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DISPELLING TINA'S† GHOST FROM THE POST-ENRON CORPORATE GOVERNANCE DEBATE

Michael E. Murphy*

"One of the marks of a truly dominant intellectual paradigm is the difficulty people have in even imagining any alternative view."[1]

I. INTRODUCTION

As the fallout from the Enron debacle settles, imagine a hypothetical poll: "Corporations in the United States are typically driven by a narrow agenda, suiting the interests of a self-aggrandizing executive elite, which is destructive to the environment, culturally degrading, and harmful to community and family life." Do you agree? Mark: (a) fully and without equivocation, (b) in some respects, or (c) are you serious? — such an intemperate view of American business should be rejected out of hand.

Those who would mark choice (a) are a diverse group, representing a significant presence in our body politic. They include many active environmentalists, a portion of the religious left, communitarian philosophers, the radical wing of the labor movement, opponents of NAFTA[2] and the WTO[3], student sweatshop activists, and

† TINA is an acronym for "There is no alternative." The expression became popular in the United Kingdom among critics of Margaret Thatcher's government because of her penchant for justifying policies with the explanation: "There is no alternative." *See* DANIEL SINGER, WHOSE MILLENIUM? THEIRS OR OURS 1-2 (1999); David Ost, *Letter from Poland*, THE NATION, Nov. 25, 2002, at 16.

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1. William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1401 (1993) (Allen was a chancellor at the Delaware Court of Chancery).

2. North American Free Trade Agreement, Dec. 17, 1992, U.S.-Mex.-Can., 32 I.L.M 605. January 1, 2002 marks the eight year anniversary of the implementation of the North American Free Trade Agreement, which was created jointly by the United States, Canada,

Pacifica Radio listeners[4]—in short, the coalition of environmentalists, trade unionists, ministers, and non-violent protesters who surged in unexpected numbers on the streets of Seattle in November, 1999. They are likely to view the Enron controversy as a call for close governmental oversight of corporate accounting.

A majority of Americans would probably settle for choice (b). They may cheer anti-corporate rhetoric, applaud Erin Brockovich, and complain about Enron and the pharmaceutical industry, but they are excited by the rapid development of the high tech sector, value their 401(k) accounts, shrug at complaints about globalization, and admire notable business leaders, such as Jack Welch, Ted Turner, and Bill Gates.

Those who would mark choice (c) are likely to remain unshaken in their belief that, despite the Enron scandal, business can clean up its own house without government interference. They are not confined to the business community but include cultural and political conservatives and the dominant schools of thought in academic departments of law, business, and economics. In law schools, the most intellectually sophisticated scholarship on the corporation has unquestionably come from the law-and-economics tradition.[5] Legal scholars dissenting from this tradition are relatively few and exceedingly moderate.[6]

The corporation is a subject that tends to polarize reasonable people into isolated and opposed bodies of opinion. The aura of consensus that one finds in the law-and-economics literature is also found in the writings of environmentalists[7] and cultural critics,[8] who

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and Mexico to create a free trade zone. *See* Department of Foreign Affairs and International Trade, *Overview of the NAFTA*, *at* http://www.dfait-maeci.gc.ca/nafta-alena/over-e.asp (2001).

3. Located in Geneva, Switzerland, the World Trade Organization was established in January 1, 1995. For more information, please visit the official WTO site, *at* http://www.wto.org.

4. Pacifica Radio is a voice of the non-corporate media.

5. *See* Allen, *supra* note 1, at 1399.

6. *See, e.g.*, PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995); Constance E. Bagley & Karen L. Page, *The Devil Made Me Do It: Replacing Corporate Directors' Veil of Secrecy with the Mantle of Stewardship*, 36 SAN DIEGO L. REV. 897 (1999); Thomas Lee Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273 (1991); David Millon, *New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993).

7. *See, e.g.*, ROSS GELBSPAN, THE HEAT IS ON: THE HIGH STAKES BATTLE OVER EARTH'S THREATENED CLIMATE 33-61 (1997); GEORGE A. GONZALEZ, THE POLITICAL

hold a starkly contradictory point of view. It is worth noting, however, that the idea of shareholder accountability yields a tenuous common ground. The anti-corporate activists may be interested in social and environmental issues, while the institutional investor and academician may be concerned about economic distortions, but all oppose management autonomy and are likely to favor private democratic controls.[9]

Wherever one stands in this spectrum of opinion, it must be conceded that the characteristic form of the U.S. corporation, with the dissociation of shareownership from active management, has a political and cultural history as well as an economic and technical basis.[10] Other industrial countries have experienced historical influences that have resulted in significantly divergent models for the corporation. Usually, large institutional investors and banks exert a degree of control over corporate governance.[11] In Japan, for example, the corporation typically maintains close relations with a particular bank that owns up to 5% of the corporation's stock and plays a backup role in monitoring management performance, intervening when it deems necessary.[12] During the post-World War II era, most western European countries engaged in a vigorous debate about "industrial democracy," which led to active experimentation in bringing employees into corporate governance. Five countries (Germany, the Netherlands, Denmark,

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ECONOMY OF U.S. ENVIRONMENTAL POLICY: CORPORATE POWER AND THE ENVIRONMENT (2001).

8. *See, e.g.*, THOMAS FRANK, ONE MARKET UNDER GOD: EXTREME CAPITALISM, MARKET POPULISM, AND THE END OF ECONOMIC DEMOCRACY (2000); JEAN KILBOURNE, CAN'T BUY MY LOVE: HOW ADVERTISING CHANGES THE WAY WE THINK AND FEEL (1999); NAOMI KLEIN, NO LOGO, MONEY MARKETING, AND THE GROWING ANTI-CORPORATE MOVEMENT (1999).

9. Management does not enjoy unqualified autonomy even in the absence of any direct accountability to shareholders through the processes of corporate governance. In a competitive industry, the market imposes constraints on management's freedom of action that are likely to mirror the interests of shareholders in many, but not all respects. *See generally* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

10. The classic analysis is found in ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1967).

11. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 11, 15-17 (1991).

12. *See* Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solution*, 25 DEL. J. CORP. L. 189, 209, 211 (2000); *see generally* Michael Bradley et al., *Challenges to Corporate Governance: The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9 (1999); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993).

Sweden, and Austria) have provided for employee representation in the board of certain corporations, and the Fifth Directive on Company Law of the European Union now allows companies to choose among four models of corporate organization, three of which assign employees a role in governance.[13]

Perhaps the most successful of these alternative models is the two-tiered board of the large German publicly owned company, the *Aktiengesellschaften* or AG company, which enfranchises both employees and certain other stakeholders.[14] Employee representatives sit on the supervisory board beside shareholder representatives who commonly include bankers, local community leaders, suppliers, and customers. The supervisory board possesses ultimate authority and oversees a lower operational board, composed of top executives.[15] In 1976, the German federal government introduced a measure that expanded employee representation by requiring that the supervisory board be composed almost equally of employee and shareholder representatives—almost because one employee director is chosen from the ranks of management and the chairman, with the deciding vote, is appointed by shareholders.[16] The measure was supported by all political parties.[17] British historian John Gray, believes that "[t]he dispersal of power among a range of stakeholders in the German system is central in accounting for its low levels of economic inequality in comparison with Anglo-Saxon economies."[18]

Both the European and Japanese models of corporate governance are rooted in precedents and culture of their own regions.[19] They may

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13. *See* Kenneth Wedderburn, *Companies and Employees: Common Law or Social Dimension*, 109 LAW Q. REV. 220, 232-35 (1993); *see also* David Charny, *Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Community*, 32 HARV. INT'L L.J. 423, 454 n.83 (1991); Clark D. Stith, *Federalism and Company Law*, 79 GEO. L.J. 1581, 1591, 1598 (1991).

14. *See also* Willi Joachim, *The Liability of Supervisory Board Directors in Germany*, 25 INT'L LAW. 41, 42-51 (1991); *see also* J. Shearman, *Corporate Governance— an Overview of the German Aufsichtsrat*, 1995 J. BUS. L. 517, 531; *see generally* Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German & U.S. Corporate Structures*, 17 ARIZ. J. INT'L & COMP. L. 555 (2000).

15. *See* Butler, *supra* note 14, at 563-66.

16. *See* Joachim, *supra* note 14, at 48.

17. *See* Shearman, *supra* note 14, at 531.

18. JOHN GRAY, FALSE DAWN: THE DELUSIONS OF GLOBAL CAPITALISM 93 (1998).

19. For a theoretical discussion of the divergence of corporate form despite the homogenizing tendencies of the global market, see Lucian Arye Bebchuk & Mark J. Roe, *A*

suggest the range of possibilities, but they cannot be transplanted directly to the foreign soil of the United States. Corporate reforms here must modify existing institutions in ways consistent with U.S. political history. The problem is that the American corporation today is *not* consistent with our own political traditions. There is a sharp dissonance between the values honored in other areas of social life and the futile proxy contexts, meaningless shareholder meetings, management autonomy, and impersonal, hierarchical structure of the corporation. This dissonance may account for much of the discontent with the corporation in our society.

