders once a takeover becomes inevitable; prior to this threshold, directors must serve conflicting constituencies. *See id.* at 182 (describing how a board may consider nonshareholder constituencies "provided there are rationally related benefits accruing to the stockholders. . . . However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress [such that the sole duty is] to sell to the highest bidder." (citation omitted)); *see also* TW Servs., Inc. v. SWT Acquisition Corp. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,173 (Del. Ch. Mar. 2, 1989) ("When a corporation is in a '*Revlon* mode,' legitimate concerns relating to the claims of other constituencies are absent and, indeed, concerns about the corporation as a distinct entity become attenuated."); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1989) (holding that a board may consider "the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests. . . .") *See generally* ABA Comm. on Corporate Laws, *Other Constituencies Statutes: Potential For Confusion*, 45 BUS. LAW. 2253 (1990) [hereinafter *Other Constituencies*] (concluding that the Revised Model Business Corporation Act should not be amended to allow direc-

on shareholders' best interests, shareholders and stakeholders simultaneously benefit.[113] Accordingly, many issues emerge from a stakeholder model in which directors are allowed to consider stakeholder interests.[114] First, because a corporation would only harm itself by discarding valuable employees or suppliers,[115] only suboptimal employees, suppliers, or creditors would be affected by a "shareholder primacy" approach.[116] Because most nonshareholders are already protected by other laws,[117] stakeholder problems resulting from board action stemming from a shareholder primacy perspective are short-term.[118]

In addition, requiring accountability to holders of conflicting interests may ultimately harm both groups.[119] Managers free to consider nonshareholder interests would be less accountable to shareholders.[120] Just as there is no gauge by which courts can

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tors to take into account the interests of persons or groups other than shareholders in performing their duties).

113. *See* Easterbrook & Fischel, supra note 60, at 1190-92.; *cf. Other Constituencies, supra* note 112, at 2269 (suggesting that a better interpretation of directors' duties, statutes, and related case law allows directors to take into account nonshareholder constituencies, but only "to the extent that directors are acting in the best interests, long as well as short term, of the shareholders and the corporation").

114. For a recent analysis of directors' duty legislation, see *Other Constituencies, supra* note 112, at 2263-71.

115. *See* Easterbrook & Fischel, *supra* note 60, at 1170-71.

116. *See id.*

117. *See Other Constituencies, supra* note 112, at 2268 (discussing how creditors, management, employees, and unions have other means of protection); Gregory R. Andre, *Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform*, 12 DEL. J. CORP. L. 865, 884 (1987) (asserting that employees are protected by labor laws and suppliers are protected by bankruptcy, antitrust, and contract laws). "Legislation governing hostile takeovers should not attempt to minimize noninvestors' risks at the expense of our free market system." *Id.* (footnote omitted).

118. For example, employees or suppliers are usually only temporarily displaced; that is, many constituencies have the capacity to find a replacement for their reliance on the target.

119. *See* Easterbrook & Fischel, *supra* note 60, at 1192; *see also* Andre, *supra* note 117, at 884 ("[M]anagement should not be asked or allowed to attempt to carry out the impossible task of acting as fiduciaries for groups with competing interests."); Ronald J. Gilson, *Just Say No to Whom?* 25 WAKE FOREST L. REV. 121, 126 (1990).

120. In the narrowest sense, when managers are free to consider nonshareholder interests in takeover scenarios rather than focus on the sole objective of maximizing shareholder wealth, their "accountability" is diminished inasmuch as shareholders can less easily monitor managers' performance. *See generally* Johnson, *supra* note 4, at 881-84 (describing this tenet and its difficulties).

Former SEC chairman Davis S. Ruder argued that director accountability to a clearly defined group (i.e., shareholders) is a cornerstone of the corporate assess whether a director breaches his duty to stakeholders, the "standard" by which courts define a director's duty to shareholders likely also defies containment.[121] The undefined parameters of this "standard" fuel directors' uncertainty regarding their allegiance to shareholders.[122]

This debate, however, presumes incompatibility of shareholder and stakeholder interests. Certainly those interests conflicted during the takeover frenzy of the 1980s, but today's economy and global markets present a new focus and a new challenge. The focus is on economic success in a global economy. The challenge for a corporation is to operate at peak efficiency in all respects, including relations among the corporate triad. The board must seek to highlight that focus, to meet the challenge and enhance economic efficiency by facilitating communication within and among management, the shareholders, and the stakeholders.

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system: "If management duties to others are declared, the process of corporate accountability will be thrown into disarray." David S. Ruder, Speech to the American Bar Association committee responsible for the Revised Model Business Corporation Act (Aug. 6, 1990), *quoted in ABA Model Act Panel Rejects Other-Constituencies Measures*, 22 Sec. Reg. & L. Rep. (BNA) No. 33, ¶ 1217 (Aug. 17, 1990).

121. Directors' duty legislation affords no guidance as to how directors should consider nonshareholder constituencies. *See* Dennis J. Block & Yvette Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L. J. 44, 69 (1983); Matheson & Olson, *supra* note 38, at 1538-45.

122. The Committee on Corporate Laws of the Section of Business Law of the American Bar Association has concluded:

> [P]ermitting—much less requiring—directors to consider [stakeholder] interests without relating such consideration in an appropriate fashion to shareholder welfare (as the Delaware courts have done) would conflict with directors' responsibility to shareholders and could undermine the effectiveness of the system that has made the corporation an efficient device for the creation of jobs and wealth.

Other Constituencies, *supra* note 112, at 2268.

The Committee believes that the better approach is to allow directors to take the interests of other constituencies into account, "but only as and to the extent that the directors are acting in the best interests, long as well as short term, of the shareholders and the corporation." *Id.* at 2269.

> The confusion of directors in trying to comply with [stakeholder] statutes, if interpreted to require directors to balance the interests of various constituencies without according primacy to shareholder interests, would be profoundly troubling. . . . When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.

Id.

III. THE INEVITABILITY OF A "CORPORATE COOPERATION" REGIME

The current corporate governance framework ill-serves modern corporate activity and, if left unchanged, will markedly undermine the United States' international competitiveness. This section describes recent advances in corporate law intended to give shareholders a greater voice in corporate governance. These advances are but a small portion of the total reform initiative needed to cure corporate law's current ills. What is really needed is a new legal paradigm: the "corporate cooperation" paradigm.