One point seems clear enough to serve as a compass for our inquiry. It is consistent with our shared democratic traditions to hold the corporation accountable, to the extent practicable, to the groups most affected by its activities. This inquiry avoids abstract standards of performance, whether related to wealth maximization or social responsibility, and proceeds instead from the premise that, in the long run, institutions are best designed to serve the interests, expectations, desires, and values of their constituencies.

As Merrick Dodd long ago observed, there are three groups of people with an interest in the activities of corporate management: the shareholders, the employees, and the general public.[20] The goal of accountability to shareholders can be sought in the internal controls of a private system of corporate governance. To the extent that it achieves shareholder accountability, corporate governance offers the great practical advantage of all democratic structures: it is, to some extent, self-regulating. The interests of employees and the general public ordinarily call for external controls enforced by governmental oversight, but the norms and procedures of shareholder democracy also present certain possibilities for incorporating an employee and community voice into a self-regulating system of corporate governance.

This article investigates, first, the ways of restoring corporate accountability to shareholders, particularly minority shareholders and those institutional shareholders that represent the most numerous and diverse constituencies in our society. This inquiry leads to the concept of representative associations of institutional investors and to the

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Theory of Path Dependence in Corporate Ownership and Governance, 52 STAN. L. REV. 127 (1999).

20. *See* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1154-55 (1932).

necessity of federal standards for corporate governance. The discussion of shareholder democracy provides a context for exploring ways the employee voice can be incorporated into a self-regulating system serving the interests of shareholders. Lastly, touching obliquely on the broad topic of the relationship between the corporation and the general public, this article will discuss the convergence of management's fiduciary responsibility with social aspirations of important shareholder constituencies.

II. THE CORPORATION AND SHAREHOLDERS

A. *Social Patterns of Shareownership*

Twenty years ago, Robert Charles Clark remarked, "Increased sharing in benefits and decreased sharing in power: one wonders whether any of the early commentators on capitalist enterprise, from Adam Smith to Karl Marx, correctly anticipated that this would be the evolutionary pattern of the capitalist system."[21] Clark would be obliged today to add a minor qualification. The 1990s have witnessed a modest resurgence of shareholder activism among institutional investors that has checked the trend toward decreasing control. Yet, the paradox of widespread ownership and limited access to power remains a central feature of corporate enterprise in the United States.

What would be the consequence of reversing this historical pattern by effectively enfranchising all shareholders? Three perspectives may lend some insight into the possibilities of change latent within the broad shareholder constituency: the demographic breadth within the population of individual shareholders, the sphere of influence enjoyed by institutional shareholder groups with a capacity and incentive for activism, and the proclivities of the larger body of institutional investors.

The New York Stock Exchange estimated that 48.5 million individuals directly held corporate stock or mutual fund shares in 1998, compared to 31.5 million individuals in 1989.[22] If the shareowning

21. Robert C. Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561, 568 (1981).

22. *See* NEW YORK STOCK EXCHANGE, SHAREOWNERSHIP 2000 17, 19-20 (2000) [hereinafter N.Y. STOCK EXCH.], *available at* http://www.nyse.com/marketinfo/shareownersurvey.html. The New York Stock Exchange report is based on the 1998 Survey of Consumer Finances conducted by the Survey

public is more broadly defined to include indirect ownership through participation in self-directed retirement accounts or defined-contribution pension plans, the number of shareowners during 1998 was 84 million individuals, an increase from 52.3 million individuals in 1989. As so defined, the percentage of adults over the age of 18 who were shareholders in 1998 was at least 43.5%.[23]

Shareownership is, of course, strongly weighted toward the wealthy. The median stock portfolio value in 1998 was only $28,000, while the mean portfolio value was $148,500—more than five times as large.[24] Nevertheless, shareownership among less privileged groups in society was by no means negligible. Counting both direct and indirect ownership, shareowners with a family income of $50,000 or less held roughly 7% of all corporate stock and those with a family income of $75,000 or less held about 15.1% of all corporate stock.[25] Shareowners without a college degree held 21.0% of all corporate stock, and shareholders within the occupational categories of service or craftspersons, laborers and farmers, and clerical, technical, or sales persons accounted for 11.1% of all corporate stock ownership.[26] Direct ownership was not unusual in the lower economic strata. For example, 16.9% of shareowners with a family income of less than $50,000, who were household heads or spouses of household heads, held stock directly.[27]

Research Center at the University of Michigan for the Federal Reserve Board. The Investment Company Institute and the Securities Industry Association have published the only other statistical study of shareownership. *See* INVESTMENT COMPANY INSTITUTE & SECURITIES INDUSTRY ASSOCIATION, EQUITY OWNERSHIP IN AMERICA (1999), *available at* http://investmentcompanyinstitute&securitiesindustryassociation.com. The differences between the two reports are sufficiently small so as not to affect the general perspectives presented here.

23. *See* N.Y. STOCK EXCH., *supra* note 22, at 15-16.

24. *See id.* at 19.

25. *See id.* at 25, 33. The available source of data on aggregate ownership of corporate stock is found in publications of the Federal Reserve Board's "Flow of Funds" accounts, which unfortunately employ a different system of classifying investment sectors than the Consumer Research Surveys. The estimates here follow the New York Stock Exchange analysis by adding direct household holdings and the indirect household holdings of private pension funds and mutual funds. The figure for direct household holdings is reduced by 5% to reflect the estimated holdings of non-profits, which the Federal Reserve oddly includes in the household sector. *See id.*

26. *See id.* at 24-25. The New York Stock Exchange analysis provides the percentages of individual shareownership represented by these categories of shareholders. These percentages have been recalculated as a percentage of total stock ownership by the method explained in note 25.

27. *See id.* at 29.

A different kind of insight into the potential influence of shareholder constituencies may be gained by surveying the institutional sectors with a demonstrated capacity for shareholder activism, in particular union-related pension funds and the cluster of institutions devoted to socially responsive investing. The term "union pension fund" usually refers to the joint-trusted funds established under the Taft-Hartley Act.[28] The Act bars employers from making contributions to union-managed funds unless the funds meet certain requirements—most notably, they must be administered by an equal number of trustees appointed by management and the union.[29] These plans, often called Taft-Hartley plans, commonly cover multi-employer bargaining units or the entire union membership.[30] Typical examples are the Carpenters Pension Trust for Southern California and the International Association of Machinists National Pension Fund. Despite the statutory scheme, Taft-Hartley plans tend to be dominated by union trustees.[31] Management trustees lack an incentive to become actively involved in investment decisions since management is obliged only to make a fixed contribution that will not change whether the fund investments fail or succeed.[32]

It has been estimated that 40% of all collectively bargained pension plans are Taft-Hartley plans.[33] Another very small category of plans, funded by union or worker contributions, are directly managed by unions.[34] Other pension plans established through collective bargaining are in fact administered by employers. In these plans, the union role is limited to bargaining over the level of contributions or benefits. Although union members are the beneficiaries of the plans, the employer appoints the trustees–typically corporate officers who have full control over administrative or investment decisions.[35]

The Department of Labor statistics provide an approximation of

28. Labor Management Relations Act of 1947, 29 U.S.C. § 141.

29. *See* Labor Management Relations (Taft-Hartley) Act § 302(a)(1) and (c), 29 U.S.C. § 186(a)(1) and (c) (1998).

30. See id.

31. *See* Council of Institutional Investors, *Council Membership*, *at* http://www.cii.org/memberdirectory.asp (last visited Nov. 15, 2002).

32. *See* Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 Mich. L. Rev. 1018, 1076-1077 (1998).

33. *See id.* at 1076.

34. *See id.* at 1076 n.270.

35. *See id.* at 1075.

the size of the shareholder constituency represented by labor unions, though a precise calculation is impossible. The Department of Labor reports that collectively bargained pension plans accounted for 34% of all private pension fund assets in 1997.[36] It offers no comparable figure for collectively bargained plans in the public sector. Nevertheless, if one considers the amount of corporate equities held by private and public pension plans,[37] it seems likely that corporate equities held by pension funds benefiting employees in collective bargaining units accounted for something in the range of 4% to 5% of all corporate equities.[38] Since very few individual shareholders vote in corporate elections, the labor pension funds account for a much higher percentage of stock that is actually voted.

Using their limited base in Taft-Hartley plans, unions aggressively pursued shareholder activism in the 1990s.[39] The Industrial Union Department of the American Federation of Labor and Congress of Industrial Organization (AFL-CIO) calls on union pension funds "to screen and actively target or exclude certain types of investment as a means of advancing the multiple and long-term economic and social objectives of plan participants."[40] Sometimes unions have engaged in "corporate campaigns" to put pressure on employers to yield concessions in collective bargaining, but they have also joined with other institutional investors in advocating corporate governance measures such as confidential balloting, appointment of independent directors, and exclusion of inside directors from audit, nominating, and compensation committees.[41]

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36. *See* U.S. DEP'T OF LABOR, ABSTRACT OF 1997 FORM 5500 ANNUAL REPORTS, PRIVATE PENSION PLAN BULLETIN, Winter 2001, at Table A.6.

37. Private pension plans accounted for about 14% of all domestic corporate equities outstanding, and state and local pension funds accounted for about 11 percent. *See* NEW YORK STOCK EXCHANGE, FACT BOOK 59 (1999) [hereinafter N.Y. STOCK EXCH.].

38. The figure that is relevant for our analysis is the amount of domestic equities held directly by Taft-Hartley plans or indirectly by defined contribution plans of employees in the private and public sector who belong to collective bargaining units. To roughly estimate this figure, it is not enough to multiply all private pension equities by the relative importance of assets held by collectively bargained plans; it is necessary also to deduct equities held by non-Taft-Hartley defined benefit plans in the private sector and add indirect ownership of equities in collective bargaining units in the public sector. The breakdown needed for a refined estimate is not available in published Department of Labor data. For a somewhat higher estimate, see Teresa Ghilarducci, SMALL BENEFITS, BIG PENSION FUNDS, AND HOW GOVERNANCE REFORMS CAN CLOSE THE GAP IN WORKING CAPITAL: THE POWER OF LABOR'S PENSIONS 166 (Archon Fung, Tessa Hebb, and Joel Rogers eds., 2001).

39. *See* Jayne Elizabeth Zanglein, *From Wall Street Walk to Wall Street Talk: The Changing Face of Corporate Governance,* 11 DEPAUL BUS. L.J. 43, 73, 85-97 (1998).

40. Schwab & Thomas, *supra* note 32, at 1078 n.287.

41. *See id.* at 1019-29. The Council of Institutional Investors is a coalition primarily of Taft-Hartley plans and public employee pension funds. *See* Council of Institutional

In contrast to the coherent objectives of union shareholder activism, the phenomenon of socially responsive investing presents a multiplicity of voices. Some socially directed funds serve idiosyncratic causes such as vegetarianism, animal rights, or a pro-life agenda; still others have a short list of disparate restrictions that barely distinguish them from other funds.[42] Nevertheless, a core group of mutual funds in the field of ethical investing actively pursue concerns of important constituencies in American life, such as environmentalism and the equal treatment of workers. Socially oriented funds grew explosively in the 1990s and held corporate equities worth $154 billion in 1999, or about 1% of all corporate equities.[43] These funds find a natural ally in the Interfaith Center for Corporate Responsibility, which serves a coalition of Protestant, Catholic, and Jewish institutional endowments and pension funds controlling about $100 billion in assets and an unreported quantity of corporate equities.[44]

The Social Investment Forum, a trade association of socially responsive investors, identifies shareholder activism as one of its three central objectives–the other two being the screening of investments and promoting local community involvement.[45] The mutual funds represented by the association, together with allied groups such as the Interfaith Center for Corporate Responsibility, control sufficient assets to serve as a catalyst in forming shareholder coalitions. In addition, these funds are in a position to serve as conduits of information to a

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Investors, *Corporate Governance Policies, at* http://www.cii.org/corp_governance.htm (last visited January 10, 2002).

42. *See, e.g.*, Patrick McGeehan, *A Socially Responsible Fund: Whose Conscience is it Anyway?*, N.Y. TIMES, Apr. 9, 2000, at BU28; Brenda Moore, *Investing with Principle Can Pay Off*, WALL ST. J. (Eastern ed.), June 9, 1999, at 1; Chet Currier, *Portfolios With a 'Conscious' Have Big Players Thinking Up New Funds*, L.A. TIMES, Jan. 2, 2000, at 3; Danny Hakim, *On Wall Street, More Investors Push Social Goals*, N.Y. TIMES, Feb. 11, 2001, at 1:1.

43. *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1267-68, 1287-89 (1999); SOCIAL INVESTMENT FORUM, 2001 REPORT ON SOCIALLY RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES (Nov. 28, 2001), *available at* http://www.socialinvest.org/areas/research/trends/2001-Trends.htm (last visited Dec. 31, 2001).

44. *See* E-mail from Diane Bratcher, Director of Communications and Planning, Interfaith Center for Corporate Responsibility, to Michael E. Murphy, Judicial Attorney, California Court of Appeals (Nov. 26, 2001) (on file with author).

45. *See* Social Investment Forum, *Introduction to Socially Responsible Investing, at* http://www.socialinvest.org/areas/sriguide/ (last visited Jan. 10, 2002).

still larger class of individual investors. Many wealthy individuals place a small fraction of their investments in a socially responsive fund as a concession to ethical concerns.

Union pension and ethical investment funds are part of the broader category of institutional investors. In 1999, U.S. institutional investors held approximately 50% of the domestic market of corporate equities. Within this sector, 17% of outstanding equities were held by mutual funds, 6% by insurance company, 2% by bank personal trusts, 2% by foundations and nonprofit endowments, 14% by private pension funds, and 11% by state and local pension funds.[46]

While most institutional investors, especially insurance companies, private pension funds, and bank trusts, have an unbroken history of shareholder passivity, some investment funds have more recently taken an active interest in corporate governance initiatives. The giant Teachers Insurance & Annuities Association-College Retirement Equities Fund (TIAA-CREF), with over $100 billion in U.S. corporate equities, has made a sustained commitment to use its financial clout to promote improved corporate governance practices.[47] Similar objectives unite the Council of Institutional Investors, a coalition of smaller institutional investors drawn from labor, corporate, and local government pension funds.[48]

Managers of public pension funds often have an incentive to appeal to political constituencies and usually tend to take proxy voting more seriously than their corporate counterparts.[49] Some managers are elected by beneficiaries; in other cases, the managers themselves serve in state offices or are chosen by elected or appointed public officials.[50]

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46. *See* N.Y. STOCK EXCH., *supra* note 37, at 59. The figure on foundations and endowments is derived from NEW YORK STOCK EXCHANGE, *supra* note 22, at 33. *See also* WILLIAM M. O'BARR & JOHN M. CONLEY, *FORTUNE AND FOLLY, THE WEALTH AND POWER OF INSTITUTIONAL INVESTING* 34 (1992).

47. *See* TIAA-CREF, TIAA-CREF ANNUAL REPORT 2000, *available at* http://www.tiaa-cref.org/libra/AR/00/index.html (last visited December 31, 2001) (gives total stock holdings of $149 billion but does not provide a breakdown between domestic and international equities). As of June 30, 2001, the fund had total stock holdings of $137 billion, of which $105 billion were in domestic equities. *See* E-mail from Thomas Pinto, TIAA-CREF Public Relations Dept., to Michael E. Murphy, Judicial Attorney, California Court of Appeals (Aug. 15, 2001) (on file with author).

48. Council of Institutional Investors, *Corporate Governance Policies*, *at* http://www.cii.org/corp_gov_init.asp. (last visited Dec. 31, 2001).

49. *See* O'BARR & CONLEY, *supra* note 46, at 194.

50. *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 799-820 (1993).

The largest public pension fund, California Public Employees Retirement Systems (CalPERS) with $60 billion in corporate equities, has long been the standard bearer among public funds in advancing progressive governance practices and targeting economically under-performing companies.[51] CalPERS published, for example, a 1995 survey of corporate governance practices of the 300 largest public companies, rating the companies with grades A through F.[52] Other public funds that aggressively pursue corporate governance initiatives include the State of Wisconsin Investment Board, the New York State Common Retirement Fund, and the New York City Funds (*e.g.*, Fire Department, Teachers Retirement, etc.).[53]

Underlying institutional shareholder activism is the belief that active monitoring of management performance can improve investment returns. Although the empirical evidence is inconclusive, it is thought that an active and independent board will be more likely to discharge under-performing CEOs, to oppose systemic defects in the corporate sector, such as the overcompensation of top executives, and to scrutinize the expected returns from acquisitions and diversification programs that may only serve to enlarge the executive power .[54] Indeed, a study by Wilshire Associates of forty-two companies targeted by CalPERS found that the companies beat the S&P 500 share index by 41% during the five-year period in which they were actively monitored.[55]

By encouraging active management monitoring, mainstream institutional investors have pursued a corporate governance agenda that

51. *See* Zanglein, *supra* note 39, at 81-82. For California Public Employees Retirement System (CalPERS) equity holdings, see CalPERS, *Asset Allocation*, *at* http://www.calpers.ca.gov/invest/asset/asset/htm (last visited Dec. 31, 2001).