A. "Cooperate Cooperation" and Recent Advances in Proxy Regulation

Many believe that recent advances in the proxy regulations of the Security and Exchange Commission (SEC) greatly enhance the shareholder's position in corporate governance. The SEC found that its old proxy and disclosure rules impeded shareholder communication and participation in the corporate governance process:

> This demonstrated effect of the current rules is contrary to Congress's intent that the rules assure fair, and effective shareholder suffrage. Apart from attempts to obtain proxy voting authority, to the degree the current rules inhibit the ability of shareholders not seeking proxy authority to analyze and discuss issues pertaining to the operation of a company and its performance, these rules may in fact run exactly contrary to the best interests of shareholders.[123]

One commentator claims that "[b]y changing proxy solicitation rules . . . the [SEC] ushered in a new era of shareholder activism. . . ."[124] Another commentator notes:

> The [SEC]'s new proxy . . . rules herald a new era of corporate governance. Shareholders now have greater access to proxy statements. They can nominate dissident board candidates along with the selected management nominees. They can vote on individual proxy proposals. And they can communicate among themselves without first filing with the SEC. In short, shareholders now have a greatly enhanced opportunity to involve themselves in company operations.[125]

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123. *See* Rule 14-6, Regulation of Communications Among Shareholders, Release No. 34-31326, 57 Fed. Reg. 48276 (Oct. 22, 1992).

124. Frederick E. Rowe, Jr., *Hurrah for October 15*, FORBES, Feb. 15, 1993, at 234, 234.

125. Louis M Thompson, Jr., *Shareholder Relations: A New Role for the Board*, HARV. BUS. REV. Jan/Feb 1993, at 81, 81.

On October 16, 1992, the SEC promulgated its final rules on shareholder communications ("SEC's 1992 Final Rules"),[126] which consummate the SEC's extensive three-year examination of the effectiveness of the proxy-voting process and its impact on the corporate governance system.[127] These amendments introduce changes that facilitate shareholder participation.

The SEC's 1992 Final Rules amended the definition of "solicitation" to specify that a shareholder can publicly announce how it intends to vote and provide reasons for that decision without having to comply with the proxy rules.[128] This safe harbor excludes from the definition of "solicitation" announcements that are published, broadcast, or disseminated to the media.[129] The safe harbor may also exclude some methods of communicating voting decisions not explicitly identified in the rules.[130]

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126. Amendments to Regulation of Communications Among Shareholders, Exchange Act Release No. 34-31326, 57 Fed. Reg. 48276 (1992) (to be codified at 17 C.F.R. §§ 240, 249).

127. *Id.* at 48277.

128. *Id.*

129. Under the amended federal proxy rules, the following communications do not constitute "solicitations":

1. The furnishing of a form of proxy in response to a shareholder's unsolicited request;
2. The company's provision of a shareholder list to another soliciting party or the mailing of such other party's soliciting material to shareholders, if required by the federal proxy rules;
3. The performance of ministerial acts on behalf of a person soliciting a proxy; or
4. A shareholder's statement of how the shareholder intends to vote on one or more matters at a shareholders' meeting and the shareholder's reasons for doing so. In order for such a shareholder statement not to constitute a solicitation, however, it must be made by a shareholder who is not otherwise engaged in a proxy solicitation requiring the concurrent or subsequent filing of a proxy statement under the federal proxy rules. It also must be:
   a. made by means of speeches in public forums, press releases or published or broadcast opinions, statements or advertisements appearing in a broadcast medium or a bona fide publication (including a newspaper or periodical) disseminated on a regular basis;
   b. directed to persons to whom the shareholder owes a fiduciary duty in connection with the voting of securities held by the shareholder; or
   c. made in response to unsolicited requests for additional information with respect to a prior communication by the shareholder made under this exclusion.

Rule 14a-1(*l*)2(i-iv), 17 C.F.R. § 240.14a-1(*l*)2(i-iv) (1993).

130. Amendments to Regulation of Communications Among Shareholders, 57 Fed. Reg. 48282.

In addition, the SEC's 1992 Final Rules[131] amended Rule 14a-2(b)[132] to create an exemption from the proxy statement delivery and disclosure requirements for communications with shareholders; this exemption applies when the person soliciting is not seeking proxy authority, does not have a substantial interest in the matter subject to vote, and is not otherwise ineligible for the exemption.[133] The rationale for the amendment is that the current rules unnecessarily curtail shareholder communications on matters related to the company and its management by creating "a chilling effect on discussion of management performance, out of fear that the communication could after the fact be found to have triggered disclosure and filing obligations under the federal proxy rules."[134] As the SEC has noted:

> [A]n essential problem in this area is that it is generally *not* possible for a shareholder to know with certainty that a communication will or will not be deemed to constitute a solicitation. The broad definition of a proxy solicitation that includes not only a request for a proxy or request to execute, not execute or revoke a proxy, but also the furnishing of . . . a communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy, creates this inherent uncertainty for shareholders. As a result of this definition, almost any statement of views could be alleged to be a solicitation, and the shareholder could be exposed to litigation. . . .[135]

The old proxy rules "thus unduly hindered free discussion that could better inform shareholders as to their voting decisions."[136]

The Rule 14a-2(b)(1) exemption "generally is available to any person, whether or not a shareholder, who conducts a solicitation but does not seek proxy voting authority or furnish shareholders with a form of consent, authorization, abstention, or revocation, and does not act on behalf of any such person."[137] The rule sets forth ten categories of persons who are ineligible to rely on the exemption, including the registrant and its affiliates, associates, officers or directors; any nominees for whose election

131. Amendments to Regulation of Communications Among Shareholders, Exchange Act Release No. 34-31326, 57 Fed. Reg. 48276 (1992) (to be codified at 17 C.F.R. §§ 240, 249).

132. 17 C.F.R. 240.14a-2(b) (1993).

133. *See* Amendments to Regulation of Communications Among Shareholders, 57 Fed. Reg. 48279-80. Public notice of written soliciting activity will be required by beneficial owners of more than five million dollars of the registrant's securities through publication, broadcast, or submission to the Commission of the written soliciting materials. *Id.*

134. *Id.* at 48279.