52. *See* Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1290 (1998).

53. *See* Zanglein, *supra* note 39, at 70-85.

54. *See* Millstein & MacAvoy, *supra* note 52, at 1291-1318; Constance E. Bagley & Richard H. Koppes, *Leader of the Pack: A Proposal for Disclosure of Board Leadership Structure*, 34 SAN DIEGO L. REV. 149, 150-51 (1997); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 898-916 (1992). *But see* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001).

55. *See* Zanglein, *supra* note 39, at 69. The Standard and Poor's 500 stock index, commonly known as the S&P 500, is a widely used measure of large-cap performance in the U.S. stock market, which is based on a representative sample of leading companies in major industries. *See* Standard & Poor's 500 Index, *Standard & Poor's Index Services*, *at* http://www.spglobal.com/indexmain500.html (last visited Apr. 23, 2002).

coincides, to a surprising degree, with the preferences of labor union funds, ethical investors, and social critics of the corporation. The issues that figure most prominently in the initiatives of large institutional investors include such broadly supported governance objectives as confidential voting, cumulative voting, selection of independent directors, assuring independent board committees, separating the offices of CEO and chairman of the board, and eliminating classified boards.[56] The issue of excessive executive compensation, which has been targeted especially by union pension funds, also finds a sympathetic resonance among many institutional investors, though they may favor different solutions.[57]

B. *Dispersion of Shareownership and Shareholder Passivity*

The wide dispersion of corporate shareownership in public corporations offers possibilities for the sharing of corporate power comparable in some ways to the stake holder model of the German publicly owned corporation, the *Aktiengesellscaften* or "AG" company.[58] If the diverse shareholder constituencies in public corporations were given an effective voice in corporate governance, that voice would inevitably introduce new and more complex considerations into corporate decision making, reflecting the perspectives of shareholder constituencies outside the present circle of management. It would, in other words, change the way corporate decisions are framed by broadening the number of relevant considerations, leading to pervasive changes in the corporate agenda.

It is, however, paradoxical to speak of the democratic promise of widely dispersed shareownership because the dispersion of ownership also divides and fragments shareholder power in a way that paralyzes shareholder action in corporate governance. The dispersion of shareownership offers both the promise of democratic reform and an explanation for shareholder passivity.

56. A detailed discussion of the 1998 proxy season may be found in Zanglein, *supra* note 39, at 74-90. *See also* Romano, *supra* note 50, at 799-820; John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1356-59 (1992); TIAA-CREFF, *Policy Statement on Corporate Governance*, *at* http://www.tiaa-cref.org/libra/governance/index.html (last visited Dec. 31, 2001).

57. *See* Schwab & Thomas, *supra* note 32, at 1086-88; *Executive PayWatch*, *available at* http://www.aflcio.org/paywatch/index.htm (last visited Dec. 31, 2001).

58. *See supra* note 14 and accompanying text.

The classic study of the modern corporation by Berle and Means reveals the deep economic and cultural roots of the dispersion of stock ownership.[59] As early as 1929, they found that many large companies had no stockowner holding more than a 2% or 3% interest; and, where a larger bloc of stock ownership existed, "the most common condition is that of wide ownership of the bulk of the stock with a substantial minority held by a single interest."[60] Moreover, income tax statistics showed "the very great extent to which persons of small or moderate means must be stockholders of corporations."[61] Berle and Means found that the wide and expanding market for corporate stock was generated both by the capital needs of industry and by the cultural willingness of Americans to invest their savings in corporate equity.[62]

Moreover, the political history of the corporation has created legislative and regulatory barriers to concentrated stock ownership. In an illuminating essay, Mark Roe details how the populist distrust of Wall Street and financial institutions, shared broadly by the American public, led to an intricate set of restrictions on banks, mutual funds, insurance companies, and pension funds that effectively blocked concentrated stock ownership and kept financial institutions from actively monitoring management performance.[63] While they did not promote these restrictions, management interest groups defended them and threw "their weight in the way of change," knowing that the dispersion of stock ownership in fact served to preserve management prerogatives and discretion.[64]

Today, the wide dispersion of shareownership among institutional investors reflects in part the regulatory demands for diversification of investments. The prudent person standard of Employee Retirement Income Security Act (ERISA) requires fiduciaries to discharge their duties "by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."[65] The Investment Company Act of 1940 and the

59. *See* BERLE & MEANS, *supra* note 10.
60. *Id.* at 48.
61. *Id.* at 60.
62. *See id.* at 63-64.
63. *See* Roe, *supra* note 11, at 31-53.
64. *Id.* at 46.
65. Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1104(a)(1)(C) (1994).

tax rules allowing pass-through of income impose other diversification requirements, including a restriction on holding more than 10% of the securities of any one company.[66] The widespread use of indexing as an investment methodology has reinforced this tendency toward high levels of diversification by calling for statistical sampling of a broad segment of the market, such as that included in the S&P 500 or the Wilshire 5000.[67]

The effects of institutional diversification are compounded at the level of the small investor, resulting in an extreme level of atomization that presents obvious barriers to participation in corporate governance. A person with a self-directed retirement account of $10,000 invested in the S&P 500 would have only a fractional share, worth an average of $20, in any one company.[68] The modest median portfolio value of an individual investor suggests there is a large population of people with such small accounts. Even individuals with larger stockholdings have a tax incentive to include within their portfolio an individual retirement account (IRA) or a 401(k) account, both of which are limited in size by legislative restrictions on the individual's annual contributions.[69]

At the institutional level, the dispersion of shareownership leads to the phenomenon of rational apathy. The individual fund manager may

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66. *See* Investment Company Act of 1940 § 5(b), 15 U.S.C. § 80a-5(b) (1997) and I.R.C. § 851(b)(3) (West 2001). In general, section 851(b)(3) of the Internal Revenue Code imposes a stringent diversification requirement on 50% of an investment company's assets; no more than 5% may be invested in the securities of any one company, and the company may not hold more than 10 percent of the outstanding voting securities of any one issuer. With respect to the entire fund of investments, the company may not invest more than 25% of total assets in the securities of one issuer. Section 5(b) of the Investment Company Act of 1940 provides that an investment company, qualifying for the privileged status of a "diversified company," must similarly segregate its investments into two asset pools, representing respectively 75% and 25% of the company's assets, and comply with the same stringent diversification requirements with respect to the 75% pool: it may not invest more than 5% in any one company and may not hold more than 10% of the outstanding securities of any one company. *See id.*

67. In the late 1990s, index funds received 25% of equity fund inflows. The level fell to 4% in 2000 and rose to 15% in the early months of 2001. *See Stock Index Funds Are Regaining Favor*, N.Y. TIMES (East Coast ed.), June 3, 2001, at 8. The stock index, commonly known as the Wilshire 5000 provides the broadest index for the U.S. equity market. *See* Wilshire Assoc., Inc., *Wilshire Broad Market Indexes*, *at* http://www.wilshire.com/Indexes/Broad (last visited April 23, 2002). For an explanation of the S&P 500, *see* Millstein & MacAvoy, *supra* note 52.

68. This example is offered only to illustrate the possible degree of fragmentation of ownership in an indexed fund. Indexed funds come in many varieties and may track a stock index by using sampling techniques without investing in the full range of stocks in the index. *See* James A. White, *The Index Boom*, WALL ST. J., May 29, 1991, at C1.

69. Annual contributions to individual retirement accounts are limited to $2,000. *See* I.R.C. § 408(a)(1) (West 2001). Annual contributions to 401(k) plans are limited to $10,000 adjusted for inflation. *See* I.R.C. § 402(g) (West 2001).

best pursue private self-interest by avoiding the costs of corporate governance initiatives, where the benefits are uncertain and, in any event, will accrue to all shareholders.[70] Even the largest funds face the prospect of futility in engaging in shareholder's initiatives. In 1990, the second and third largest pension funds in the country, CalPERS and the New York State and Local Retirement Systems unsuccessfully attempted to intervene in the selection of a new CEO for General Motors. Although each fund owned approximately five million shares, each held less than 1% of General Motor's common stock— too little to entitle them to a hearing.[71] Despite a mild resurgence of institutional shareholder activism, more widespread institutional engagement in corporate governance is unlikely unless the problem of rational apathy is minimized by keeping costs low and maximizing the benefits of shareholder activism.

C. *Preliminary Legal Obstacles*

1. *Survey of the Problem*

As a logical proposition, the effects of the dispersion of shareownership can be addressed by either of two options: (1) reducing the level of dispersion or (2) finding ways for concerted action among shareholders. The former strategy does not lead one very far. While it may make sense to relax somewhat the regulatory diversification requirements,[72] a policy encouraging concentrated ownership would offend financial prudence and traditional distrust of the consolidation of financial power.

An effective remedy to shareholder passivity clearly must be

70. For a more rigorous analysis of the phenomenon of rational apathy, *see* William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1903-25 (1995); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277, 1281, 1284, 1317-28 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445, 453-78 (1991).

71. *See* A. A. Sommer, Jr., *Corporate Governance in the 1990s*, 59 U. CIN. L. REV. 357, 367, 374 (1990).

72. There is no theoretical justification for limiting investment in a single company to as low a level as 10% of the company's outstanding securities, as required by the Investment Company Act and the pass-through provisions of the tax code. Furthermore, the ERISA standard represents an extreme position by requiring diversification to "minimize" losses, unless other "compelling" reasons appear. According to a leading text on portfolio theory, nearly all the benefits of diversification may be achieved with a portfolio of sixteen stocks. *See* JAMES H. LORIE, ET AL., THE STOCK MARKET: THEORIES AND EVIDENCE. 85 (DowJones-Irwin, 3d ed. 1985).

sought in concerted action by shareholders. But the most immediate difficulty is found in the complex federal and state laws that serve to sanction and preserve the phenomenon of shareholder passivity. It is not possible to address organizational strategies for concerted action without first finding a way through this legal labyrinth.

At the risk of over-simplification, I will first discuss three legal obstacles having particularly direct and immediate relevance to concerted shareholder action: the barriers to shareholder communications, the litigation risks entailed in concerted shareholder action, and the decline of cumulative voting. I will then turn to organizational strategies for concerted action and finally survey the array of other legal impediments to shareholder democracy.

2. *Proxy Regulation*

Regulatory reforms, as is well known, have a way of working unexpected consequences. Section 14(a) of the Securities Exchange Act of 1934 gave the Securities and Exchange Commission jurisdiction to regulate proxy solicitation in the public interest.[73] The Act's sponsors aimed to curb fraud and promote management accountability by requiring shareholders to be fairly informed about the matters upon which they were asked to vote. The proxy rules, which the SEC has promulgated under this statutory scheme,[74] unquestionably provide safeguards against fraud and may foster management accountability in some contexts, but they also impose costs, delays, and restrictions on shareholder communications.[75]

All proxy solicitations must be accompanied or preceded by a formal proxy statement that meets certain detailed requirements. Before being disseminated to shareholders, the proxy statement must be filed with the SEC so as to allow it sufficient time to review and clear its content. Other public statements relating to shareholder voting must be filed with the SEC on the day they are made.[76] The rules

73. *See* Securities Exchange Act of 1934 (the "Exchange Act") § 14(a), 15 U.S.C. § 78n(a) (1997).

74. *See* Rule 14, 17 C.F.R. §§ 240.14a-1 to 240.14a-101, 240.14b, and 240.14c (2001).

75. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 536-542 (1990); Alfred F. Conrad, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988); Sommer, *supra* note 71, at 359, 368; 4 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1912-2120.22 (3d ed. 2000).

76. The SEC requires ten days before mailing written materials and five days before a telephone campaign. *See* Rule 14a-3, 17 C.F.R. §§ 240.14a-3 (2001); Rule 14a-6, 240.14a-

broadly define the term proxy to include all consents and authorizations relating to shareholder voting, even a request for money to fund a shareholder committee. Similarly, a solicitation embraces any communication reasonably calculated to result in a proxy, thus including preliminary inquiries to "test the waters" of shareholder sentiment.[77]

These SEC anti-fraud provisions are peculiarly misplaced in elections for the board of directors, which raise issues of personal qualifications, biases, and policies of the candidates comparable to those in any other type of election. In other spheres of civic life, the free expression of opinion is regarded as the best guarantee of truth, but a person soliciting proxies in an election of directors is at risk of incurring liability for inaccurate statements. More precisely, the solicitor may incur liability by making "any statement which . . . is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any [prior] statement . . . which has become false or misleading."[78]

More fundamentally, management alone possesses the funds to bear the costs of contacting the mass of shareholders. Under SEC Rule 14a-7, a corporation may refuse to give a shareholder the names and addresses of other shareholders, provided that it offers to mail proxy material for the shareholder at the shareholder's expense.[79] In a large corporation, the costs of solicitation are far beyond the means of all but the most wealthy shareholders, the chances of success in a proxy contest exceedingly slim,[80] and the possibilities of recovering costs of solicitation from the corporation close to nil.[81] In theory, the

6 (2001).

77. *See* Rule 14a-2(f) and (l), 17 C.F.R. § 240.14a-2(f) and (l) (2001).

78. Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a) (2001).

79. *See* Rule 14a-7(a), 17 C.F.R. § 240.14a-7(a) (2001).

80. *See* Robert N. Shwartz, Note, *A Proposal for the Designation of Shareholder Nominees for Director in the Corporate Proxy Statement*, 74 COLUM. L. REV. 1139, 1167 n.148 (1974).

81. Upon receiving a shareholder's request for a list of security holders, management has the option of providing the names and addresses of security holders or of offering to mail proxy material for the shareholder, at the shareholder's expense. Rule 14a-7(a), 17 C.F.R. § 240.14a-7(a) (2001). In most cases, management prefers to make a separate mailing of the shareholder's proxy material, and charges the shareholder for materials, postage, and administrative costs. *See* LOSS & SELIGMAN, *supra* note 75, at 1984-85. A shareholder will have no grounds to ask the company to reimburse the expense of the proxy contest if his candidate is not elected. *See* Royal Business Group, Inc. v. Realist, Inc., 933 F.2d 1056, 1060 (1st Cir. 1991). Moreover, if the shareholder does not gain control of the

shareholder has the alternative of nominating candidates from the floor of the annual stockholders meeting. But the annual meetings attract few, if any, uncommitted shareholders, and management then possesses enough proxies to nominate and elect its own candidates. Nominations from the floor, therefore, have no chance of success.

The only exception to management control of shareholder communication relates to shareholder proposals that are on certain designated subjects and comply with a prescribed form; if such shareholder proposals are submitted to management 120 days in advance of the date management releases its own annual proxy statement for the shareholders' meeting, management must include the proposals in its proxy statement and proxy card.[82] Since Ralph Nader's famous "campaign GM" in 1970, shareholder activists have viewed shareholder proposals as the only realistic avenue to pursue the goals of corporate accountability.[83] However, the shareholder proposal rule gives shareholders little power in corporate governance. As Alfred Conrad observed, "it provides no means of challenging the essential quality and policies of management. A shareholder proposal can neither nominate directors, nor express opposition to the management's nomination."[84]

3. *Litigation Risks of Concerted Shareholder Action*

The securities laws create a veritable minefield of obstacles for shareholders, who wish to act in concert with other shareholders in the exercise of their voting rights. In most cases, these restrictions arguably should be narrowly confined to specific problems or abuses,[85] but they still create a risk of litigation that effectively chills the right of

board, it may face resistance in persuading the board to reimburse the expenses of a proxy campaign. There is, however, some authority for the view that the board of directors may properly reimburse the director for his campaign expenses. *See* Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, 293 (N.Y. 1955); Stenberg v. Adams, 90 F. Supp. 604, 607-08 (S.D.N.Y. 1950).

82. *See* Rule 14a-8, 17 C.F.R. 240.14a-8 (2001).

83. *See* Donald E. Schwartz, *Public-Interest Proxy Contest: Reflections on Campaign GM,* 69 MICH. L. REV. 421, 426 (1971).

84. Conrad, *supra* note 75, at 155. The proxy rules expressly bar shareholder proposals relating to selection of directors. Rule 14a-8(i)(8) provides that a company has no obligation to include a shareholder proposal in its proxy statement "[i]f the proposal relates to an election for membership on the company's board of directors or analogous governing body." Rule 14a-8(i)(8), 17 C.F.R. § 240.14a-8(i)(8).

85. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 896-903 (1991).

free association among institutional shareholders. Since these impediments to concerted shareholder action have been aptly analyzed elsewhere, it is enough here to indicate briefly the areas of difficulty.[86]

Under federal law, the most prominent restrictions fall into four categories. First, by agreeing to vote securities together for a common purpose, shareholders may find themselves subjected to the disclosure requirements of section 13(d) of the Exchange Act, which applies to shareholder groups that own 5% or more of the stock of a public company.[87] Secondly, by participating in the selection of directors, shareholders may be exposed to the insider regulations of section 16 of the Exchange Act and SEC Rule 10(b)-5, which come into play where shareholders have a relationship with a director.[88] Thirdly, the principal exemptions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 turn on the acquisition of stock "solely for investment purposes," a condition that may be inconsistent with active involvement in corporate governance initiatives.[89] Finally, a shareholder coalition that achieves a position of influence within a corporation will encounter the manifold problems of corporate control that pervade the securities laws.[90]

86. *See* Conrad, *supra* note 75, at 152-62; Black, *supra* note 75, at 542-60.