135. *Id.*

136. *Id.*

137. *Id.* at 48280 (footnote omitted).

as a director proxies are solicited; any person soliciting in opposition to extraordinary transactions such as mergers;[138] any person required to report beneficial ownership of the registrant's equity securities on Schedule 13D;[139] any person who receives compensation (other than reimbursement pursuant to the shareholder communications rules) directly related to the solicitation of proxies from an ineligible person; any registrant that is an investment company; and any person who, because of a substantial interest in the subject matter of the solicitation, is likely to receive a benefit from a successful solicitation that will not be shared pro rata by all shareholders.[140] In addition, notice requirements are imposed on "all written solicitations conducted by a person who has beneficial ownership of more than $5 million of the securities that are subject to the solicitation other than speeches in a public forum, press releases, and published or broadcast opinions, statements or advertisements."[141]

The SEC's 1992 Final Rules minimized preclearance requirements in two ways. First, amendments to Rules 14a-3(a)[142] and 14a-4[143] allow registrants and other soliciting parties to commence a solicitation on the basis of a preliminary proxy statement publicly filed with the SEC.[144] In addition, amendments to Rule 14a-6[145] allow solicitation materials other than the proxy statement and form of proxy to be filed with the SEC in definitive form at the time of dissemination.[146] The amendments retain the preliminary filing requirements of Rule 14a-6(a) relating to written proxy statements and forms of proxy.[147]

138. *Id.* at 48280-81. Recapitalizations, reorganizations, sales of assets, and other extraordinary transactions are also included. *Id.* at 48281.

139. *Id.* This applies unless the person has filed a Schedule 13D and has not disclosed an intent, or reserved the right, to engage in a control transaction, or a contested solicitation for the election of directors. *Id.*

140. *Id.*

141. *Id.* at 48280.

142. 17 C.F.R. § 240.14a-3(a).

143. *Id.* § 240.14a-4.

144. Amendments to Regulation of Communications Among Shareholders, 57 Fed. Reg. 48283. No form of proxy, however, can be provided to the solicited shareholders until a definitive proxy statement is disseminated. *Id.*

145. 17 C.F.R. § 240.14a-6.

146. Amendments to Regulation of Communications Among Shareholders, 57 Fed. Reg. 48283. In addition, preliminary proxy statements are now available for public inspection when filed except in connection with business combinations other than roll-ups and going-private transactions. *Id.*

147. *Id.* at 48283.

The SEC's 1992 Final Rules amended Rule 14a-7 to require registrants, in the case of transactions subject to the SEC's roll-up or going-private rules, to provide shareholders, on written request and satisfaction of certain conditions, copies of its list of shareholder names, addresses, and position listing, as well as any list of non-objecting or consenting beneficial owners if in possession of the registrant;[148] in all other cases, registrants must make an election either to provide a list to, or mail materials for, the requesting shareholders.[149] If management proposes to solicit proxies, Rules 14a-7 (a) and (b) may require it to assist any shareholder to communicate with other shareholders. At the written request of an insurgent, management may either provide a shareholder list that complies with Rule 14a-7(c),[150] or mail to shareholders the insurgents' material at the insurgents' expense.[151] The amended Rule 14a-7 provides that registrants

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148. *Id.* at 48285.

149. The salient provisions of the SEC's 1992 Final Rules amending Rule 14a-7 include sections addressing a registrant's obligation and shareholders' certification:

Regarding a registrant's obligation, the revised rule requires registrants to deliver, within five business days after receipt of a shareholder request, a list or statement including the following information: notification that the registrant elects to mail the shareholder's soliciting materials; the approximate number of record holders and beneficial holders (separated by type and class) owning securities in the same class of holders solicited by management or any more limited group of such holders designated by the shareholder; and the estimated cost of mailing a proxy statement, form of proxy or other communication to such holders. 17 C.F.R. §§ 240.14a-7(a)(1)(i-iii). The information must be reasonably current and must include a list of beneficial owners obtained by the registrant (the NOBO/COBO list). *Id.* § 240.14a-7(a)(2)(ii).

Addressing shareholders' certification, the revised rule permits beneficial owners to request a shareholder list as long as adequate documentation of beneficial ownership is provided with the initial request. Shareholders receiving a list under revised Rule 14a-7 must provide the registrant with a certification identifying the proposal that will be the subject of the shareholder's solicitation or communication and attesting that the shareholder will not: (a) use the list information for any purpose other than to communicate with or solicit security holders regarding the same meeting or action by consent or authorization for which the registrant is soliciting proxies; nor (b) disclose the list information to any person other than a beneficial owner for whom the list request was made, or an employee or agent to the extent necessary to effect the communication or solicitation. *Id.* §§ 240.14a-7(c)(i-ii).

150. Rule 14a-7(c) requires the list to indicate the names and addresses of shareholders of the company, but it does not require the company to divulge the number of shares owned by each shareholder. *Id.* § 240.14a-7(c) (1993).

151. *Id.* § 240.14a-7(c) (1993). This choice, however, is not available to management if the insurgents lawfully obtain the shareholder list on their own and make no request of management. First Surety Corp. v. Community Bank, 337 F. Supp. 667, 670 (C.D. Cal. 1971). Thus, management has no control over an insurgent's solicitations absent a written request for assistance.

retain the option to deliver the shareholder list or to mail soliciting materials on behalf of the soliciting shareholder.[152]

B. "Corporate Cooperation" and Shareholder Advisory Committees

Reformers have also tried to use means other than proxy regulation to create opportunities for involvement in corporate governance. For institutional investors "to comply with their own fiduciary duties to invest prudently, [they] must have the information necessary to evaluate the performance of the directors to whom they have delegated managerial responsibility."[153] Shareholders currently seek to use the shareholder advisory committee as a mechanism by which to formally or informally discuss governance issues.[154]

Shareholder advisory committees are not a new concept:

> The idea [behind shareholder advisory committees] has considerable historical precedent. In earlier eras, free of regulations that deter the formation of outside shareholder groups . . ., shareholder committees were a relatively widespread phenomenon at public corporations. They were typically organized informally when corporate performance or board behavior was suspect, and convened to oversee and question the board. The current crop of shareholder committees propose a modern-day equivalent that is formal and internal to the corporation due to the deterrents that the regulations place on outside committees and groups.[155]

The California Public Employees Retirement System (CalPERS) proposed establishing such a committee to Avon Products, Inc.; Texaco, Inc.; and Sears, Roebuck & Co.[156] Howard Sherman of Institutional Shareholder Services, Inc., views CalPERS' current proposals to establish shareholder advisory committees as "the most important shareholder initiative attempting to influ-

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152. Specifically, the registrant must provide a requesting shareholder with a list of holders of securities of a class from which proxies have been solicited or are to be solicited on management's behalf in connection with a shareholder meeting or action by consent or authorization; or mail the requesting shareholder's soliciting materials to shareholders or subgroups of shareholders of that class. Amendments to Regulation of Communications Among Shareholders, 57 Fed. Reg. 48286.

153. *See* David G. Ball, *The Inevitability of Getting Involved*, Directors & Boards, Winter 1991, at 56, 56; Koppes & Gillan, *supra* note 90, at 30.