87. Section 13(d) of the Exchange Act requires any shareholder group owning more than 5% of the stock of a public company to make certain disclosures of its investment plans. *See* Exchange Act § 13(d), 15 U.S.C. § 78m(d) (1997). The SEC defines the term "group" to include "two or more persons [who] agree to act together for the purpose of acquiring, holding, *voting*, or disposing of equity securities." Rule 13d-5(b)(1), 17 C.F.R. § 240.13d-5(b)(1) (2001) (emphasis added). The existence of a group may be based on an informal understanding proven by circumstantial evidence. *See* Wellman v. Dickinson, 682 F.2d 355, 363 (2d Cir. 1982); SEC v. Savoy Industries, 587 F.2d 1149, 1163 (D.C. Cir. 1978). Thus, shareholders who make informal voting overtures to other shareholders enter into a hazardous ground in which they may be uncertain of their filing obligation and incapable of providing the requisite information about the other shareholder's intentions.

88. Section 16 of the Exchange Act requires corporate directors to make reports of their holdings and to disgorge profits from "short-swing" trades. *See* Exchange Act § 16, 15 U.S.C. § 78p (1997). The courts have held that a party who deputizes a director to act on its behalf may itself be treated as a director, making it imprudent for an investor to sponsor a candidate for the board of directors. *See* Blau v. Lehman, 368 U.S. 403, 408-09 (1962); Feder v. Martin Marietta Corp., 406 F.2d 260, 263 (2d Cir. 1970); Lowey v. Howmet Corp., 424 F. Supp. 461, 464. (S.D.N.Y. 1977). Rule 10(b)-5 imposes liability for trading a company's stock on the basis of inside information. *See* Rule 10(b)-5, 17 C.F.R. § 240.10b-5 (2001). An investor who participates in the selection of a director or who allows its own officer to sit as a director of a company, risks creating a relationship which may be construed as a conduit of inside information. *See* Chiarella v. United States, 445 U.S. 222, 227, 230 (1979).

89. *See* Hart-Scott-Rodino Antitrust Improvements Act of 1976 § 201, 15 U.S.C. § 18a(c)(9) (1997); 16 C.F.R. §§ 801.1(i)(1), 802.64 (2001).

90. A controlling shareholder, among other things, is subject to restrictions in selling a corporation's shares and may be jointly and severally liable for securities law violations of the corporation. *See, e.g.*, Securities Act of 1933 §§ 2, 15, 15 U.S.C. §§ 77b(11), 77o;

The obstacles to concerted shareholder action extend into the field of state law as a result of the anti-takeover legislation of the 1970s and 1980s. A patchwork of state legislation causes undesirable consequences to flow from the acquisition of a certain level of stock ownership—for example, filing requirements, suspension of voting rights, liability for severance benefits, or disgorgement of profits. Alternatively, the legislation allows corporations to adopt by-law provisions, such as "poison pill" stock-purchase rights that dilute rights of third parties acquiring a large stock interest.[91] These state laws or by-law provisions may bring any shareholder coalition within their terms where the threshold level of ownership is defined in terms of voting power. Although the pitfalls to concerted shareholder action may be unintended, they represent a genuine litigation risk for shareholder groups seeking a voice in corporate governance.

4. *Cumulative Voting*

The removal of barriers to concerted shareholder action would, however, make little difference in the absence of the privilege of cumulative voting—the right of minority shareholders to secure representation on the board proportionate to their share ownership.[92]

Exchange Act § 20, 15 U.S.C. § 78t(a) (1997). The concept of control is not synonymous with a majority interest but rather presents a "complex factual question." Kersh v. General Council of Assemblies of God, 804 F.2d 546, 548 (9th Cir. 1986). A 1989 SEC release acknowledges the widely accepted view that a 20% stock ownership "in most instances constitutes control." SEC Release No. 34-27035, 54 Fed. Reg. 30492 n.23 (July 20, 1989). Control may rest on a group of shareholders voting as a bloc, which has the potential power to direct management decisions, even if it is not exercised. *See* Landay v. United States, 108 F.2d 698, 704 (6th Cir. 1939) ("appellants by voting their shares as a block completely dominated the corporation"). For a definition of control, see Rule 405, 17 C.F.R. § 230.405. *See also* LOSS & SELIGMAN, *supra* note 75, at 1724, *citing* Arthur Children's Trust v. Keim, 994 F.2d 1390, 1397 (9th Cir. 1993) *and* Rochez Brothers, Inc. v. Rhoades. 527 F.2d 880, 890-91(3d Cir. 1975).

91. *See* Black, *supra* note 75, at 550-51, 556-60. The term "poison pill" refers to stock purchase rights distributed to shareholders that become effective upon the occurrence of a triggering event such as a third party acquisition of a certain percentage of stock. *See id.*

92. Under cumulative voting, director candidates are elected as a group by rules that allow individual shareholders to cast all their votes for one or more candidates, thereby assuring representation on the board to minority shareholders with a requisite number of shares. The alternative to cumulative voting, "straight voting," involves a separate contest for each board seat, assuring that a simple majority of shareholders will elect directors to all vacant seats. *See* 2 JAMES D. COX ET AL., CORPORATIONS § 13.21 (2001 Supp.). Thus, in an election to fill nine vacancies on the board, cumulative voting will allow an individual shareholder with 100 shares to cast 900 votes for a single candidate or distribute the 900 votes among two or more candidates. With "straight voting," the shareholder would have the right to cast 100 votes for each of the nine vacancies.

Cumulative voting today is the sine qua non of any scheme to give a voice in corporate governance to the dispersed mass of shareholders in the large public corporation. Without cumulative voting, the full board of directors would inevitably be elected by the shareholders holding a majority of voting power; with cumulative voting, the membership of the board can reflect the diverse interests and views of the shareholder constituencies.

The idea of cumulative voting was an innovation of the 1870 Illinois Constitutional Convention.[93] The practice spread to other states, which adopted mandatory cumulative voting statutes or permissive statutes that authorized corporations to adopt cumulative voting by charter provision or through their by-laws.[94] The practice reached a high point of acceptance in the mid-twentieth century when twenty-two states had mandatory cumulative voting provisions. A survey of the 2,900 largest corporations in the 1940s revealed that 40% offered shareholders the right of cumulative voting.[95] The practice, however, came under attack in the 1960s and 1970s and fell off sharply in the 1980s. By 1992, only six small states required cumulative voting, and in states with permissive statutes, a relatively small percentage of corporations still offered the privilege to shareholders. A 1992 survey of the Fortune 500 companies found that only 14% had cumulative voting. Among Delaware corporations, only 11% had cumulative voting.[96]

Reviewing the decline of cumulative voting, Jeffrey Gordon reports that the practice was attacked as bringing discord to the board room, promoting expensive proxy contests, and facilitating hostile takeovers. The most potent argument was that cumulative voting created a hostile business climate, causing corporations to prefer to incorporate in states that did not require the practice.[97] California, the last major state with a mandatory cumulative voting statute, switched to permissive cumulative voting in 1989, after several large

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The practice of cumulative voting involves mathematical complexities, which may be resolved through well-known algebraic formulas. *See* Lewis R. Mills, *The Mathematics of Cumulative Voting*, 1968 DUKE L.J. 28; Amihai Glazer et al., *Cumulative Voting in Corporate Elections: Introducing Strategy into the Equation*, 35 S.C. L. REV. 295 (1984).

93. *See* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 142-45, 160 (1994).

94. *See id.* at 143.

95. *See id.* at 144-45, 160.

96. *See id.* at 145-46, 160.

97. *See id.* at 146-65.

corporations reincorporated in Delaware.[98] Surprisingly, cumulative voting was never subject to persuasive economic objections. On the contrary, a study of NYSE firms between 1962 and 1982 indicated that amendments to eliminate cumulative voting rights reduced share values by an average of 1.57%.[99]

The resurgence of institutional shareholder activism in the 1990s provides a new argument for cumulative voting. Gordon notes that institutional investors "have little incentive to pursue private gains because they cannot capture such gains in their compensation. The strategy that institutions would reliably pursue under cumulative voting would be to enhance the quality, independence, and accountability of the board in the hope that this will improve the firm's performance."[100] In this way, he argues, "the benefits of institutional engagement [would] flow to all shareholders."[101] In the large public corporation in which institutional investors own 50% or more of the stock, cumulative voting would become "a vehicle for virtual representation of majoritarian interests by a well-motivated minority."[102]

In summary, the genius of cumulative voting is that it permits effective expression of the diverse interests of shareholders. For the institutional investor, it is a means of enhancing board independence and improving the monitoring of management performance. For other minority shareholder constituencies, it offers the possibility of acquiring a voice on the board by electing a representative director. With existing patterns of shareownership in the United States,[103] it is impossible to conceive of any effective system of shareholder accountability for the large public corporation not based on the practice of cumulative voting. For the purpose of this article's inquiry into the possibility of self-regulating systems of accountability, the existence of cumulative voting is an essential assumption.