154. The Securities and Exchange Commission has consistently ruled that shareholder advisory committees are proper subjects for shareholder proposals. *See, e.g.*, TRW, Inc., SEC No-Action Letter 1990 WL 286008 (S.E.C.).

155. *Institutional Voting Research Service Client Advisory Letter* (May 1990), *in* Institutional Investors, *supra* note 42, at 24.

156. *See* Koppes & Gillan, *supra* note 90, at 30.

ence shareholder-board relations."[157] In a proxy contest between Harold Simmons and Lockheed Corp., Simmons promised to promote the creation of a shareholder advisory committee if his slate of director nominees was elected.[158] In 1989, Travis Reed, Jr., proposed that First Executive Corporation's board establish a seven member shareholder advisory committee.[159]

Shareholder bankruptcy committees permitted under Chapter 11 of the Bankruptcy Code[160] serve as one possible model for corporate shareholder advisory committees.[161] As in the bankruptcy setting, directors' conflicts of interest[162] and responsibil-

157. Howard D. Sherman, *Special Report: The 1990 Proxy Season* (Institutional Shareholder Serv., Inc., Aug. 10, 1990), *in* INSTITUTIONAL INVESTORS, *supra* note 42, at 306.

158. *See* Koppes & Gillan, *supra* note 90, at 30.

159. First Executive Proxy Statement, at 11-12 (May 1, 1989) (WESTLAW, SEC-ONLINE file).

160. 11 U.S.C. §§ 1101-1174 (1988).

161. Section 1102 of the Bankruptcy Code provides as follows:

> (a)(2) On request of a party in interest, the court may order the appointment of additional committees . . . of equity security holders if necessary to assure [their] adequate representation. . . .
> (b)(2) A committee of equity security holders appointed under subsection (a)(2) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest amounts of equity securities of the debtor of the kinds represented on such committee.

11 U.S.C. § 1102(a)(2), (b)(2) (1988).

Shareholder bankruptcy committees thus are one possible paradigm for shareholder advisory committees outside of the Chapter 11 context. Under Chapter 11, these committees exhibit three key characteristics. First they are given the duty and power to represent the equity security holders and may do as follows:

> [C]onsult with the trustee or debtor in possession concerning the administration of the case; investigate the acts, conduct, assets, liabilities, and financial condition of the debtor . . . ; participate in the formulation of [reorganization] plan[s] . . .; request the appointment of a trustee or examiner . . .; [and] perform such other services as are in the interest of the equity security holders.

Id. §§ 1103(c)(1-5). They also have the power "with the court's approval . . . [to] select and authorize the employment [of] one or more attorneys, accountants, or other agents, to represent or perform services for such committee[s]." *Id.* § 1103(a). In addition, shareholder bankruptcy committees have a fiduciary duty to represent the interests of the other shareholders. *In re* Beker Indus., 55 B.R. 945, 949 (Bankr. S.D.N.Y. 1985). Finally, incumbent directors generally may not serve on these committees because of potential conflicts of interest. *In re* Penn-Dixie Indus., 9 B.R. 941, 944-45 (Bankr. S.D.N.Y. 1981); *In re* Realty Assoc. Securities Corp., 56 F. Supp. 1008, 1009 (E.D.N.Y. 1944), *aff'd*, 156 F.2d 480 (2d Cir. 1946).

162. "When a corporation enters into a Chapter 11 reorganization, the board of directors faces a conflict among its duties and loyalties to its shareholders, officers, employees, creditors, and the court." Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 493 (1991).

ity to multiple constituencies may prevent the director from adequately recognizing and representing shareholder interests, for example, with hostile takeover bids and derivative suits filed against officers or directors.[163]

Because shareholder advisory committees are an untested, evolving concept, they have no definitive composition.[164] As CalPERS proposed to Avon, for example, a shareholder advisory committee would consist of at least nine members.[165] The board would retain discretion to establish procedures for selecting members willing to serve, provided the board structure satisfies three criteria: each member is a beneficial owner of at least 1,000 shares of common voting stock for the entire period of membership; no member has any affiliation with the corporation other than as a shareholder; and at least five members are selected from the fifty largest beneficial owners of the corporation's voting shares.[166] CalPERS further urged that each membership term be limited to one year, that no member be eligible to serve more than three consecutive terms, and that the committee be limited to providing nonbinding, advisory counsel to the company's board.[167] Finally, CalPERS proposed that Avon's shareholder advisory committee, if created, provide advice to the board "regarding the interests of shareholders on principal policy considerations relevant to the company and its business, such as major restructuring or acquisitions, mergers, compensation issues, and other matters on which the board may choose to consult the committee."[168] Structured as CalPERS proposed, shareholder advisory committees would serve as a resource to the board and enhance relationships between a corporation and its largest providers of capital.[169]

Shareholder advisory committees are designed to overcome the free-rider problem, a classic problem in shareholder governance participation. The free-rider problem is one of incentives. No individual shareholder has the incentive to take action that will benefit shareholders as a class because each shareholder

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163. *See id.* at 494. In these circumstances, "directors may be ill-suited to represent the interests of shareholders." *Id.* (citation omitted).

164. *See* Koppes & Gillan, *supra* note 90, at 30-31 (describing the composition of a shareholder advisory committee as proposed by CalPERS to Avon).

165. *Id.* at 31.

166. *Id.*

167. *Id.*

168. *Id.* at 31-32.

169. *Id.* at 32.

knows that its efforts will be enjoyed by all. Rather, shareholders have an incentive to take no action and enjoy a free ride.[170]

The shareholder advisory committee may provide an efficient mechanism for large shareholders to be involved in the governance process.[171] The extent of the benefit from this form of monitoring, however, depends on the role and function of the committee. For example, the benefits to a shareholder from a purely advisory committee, although potentially substantial, would likely be less than those of a mandatory committee.[172] In addition, with mandatory committees, the costs of organizing, monitoring, and influencing management would correspondingly decrease because many costs would be reimbursed and because the costs of small, officially recognized committees should be lower than the comparable costs for large or ad hoc groups, such as those formed for a particular issue.[173]

For all the potential that shareholder advisory committees may hold, their creation in all but the most extreme circumstances is unlikely. As in the bankruptcy context, significant problems typically must arise in the operation of the corporation before attention from institutional shareholders will be sufficiently intense to force changes in the system. Absent such extreme problems, there is little likelihood that institutional shareholders will focus their energies on creation of shareholder advisory committees at any particular corporation.

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170. *See* Rock, *supra* note 162, at 456 (describing the classic collective action dilemma as follows: "while it is better for all if each contributes, it is better for each not to contribute, with the result that discipline, while in the collective interest of the shareholders, is not provided." (footnote omitted)).

171. The potential benefits of providing discipline increase while the corresponding costs decrease. *Id.* at 460.

172. *Id.* at 495

> If certain key decisions, such as whether the corporation should be sold or whether or not to pursue a derivative suit, were delegated to the committee, the committee would be likely to have a significant impact. If the committee were purely advisory, the increase . . . could still be substantial, because once the committee was in place, the managers of a concentrated corporation could only ignore the institutional shareholders' collective, organized advice at their peril.

Id.

173. *Id.* at 495. To the extent major shareholders are repeat players, "the likelihood is low that free riding will significantly undermine the shareholders' committees." *Id.* at 496.

C. THE POTENTIAL OF "RELATIONAL INVESTING"

According to Columbia's Louis Lowenstein and other experts,[174] the solution to America's corporate governance dilemma resides in a concept labeled "relational investing."[175] In relational investing, institutional investors make very large, long-term investments in a few companies while maintaining close ties with the companies' top management.[176] According to Lowenstein, relational investing will allow shareholders to realize their gains in the growing stream of income produced by the businesses in which they invest.[177]

Other commentators doubt the viability of relational investing for several reasons. First, fiduciary duties and other legal constraints effectively prevent pension managers from locking up their beneficiaries' funds for long periods.[178] In addition, conflict of interest problems may arise when a fund establishes a "special relationship" with corporate management that is not available to other shareholders.[179] Finally, very few pension fund managers have the ability and incentive to emulate the likes of Warren Buffet.[180]

These criticisms, however, miss the point by emphasizing unusual situations. Stakeholders and shareholders, together with management, usually fare best when there is active communication and a focus on the economic well-being of the business. To accentuate aberrational situations is to ignore the opportunity created by enhanced communication and an altered role for the board of directors. If relational investing helps institutional investors focus on better communication and long-term results, the corporate cooperation regime will benefit.

174. *See generally* Joel Chernoff & Marlene Givant Star, *Three Studies Support Relationship Investing*, PENSIONS & INVESTMENTS, Jan. 11, 1993 at 3, 30.

175. *See* Louis Lowenstein, *Dear Mr. Clinton. How to Repair the Market*, BARRON'S, Feb. 8, 1993, at 20, 22 (recommending changes in tax and accounting rules to encourage relational investing).

176. *See generally* Cordtz, *supra* note 8, at 28 ("Stripped of its qualifiers, [relational investing] means that institutional investors should all be Warren Buffets.").

177. Lowenstein, *supra* note 175, at 22.

178. Cordtz, *supra* note 8, at 28.

179. *See id.*

180. *See id.*

IV. "CORPORATE COOPERATION" AS THE NEW CORPORATE LAW REGIME

Boards traditionally have not facilitated communication among the corporate constituencies. They have not sought to mediate between the interests of shareholders and nonshareholders by resolving conflicts or advancing mutual interests. Boards have lacked incentive to seek shareholder input. No legal framework exists to balance the often opposing interests of shareholders and nonshareholders. The current board approach is designed for a bygone era.

The proposition that reform must ultimately focus on the board is consistent with the economic rationale for a board-centered governance system. Board-centered reform must ultimately mesh with the current "agency-cost" model on which most corporate codes are based. The monitoring resulting from directors' fiduciary duties forms the basis of contemporary corporate law and governance.

A. The Proposed "Corporate Cooperation" Regime

Ultimately reform must confront the ascendancy and growing expertise of longterm shareholders, especially sophisticated institutional investors. These institutional investors will not tolerate entrenched management and unresponsive boards. Accordingly, reform proposals must simultaneously recognize the preeminent status of the board, the need for input from major institutional shareholders, and the need to supplement shareholder input with that of stakeholders. Reform must boost monitoring effectiveness by increasing the trialogue among the three key players.

The board-as-mediator proposal most closely addresses the twin goals of strengthening the board and harnessing the expertise of contemporary institutional investors and stakeholders. Ideally, the board would serve as a central nervous system linking longterm shareholders and longterm stakeholders. This proposal contemplates three primary board functions: a management function, in which the board actively makes corporate policy; a monitoring function, in which it keeps tabs on issues and areas it does not actively manage; and a new, relationship management function, in which it aggressively creates a communication trialogue with shareholders and stakeholders. The only way to strengthen the board is to enhance the focus on the third function. The proposal thus envisions a corporate governance framework that reconfigures the relationship between the three key players—the board of directors, longterm shareholders, and longterm stakeholders—in a way that enables them to engage in trialogue toward maximizing the long-term profitability of the corporate enterprise.

Obviously, such a board structure requires directors of the highest caliber. Accordingly, boards should be infused with what Gilson and Kraakman call "professional directors." Furthermore, consistent with the longterm shareholder focus, board members should strive to become "long-term directors."[181] The board would thus be populated by "long-term professional directors." These "professional directors" could serve a long-term tenure of perhaps five years in carrying out their function as mediators between longterm shareholders and longterm stakeholders. Structured this way, corporate governance would maximize both the long-term profitability of a corporation and the long-term economic efficiency of the nation.[182]

To increase the trialogue function of the board, a corporation should take the following three actions: create a new board committee, the "relationship management committee," designed to bring about a corporate trialogue; urge longterm shareholders and stakeholders to invent and experiment with new mechanisms for informing directors; and explicitly commit themselves to maximizing long-term corporate value by enhancing corporate communications.

B. Advantages of a "Corporate Cooperation" Regime

1. Enhanced Monitoring and Accountability

The more the law grants stakeholders and longterm shareholders a voice regarding matters in which management's interest may diverge from stakeholders' and society's interests, the more likely that management will be accountable to those with vested corporate interests. Monitoring requires significant effort. Only those stakeholders with incentives to monitor will undertake the task. By focusing on relationship management, the proposed framework takes advantage of the incentives for longterm shareholders to monitor the aspects of corporate gov-

181. Perhaps even Martin Lipton would sanction this. *See* Lipton & Rosenblum, *supra* note 4, at 225-28.

182. Yet the Matheson/Olson proposal does not go far enough because its primary focus is upon corporate law. *See* Matheson & Olson, *supra* note 6. Indeed, the authors propose an entirely new code of statutory corporate law. *Id.* It is necessary to augment their framework with the specific means by which directors can fulfill their new function.

ernance relevant to each of their shareholdings. As a result, corporations will have a mechanism to minimize conflict situations while holding management accountable to major longterm stakeholders.