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98. *See* Susan A. Rose, Comment, *Optional Cumulative Voting & Staggered Terms of Directors: Is the California Climate Warming to Corporations?*, 27 SAN DIEGO L. REV. 467, 468-69 (1990).

99. *See* Sanjai Bhagat & James A. Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339, 353-54 (1984).

100. Gordon, *supra* note 93, at 171.

101. *Id.*

102. *Id.*

103. *See* discussion *infra* Part II.A.

D. *Strategies for Concerted Shareholder Action*

1. *Limited Deregulation*

As a practical matter, the establishment of a general system of cumulative voting implies a new regime of corporate law, founded on federal standards, that would most likely be part of a pervasive and coherent program of reform. I will defer discussion of this subject until later. It should, however, be noted here that the legal barriers to shareholder communication and concerted shareholder action could be removed by a simple process of deregulation, which would chart a narrow series of exemptions pertaining to the nomination and election of directors. An exemption to the proxy rules would apply to all statements and solicitations pertaining to the election of a candidate for the board, thereby freeing communications in a realm of discourse akin to the political sphere in which the free flow of information and the competition of ideas are the best guarantees of truth.[104] An exemption to the legal barriers to concerted action would limit overly broad statutory language without calling into question the broader purposes of the legislation underlying section 13(d) of the Exchange Act, insider regulation, and regulatory consequences of corporate control.

2. *Associations of Institutional Shareholders*

Assuming the practice of cumulative voting and the elimination of regulatory obstacles to shareholder communication and concerted action, it becomes possible to discuss, with a degree of realism, the key issue of organizational strategies for establishing a system of shareholder democracy. It is clear that any practical solution to the problem of rational apathy must begin with institutional shareholders, who possess the largest holdings. The pattern of dispersed shareownership imposes insuperable difficulties for organized

104. In general, the filing pre-clearance requirements for proxy statements and other related material present an unnecessary burden on communications related to election contests for director, but these requirements may still be justified in one context: the solicitation of proxies by a major shareholder or outside investor as part of a takeover strategy. In such a case, there is indeed a need for the elaborate disclosures of the identity and affiliations of the proxy solicitor. *See* Rule 14a-101, 17 C.F.R. § 240.14a-101, items 4 and 5 (2001). A policy of deregulation would call for a general rule exempting all communications (whether among shareholders or between shareholders and third parties) relating to the qualification of directors or solicitation of proxies for director candidates, subject to a specific rule applying to the takeover situation.

initiatives of individual shareholders. However, I will argue, that institutional shareholder associations could have a representational function, serving the interests not only of other institutions but also of the varied constituencies of individual shareholders, thus creating an effective system of shareholder democracy.

A proposal of Gilson and Kraakman is worth close examination because it reveals the plausibility of the concept of shareholder associations for the mainstream institutional investors that might seem least disposed to engage in concerted action.[105] The authors begin with a striking assessment of rational apathy among institutional investors. The growth of investment funds with broad positions in the market, particularly indexed funds, gives institutional investors the collective power to monitor corporate performance, but removes individual incentive for them to do so. The authors argue that the new interest of some institutional investors in the monitoring of management is actually misdirected. "[I]nstitutions *should not* take such an interest because they stand to gain much less from it than traditional owners might gain."[106] The only rational objective of institutional investors with broad positions in the market is to improve "the corporate governance *system* rather than by attempting to improve the management of particular companies."[107]

Following familiar ground, the authors observe that the selection of independent directors "remains key to any plausible effort to introduce effective monitoring,"[108] but argue that it is not enough to focus on election of independent outside directors. In most cases the outside directors are themselves chief executives of other public companies and therefore tend to be ideologically disposed to avoid active monitoring of management. Moreover, they serve at management's pleasure, share social connections with management, and lack any financial incentive to devote time to directorship duties.[109] In short, the outside director is neither independent nor accountable to shareholders.

As a solution, Gilson and Kraakman propose that institutional

105. *See generally* Gilson & Kraakman, *supra* note 85.
106. *Id.* at 866.
107. *Id.* at 867 (emphasis added).
108. *Id.* at 882.
109. *See id.* at 884.

investors collectively establish a "clearinghouse" charged with recruiting a corps of professional directors that would be accountable to institutional investors: "To function effectively, the clearinghouse would merely need to know that institutional investors, out of self-interest, ordinarily would vote for its nominees, who would be selected expressly to promote shareholder interests."[110] The new professional investor might serve on the board of perhaps six corporations—a role that would offer enough financial compensation and professional challenge to attract qualified candidates from business schools, accounting firms, or management consulting firms.[111]

The Gilson and Kraakman proposal is impeccably logical as a solution to the problem of rational apathy. A shareholder association, engaged in screening and nominating directors, could spread the cost of shareholder activism and concentrate on the central importance of the selection of directors in the scheme of corporate governance,[112] largely eschewing the limited promise of shareholder proposals, which has been the traditional focus of shareholder activism.[113] A corps of outside directors, depending on the support of an association of institutional investors, could be expected to influence corporate performance in ways that would reward a modest investment in membership of the association.

It may be doubted, however, that the financial incentive of mainstream institutional investors to improve the monitoring of management is strong enough to prompt such an ambitious collective

110. *Id.* at 887.

111. *See* Gilson & Kraakman, *supra* note 85, at 885.

112. It is elementary that the board plays the central role in corporate governance; it selects the principal executive officers, evaluates their performance, and approves major corporate activities. Ultimately, the board alone has the power to effectively monitor management policy and performance. Commentaries on corporate governance reiterate this role of the board in similar terms. *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE, ANALYSIS AND RECOMMENDATIONS (Proposed Final Draft), § 3.02 (1992); AMERICAN BAR ASSOCIATION, CORPORATE DIRECTOR'S GUIDEBOOK 4 (3d ed. 2001); The Business Roundtable, *Corporate Governance and American Competitiveness*, 46 BUS. LAW. 241, 246 (1990). On the theory and evolving practice of actively monitoring boards, *see* Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265 (1997).

113. There have been repeated calls for reform of rule 14a-8 to allow freer use of shareholder proposals. *See* LOSS & SELIGMAN, *supra* note 75, at 2051-54. While such reforms may have merit, shareholder proposals have a limited potential for enfranchising shareholder constituencies and lie outside of the subject of this article, which explores the possibility of a representative board of directors monitoring the full range of corporate activities.

undertaking. A far more likely catalyst for change may be found among the institutional investors with the strongest incentive to place representative candidates on the board of directors—the Taft-Hartley pension funds, TIAA-CREF, the Social Investment Forum, the Interfaith Center on Corporate Responsibility, and the public pension funds with politically responsive leadership. In each of these groups, investment managers serve a constituency that would be likely to approve an activist role in corporate governance either on broad social grounds or to improve the general quality of management monitoring. It is most plausible to imagine that the sort of clearinghouse that Gilson and Kraakman imagine would first emerge in these sectors and then spread through a process of imitation and competition to mainstream institutional investors, who would also find such a system to be in their interest.

E. *Outreach to Individual Shareowners*

1. *Procedural Mechanics*

The institutional investors who have demonstrated the strongest propensity to engage in corporate governance initiatives are often in a position to serve as a conduit of information to a broader population of individual investors. For example, union members with small stockholdings may be disposed to follow the lead taken by Taft-Hartley funds in filling out their proxy cards. Investors in socially responsive funds commonly possess other larger holdings and, by their investment in the funds, display a certain willingness to defer to the judgment of fund managers. TIAA-CREF enjoys great credibility among teachers who include a significant population of individual investors. The same can be said of CalPERS and many other activist public pension funds.