2. Enhanced Board Decision Making

The board structure that best lends itself to reasoned, independent, thoughtful decision making is not one in which much effort is spent erecting roadblocks to shareholder input and maintaining the status quo, including routine approval of management actions. Rather it is a board structure in which longterm shareholders and longterm stakeholders challenge, expand on, and inform managerial discretion. By soliciting the input of major stakeholders, including longterm shareholders, in appropriate fundamental transactions, directors will make better reasoned decisions.

Directors seeking to balance the needs of shareholders and nonshareholders will face a quagmire of uncertainty unless they actively seek and encourage shareholder input for fundamental decisions that influence the corporate governance regime. "By failing to encourage shareholder input, the current legal landscape effectively discourages directors from mitigating their uncertainty; it discourages directors from seeking shareholder guidance."[183]

3. Enhanced Economic Efficiency

To maximize economic efficiency, corporate decisions require an optimal blend of incentives, information, discretion, and oversight. Incentives, however, are the key. Constituencies motivated by adequate incentives will find ways to increase the amount of information, discretion, and oversight at their disposal.

Most decisions are best left to managers. Only managers have the incentives and information to perform and oversee daily operations. Other stakeholders lack such incentives and information and cannot therefore participate effectively in this operational domain. Easterbrook and Fischel argue, however, that shareholders possess powerful incentives to monitor management and guide directors:

> As the residual claimants, the shareholders are the group with the appropriate incentives . . . to make discretionary decisions. The firm

183. Matheson & Olson, *supra* note 38, at 1491.

> should invest in new products, plants, etc., until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion [or ensure that it is exercised on their behalf].[184]

Easterbrook and Fischel further suggest that the shareholders' position within the firm is unique because only shareholders have a stake in *every* decision made by a corporation.[185]

There are two types of situations in which corporate cooperation rather than simple management control is a *sine qua non* for maximizing economic efficiency. The first is those fundamental corporate transactions that so influence longterm shareholders' and stakeholders' financial interests that only longterm shareholders and stakeholders possess the requisite incentives to monitor the transactions' procedural and structural integrity. Procedural and structural transactions common to all corporations are especially likely to fall in this category. In this type of situation, shareholders can harness economies of scale in monitoring and providing input,[186] which allow them to overcome their tendency toward passivity.[187] Furthermore, shareholders who monitor and provide input on the same type of procedural or structural issue time after time develop even greater incentive and ability to provide useful input. If shareholders' input actually affects corporate performance, the incentive for them to provide guidance increases even more. Thus, whether an investor has monitoring skills today is irrelevant. The issue is whether certain types of shareholders may have the incentive to develop into effective monitors if given a more sympathetic governance regime.

The second type of situation in which corporate cooperation is essential involves transactions that are so fraught with conflicts of interest that no one decision maker can make an optimal decision. In these situations, the central decision maker should solicit input from those whose interests compete for supremacy.

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184. Easterbrook & Fischel, *supra* note 33, at 403.

185. *Id.* at 404.

186. *See, e.g.*, KNIGHTS, RAIDERS, AND TARGETS , *supra* note 49, at 1352 (noting that "because indexed investors hold shares in numerous companies, they seem more able to exploit economies of scale in reaching voting decisions and coordinating to oppose management").

187. *See generally* Black, *supra* note 4 (discussing that shareholders tend to view their investments as passive).

Here, a board must balance the input of managers, longterm shareholders, and longterm stakeholders. This balancing of competing interests will more likely lead to an optimally efficient outcome consistent with the long-term objectives and expectations of all corporate stakeholders.

The focus on longterm shareholders maximizes and optimizes economic efficiency in the long run. Harnessing shareholder incentives to monitor and guide directors will lead to systemic improvements in corporate governance. These improvements in the allocation of corporate governance powers guarantee that society will benefit in the long term. This, in turn, will pave the way for the United States to compete effectively in the global marketplace.

4. Bridging Ownership and Control

Focusing on shareholder voice rather than shareholder control bridges rather than unites ownership and control. Although liquidity remains intact, for shareholders to become stakeholders, they must have a genuine stake in the underlying profitability of the enterprise. Such a stake implies a long-term commitment and thus forecloses unhampered liquidity.[188]

Bridging ownership and control also implies bridging the conflicts of interests that inhere in the dichotomy between ownership and control. This minimizes conflicts of interest between shareholders and managers. By soliciting and balancing the input from other longterm stakeholders, the board is well-situated to arrive at a decision that eliminates or minimizes the conflicts of interest between shareholders and nonshareholders.

C. "Corporate Cooperation" and the Goals of Corporate Law

A root problem of the current corporate legal landscape is the uncertainty surrounding the proper purpose of the corporate enterprise. All of corporate law doctrine ultimately must confront the question of the proper goal of corporate governance, and no real reform can proceed without articulating precisely what that goal should be. Since the inception of the corporation, corporate governance has wrestled with the most fundamental

188. For a thoughtful discussion of the dichotomy between liquidity and control, see Knights, Raiders, and Targets, *supra* note 49, at 1287 (concluding that "those institutions that most desire liquidity would make poor monitors").

question of corporate legitimacy and purpose: determining the proper object of the corporation's allegiance.

Debate over the proper corporate objective and the propriety of managers diverging from the goal of profit maximization has raged without repose for more than half a century. By 1932, Professors Adolf Berle and E. Merrick Dodd debated the scope of management's responsibility.[189] Professor Berle asserted that, based on fiduciary duties owed shareholders, "powers granted to a corporation . . . are necessarily and at all times exercisable only for the ratable benefit of all the shareholders."[190] Professor Dodd countered that public policy demands that corporations be "an economic institution which has a social service as well as a profit-making function."[191] This debate demarcated the initial boundaries between a fiduciary shareholder primacy norm and a stakeholder approach.[192]

Despite the importance of defining the goals of corporate law, no corporate statute tries to do so.[193] Recent scholarship on corporate governance demonstrates how governance goals elude scholars.[194] Perhaps the goal of corporate governance—that is, maximizing corporate, and thus shareholder, value—has always been so theoretically straight-forward that it has not needed explication.[195] At least this is the notion with which the law of corporations and the principles of corporate governance began.

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189. *See* Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1930-31); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

190. Berle, *supra* note 189, at 1049.

191. Dodd, *supra* note 189, at 1148.

192. *See* Schwartz, *supra* note 4, at 521.

193. *Id.* at 523 ("Corporate statutes . . . do not specify the purpose of the corporation."); Johnson, *supra* note 4, at 874 ("[N]ot a single corporate statute explicitly addresses the purpose of corporate activity."). Still, many business corporation statutes and the Revised Model Business Corporation Act define "corporation" as a corporation for profit. *See, e.g.*, N.Y. BUS. CORP. § 102(a)(4) (1986).

194. *See* Lipton & Rosenblum, *supra* note 4, at 187 ("In much of the recent academic literature on corporate governance, . . . the goals are either ill-defined or assumed without examination.").

195. "Every business manager 'knows' what corporations are all about—corporations make money from their products or services . . . ." Schwartz, *supra* note 4, at 514; *see also* Johnson, *supra* note 4, at 877-78 ("Most persons in this country probably would be astounded to hear that maximization of shareholder wealth is the *raison d'etre* of corporate existence, yet the corporate doctrine takes that focus for granted.").

Alternatively, perhaps legislators prefer to defer to scholars the resolution of the knotty question of the meaning of corporate law. Although many possible goals of corporate endeavor have emerged, maximizing shareholder profits (with various exceptions, such as charitable donations) is the most established.

Professor R. Edward Freeman articulates five generic enterprise level strategies that attempt to reconcile shareholders, stakeholders, values, and social issues: a stockholder strategy, which seeks to maximize benefits to stockholders and "financial stakeholders";[196] a narrow stakeholder strategy, which seeks to maximize the benefits to one or a small set of stakeholders;[197] a utilitarian strategy, which seeks to maximize benefits to all stakeholders—the greatest good for the greatest number—and thus maximize the average welfare level for all stakeholders;[198] a Rawlsian strategy, which seeks to raise the level of the worst-off stakeholder, consistent with Rawls' insistence on "a like liberty for all";[199] and a social harmony strategy, which seeks to create social harmony by gaining consensus from society.[200]

Other goals of corporate law include maximizing long-term corporate welfare, maximizing the interests of the corporation and its shareholders, various economic goals, and various political goals (where the law should compel the corporation to pursue social goals which benefit society). *See* Schwartz, *supra* note 4, at 525-26 (noting that the "political model is totally unworkable"); Melvin A. Eisenberg, *Corporate Legitimacy, Conduct, and Governance—Two Models of the Corporation*, 17 CREIGHTON L. REV. 1, 2 (1983-84) (discussing "political model").

196. *See* R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 103-04 (1984).

197. *See id.* at 102-03. For example, if "customer service" and "employee welfare" are the basic values for a particular organization, and if the *raison d'etre* of the firm is to achieve these values, then the firm has more or less adopted what Freeman dubs a "specific stakeholder strategy." *Id.*

198. *Id.* at 104-05. Freeman's utilitarian rule reads as follows: "If the actions of a firm are perceived by its managers to have a wide range of effects on stakeholders, and if the managers have utilitarian values . . ., then the firm will adopt a utilitarian strategy to maximize the welfare of as many stakeholders as possible." *Id.* at 105. Freeman suggests that AT&T's development and implementation of "universal service" as its guiding principle in part is due to AT&T's acknowledging the social desirability of telephone service and so should be made available to as many people as possible. Accordingly, AT&T's pricing and service strategies flow from AT&T's overriding "utilitarian strategy." *Id.*

199. *Id.* at 105.

200. *Id.* at 106-07. Under such a strategy, the company derives its essential identity from the community. Accordingly, when conflicts arise among stakeholders, "major efforts are undertaken to resolve the conflict to the 'mutual understanding' of all parties." *Id.* at 106. Freeman's rule for implementing the harmony strategy is as follows:

> If the actions of a firm are perceived to have wide ranging effects on society, and if the values of the managers are oriented towards communitarianism, i.e., an identification with the local community, and if social issues concern the promotion of community interest, then the firm will adopt a harmony strategy. It will seek to minimize the amount of friction between the firm and the local community, and to identify the interests of the firm with the community.

Id. at 107.

Each of these views misses the point, given the modern corporate governance triad. The key to improving governance and enhanced efficiency is improving communication. The corporate board must be the impetus for the creation of relationships, not merely contracts, with the other governance groups. The board must actively seek to facilitate a multi-party communication network.

D. The Critical Need for Enhanced Cooperation

From Michael Porter's perspective, competitiveness today depends on the capacity of the United States to upgrade its competitive advantage to more competitive types.[201] The competitive position of several sectors of the U.S. economy, however, appears to have declined relative to that of other nations. Aggregate investment in property, plant and equipment, civilian research and development, and intangible assets such as corporate training and related forms of corporate human resources development is lower in the United States than in Japan and Germany.[202] Japanese rivals outinvest leading American firms in many industries, including construction equipment, computers, and tires.[203]

As Securities and Exchange Commission Chairman Richard Breeden has noted, "the most important objective . . . for investors is good long-term economic performance. From the perspective of investors, there is no substitute for growth in the value of a company."[204] Breeden also notes that achieving sustained economic growth in an intensely competitive national and international economy depends heavily on a corporation's "ability to pursue long-term strategic objectives ranging from fundamental research and development to patient expansion of market share."[205] As one commentator stated: "The United States economy and financial system suffer from 'short-termism,' an affliction caused by a lack of attention to long-term economic performance. Financial markets put pressure on corporate

201. Michael E. Porter, Capital Choices: Changing the Way America Invests in Industry 4 (1992).

202. *Id.* at 25.

203. *Id.*

204. *Shareholder Rights: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 102d Cong., 1st Sess. 120 (1991) (statement of Richard C. Breeden, Chairman of the Securities and Exchange Commission).

205. *Id.*

managers to focus too much on quarterly profits and too little on patient investment for the long haul."[206]

Ensuring that the board focuses on long-term corporate performance requires that the board enlist the information, incentives, and expertise of long-term constituents, shareholders and nonshareholders alike. Nevertheless, shareholder rather than nonshareholder guidance is the focal point for two reasons. First, the pervasive conflicts of interest between shareholders and stakeholders blur a board's ability to discern and serve the best interests of shareholders. In addition, only asset owners possess incentives to maximize the return on their investment. Accordingly, because of these conflicts of interest and lack of incentives by the board to maximize shareholder welfare, directors may benefit from shareholder guidance.

1. Minimizing Conflicts of Interest

Shareholder input may minimize conflicts of interest. As the potential for conflicts of interest between shareholders, management, and stakeholders increase—with a corresponding increase in the likelihood that management will ignore shareholder concerns—the likelihood that directors' business judgement will be skewed against longterm shareholder interests intensifies. At a minimum, a lack of shareholder input in such conflicts of interest adds to the uncertainties directors face in determining an optimal course for longterm shareholders.[207]

Conflicts of interest among the corporate triad are especially serious in takeover scenarios.[208] Economists tend to view these situations from either a market efficiency position[209] or an

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206. Cordtz, *supra* note 8, at 25.

207. *See* R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 8 (1987).

> [T]he inevitable uncertainties with respect to application of the business judgment rule in particular situations . . . . ha[s] contributed to an atmosphere of uncertainty [even as] directors . . . act in good faith to meet their responsibilities. [For example,] [s]uch uncertainty could force directors to act defensively out of concern over costly personal litigation rather than in directing and managing the business of the corporation.

Id.

208. *See* Matheson & Olson, *supra* note 38, at 1425.

209. According to the market efficiency theory, managers shield themselves in anti-takeover devices without proper accountability to shareholders, usurping for themselves undue market power while ridding themselves of incentive to run a more efficient corporation. *Id.* at 1493-94. Proponents of this view argue that tender offers maximize outsiders' ability to monitor the target company's management performance. *Id.* Thus, takeovers maximize efficiency

auction market position,[210] both of which place shareholders in preeminent status. Many economists suggest that directors erecting anti-takeover armaments should objectively consider the manifold alternatives for maximizing corporate profits and should implement defensive measures only to limit inadequate or coercive bids or to develop superior bids or restructuring plans.[211] Conflicts of interest also appear in many other corporate transactions, including executive compensation and dismissal of shareholder derivative suits.

2. Maximizing Economic Efficiency

Shareholders' guidance may also promote economic efficiency: "Only asset owners have the unfettered incentive to seek out economically efficient alternatives."[212] Directors, who lack the incentives of asset owners and are saddled with conflicting economically inefficient prejudices may fail to search for optimal alternatives unless guided by shareholders.[213]

Some scholars assert that corporate governance should merely seek to facilitate the operation of the market and reduce transaction costs.[214] This market model posits that the corporation merely substitutes for costly multiple contractual arrangements to increase efficiency with the goal of maximizing profits.[215] Supporters of the market model tend to ally themselves with proponents of the efficient capital market hypothe-

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either by allowing suboptimal directors and managers to be taken over or by motivating directors to run the corporation more efficiently—essentially, the "market" monitors managerial performance while shareholders hold management accountable for profit performance. Further, this enhanced efficiency generates more wealth for both shareholders and non-shareholder constituencies. *Id.* The theory's bottom line is that directors should remain "passive" amid control change transactions. *Id.*

210. A more moderate approach focuses on the use of defensive anti-takeover weaponry, such as a poison pill, in facilitating an auction market amid hostile overtures. *Id.* at 1494-95. While the existence of an auction market will generate greater premiums for shareholders, it is more significant that such a market will maximize the likelihood of assuring the most productive match among raider and target. *Id.* This optimal "match" maximizes long-term economic efficiency. *Id.* Delaware courts have traditionally embraced the modified "auction model" for corporate control. *Id.*

211. *See id.*

212. Matheson & Olson, *supra* note 38, at 1491.

213. *See id.*

214. *See, e.g.*, Fischel, *The "Race of the Bottom", supra* note 4, at 921; Fischel, *The Corporate Governance Movement, supra* note 4, at 1265; *see also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 14.3, at 369 (3rd ed. 1986) (noting that the primary purpose of corporate law is to provide standard terms).

215. *See* Schwartz, *supra* note 4, at 523.

sis. According to this hypothesis, even when a change of control is not threatened, stock prices accurately reflect all available information about the corporation, including the extent of agency costs arising from behavior that protects management.[216]

In addition, proponents of the market monitoring model emphasize the invisible hand of the marketplace, which they believe compels managers to align their conduct with shareholders lest the value of the corporate enterprise diminish.[217] They stress that the optimal governance structure must be derived from experience rather than theory. Corporations that persuade shareholders that they offer the highest return will garner the largest investments. Thus, only firms and managers that make choices investors would ordinarily prefer will prosper relative to others.[218]

E. Applying the "Corporate Cooperation" Regime

The leading corporate law case, *Paramount Communications, Inc. v. Time, Inc.*,[219] illustrates how a proactive corporate cooperation regime may strengthen relations between board members and stakeholders while maximizing longterm shareholder and corporate value. The Delaware Supreme Court allowed Time's board to redesign its proposed business combination with Warner, thereby eliminating the need for trialogue with shareholders and stakeholders.[220] Specifically, Time and Warner originally agreed on a stock-for-stock merger in which the Time shareholders would receive roughly $125 per share.[221] But when Paramount entered the drama with a cash bid for $175 (later raised to $200) per share, Time and Warner revised their plan, making the transaction a tender offer instead of a merger, thereby circumventing shareholder voting requirements and incurring an enormous debt burden of seven to ten billion dollars.[222]

216. For a general overview of materials relevant to the efficient capital market hypothesis, see Robert W. Hamilton, Corporation Finance 252-95 (2d ed. 1989). Chancellor Allen has questioned the infallibility of the efficient market hypothesis. Paramount Communications, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,514, at 93,264 (Del. Ch. July 14, 1989), *aff'd*, 565 A.2d 281 (Del. 1989).

217. *See supra* note 56 and accompanying text.

218. *See* Easterbrook & Fischel, *supra* note 56, at 1420.

219. 571 A.2d 1140 (Del. 1989).

220. *Id.* at 1154-55.

221. *Id.* at 1146.

222. *Id.* at 1147-49.

Time-Warner avoided trialogue. Instead it forced on shareholders and stakeholders a plan that was at least $50 to $75 per share below the market's evaluation of the stock; restructured the deal to preempt shareholder approval requirements while incurring massive amounts of debt; refused to meet with Paramount to discuss its offer; and established a line of succession for managing and directing the company, thereby eliminating a fundamental function of future boards elected by the shareholders.[223] Under a more amicable corporate cooperation regime, longterm shareholders, longterm stakeholders and directors would have communicated to best determine the fate of Time-Warner. A corporate cooperation regime would have fostered a fairer and more efficient outcome. Longterm shareholders and longterm stakeholders would have debated the advisability of incurring massive debt, limiting the succession of directors and managers, and adopting and redeeming Time's poison pill.[224]

V. CONCLUSION

This Article sets forth a legal approach necessary to meet the emerging need for communication between the three key players of corporate governance: the board, longterm shareholders, and longterm stakeholders. In response to the board's new trialogical imperative, this Article identifies a new duty for board members: relationship management. In that capacity, the board can serve as a catalyst and mediator for trialogue between longterm shareholders and longterm stakeholders toward maximizing long-term corporate competitiveness and profitability. It is our hope that corporate boards will recognize and actively pursue their inevitable role in this communication process.

223. *Id.*
224. *See supra* note 38 and accompanying text (describing poison pills).