Such funds could significantly amplify their influence in selecting directors by enlisting the support of their constituencies of individual investors. An effective way to allow the expression of the individual shareowner voice in the election of directors would be the tried and tested method employed for shareholder proposals: the inclusion of alternative choices on the same proxy card as management recommendations, with an identification of the candidate's sponsors.[114]

It would be a simple matter to design a proxy card that would

114. For a history of proposals for mandatory inclusion of shareholder board nominees in the corporation's proxy statement, *see* Bratton & McCahery, *supra* note 70, at 1925.

identify a candidate for director as being sponsored by a particular shareholder association and, in the Internet era, to provide a website where more information could be obtained. Political sponsorship of this sort is the gist of democracy. People commonly vote for the candidate of their party or, in local elections, for the candidate endorsed by a public official they trust. In the same way, a teacher might reasonably expect a candidate recommended by TIAA-CREF to reflect the values and interests of educators, particularly if this assumption could be verified by consulting a pertinent website. For a union member, the choice may be still easier: a candidate endorsed by the AFL-CIO, for example, may be counted upon to support the member's interests as a worker.

Would such a system result in chaos? Not if it were properly regulated. The privilege of naming candidates on the company proxy card could be limited to shareholder associations, with a requisite number of members, which collectively hold a significant share of all corporate equities, perhaps $150 billion in corporate equities or roughly 1% of the market. As a practical matter, shareholder associations would have to represent a much larger share of corporate equities to effectively place candidates, but a higher threshold might impede the entry of new associations. In light of the advantage of forming the largest possible shareholder coalition, it is unlikely that there would be a confusing profusion of nominations.

2. *The Distinct Issue of the Large Shareholder*

A system allowing shareholder associations to nominate directors on the corporation's proxy card would not necessarily lead to a similar privilege for large shareholders in a particular corporation. The rationale for conferring this privilege on shareholder associations rests on their representative capacity. With the extreme dispersion of shareownership, the latent shareholder voice in a particular sector of the market can find expression only by allowing individual shareholders to follow the lead of associations representing the interests of that sector. The issue of giving large shareholders in a particular corporation access to the proxy machinery rests on entirely different considerations, beyond the scope of this article.[115]

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115. The idea of giving large shareholders access to proxy machinery has its advocates. *See, e.g.*, MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 117-21 (1976); LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 209-11 (1988); George W. Dent, Jr., *Toward Unifying*

3. *The Potential of Electronic Communication*

New electronic technology lends a new degree of feasibility to any complex institutional undertaking, including a system of representative shareholder associations.

The threshold problem of obtaining shareholder lists, which has traditionally burdened proxy contests, can yield to new technologies that give shareholder associations quicker access to corporate shareholder records and better data on the holdings of their members and supporters.[116] The growing use of the Internet in the securities industries also offers shareholder associations new ways of enlisting the support of individual shareholders.[117] In some instances, insurgent shareholders have already succeeded in making effective use of websites in proxy contests, despite the restrictions of proxy rules.[118] With regulatory barriers removed, shareholder coalitions could craft new systems for communication with their constituencies, including web sites as well as such devices as newsgroups, bulletin boards, and online discussion groups.[119] Among cohesive groups of a limited size, e-mail is an incomparably effective method of communication. It is widely used today to distribute annual reports and proxy statements to employee shareholders,[120] and offers a potentially powerful tool for an organizational network, such as the labor movement, to coordinate corporate governance strategies.

Ownership and Control in the Public Corporation, 1989 WIS. L. REV. 881, 907-08.

116. For Delaware law on inspection and copying of shareholder lists, *see* 2 DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 27.03 (1987). *See also* 2 and 3 MODEL BUSINESS CORPORATION ACT ANNOTATED §§ 7.20, 16.02 (3d ed. 1993 supp.).

117. Most Fortune 150 companies maintain investor relations websites. *See* HOWARD M. FRIEDMAN, SECURITIES REGULATION IN CYBERSPACE, ch. 10 (2d ed. 1998); Steven E. Bockner & Anita S. Press, *Corporate Disclosure Practices in the Electronic Age: The Website—Opportunities and Pitfalls*, WALLSTREETLAWYER.COM, April 1998, at 1. The SEC has approved electronic distribution of annual reports and proxy statements under circumstances that provide notice equivalent to paper delivery. *See* Use of Electronic Media for Delivery Purposes, SEC Release No. 33-7233, *available at* 1995 WL588462. The practice is now growing in acceptance. *See* Cary I. Klafter & Gregory L. Silva, *Moving Investor Relations Online*, WALLSTREETLAWYER.COM, August 1997, at 1.

118. *See* Gloria Santana, *More Corporations Using 'Net to Reach Investors*, NAT'L L.J., July 14, 1997, at B16 (CalPERS uses the Internet to solicit support for shareholder proposal relating to Archer-Daniels-Midland); Karen Donovan, *The Web—a Valid Proxy for Proxy-Fight Notices?*, NAT'L L.J., Jan. 26, 1996, at B1 (minority shareholder puts spin-off proposal on website of proxy solicitor); Nell Minow, *Shareholder Activists Flock to the Internet*, WALLSTREETLAWYER.COM, November 1997, at 15.

119. *See* FRIEDMAN, *supra* note 117, at 10-2, 11-3, 11-11, and 12-1.

120. *See id.* at 11-6.

F. *Outreach to Indirect Shareowners*

1. *Procedural Mechanics*

The privilege of placing director nominees on the management proxy card would allow an association of institutional shareholders to amplify its influence by cultivating a constituency of individual shareholders, but it would offer only partial enfranchisement to the broad demographic base of shareholders, who are likely to participate in stock ownership through self-directed retirement plans and defined contribution plans.[121] A successful system of representative shareholder associations, however, could also enfranchise indirect shareowners by a simple procedural innovation—giving indirect shareowners the power to instruct fund managers to vote for a qualifying shareholder association. Imagine a corporate sector with three major clearinghouses engaged in screening and nominating directors, each officially recognized by the SEC and qualified to place nominations on management proxy cards. The participant in a self-directed retirement plan could take advantage of the existence of these shareholder associations by instructing his fund manager to vote his holdings in the next year for candidates sponsored by a particular clearinghouse. The power of giving such advance voting instructions could be extended to participants of defined contribution plans.[122]

The mechanics of such a system should not involve any important obstacles. Fiduciaries of self-directed retirement plans and defined contribution plans could mail an instruction card with the annual report including a self-addressed envelope. Although individual accounts might be small, they would form part of a common fund and would precisely mirror the holdings in that fund. Thus, if 10% of plan participants were to instruct the fund manager to vote for a candidate of a particular clearinghouse, the manager could vote 10% of its domestic stock holdings for such candidates when they appear on the proxies of particular companies.

121. NEW YORK STOCK EXCH., *supra* note 22, at 15, 19.

122. In addition, the right to give such advance instructions could be extended to beneficiaries of bank-administered personal trusts, presumably with the trustor's authorization.

2. *Fiduciary Issues*

Critics might object, however, that such voting instructions would impinge on the fiduciary duties of the fund manager. The Department of Labor has ruled that the fiduciary duties of investment managers of employee benefit plans include the voting of proxies for corporate stock, and it makes no distinction for index funds managed according to a formula to match market performance.[123] Nevertheless, participants in self-directed retirement plans and defined contribution plans possess enough indicia of ownership over their stock holdings to justify a right to direct voting. They bear the risk of the success or failure of the investments and commonly select their particular fund from a menu of options. It is consistent with the participants' assumption of risk in the economic fortunes of the investment to give them control over voting of their stocks.

In a defined-contribution plan, beneficiary-directed voting would involve at most a very minor adjustment of the fund manager's fiduciary responsibility. Unlike the trustee of a defined benefit plan, the manager is not responsible for satisfying a particular financial commitment but only for delivering the product that the participant chooses, i.e., a mix of stock with the desired risk and potential for growth and income. Moreover, to the extent that the manager relies on indexing, the manager's fiduciary responsibilities become very limited. The manager of an indexed fund is responsible only for buying and selling stock according to an accepted formula to assure a representative portfolio. The Department of Labor's position that indexing is irrelevant to fiduciary responsibility rests on a theoretical level of reasoning removed from the realities of fund administration.[124]

It is true that a plan participant might favor candidates of a particular clearinghouse opposed by most other shareowners. A labor-sponsored candidate, for example, might argue for social policies that other investors might regard as detrimental to corporate productivity. However, the relevant issue pertains to the functioning of the system as a whole. The existence of diverse approaches to corporate performance could serve as a stimulus for more active institutional monitoring throughout the corporate sector. The presence of the

123. *See* Interpretive Bulletin 94-2, 59 Fed. Reg. 38,860, 38,862 n.6 (July 29, 1994).
124. *See id.* at 38,862-38,863.

dissenting view of a labor-sponsored candidate might lead to a heightened quality of overall monitoring that would in fact benefit shareholders of every persuasion.

It is premature to propose a system to give expression to the voice of indirect shareowners. An effective system of representative associations of institutional shareholders, with access to proxy machinery, must first be created. My purpose in pursuing this scenario is to show that such a system would have the capability of being extended to the small indirect shareholder at the broad demographic base of the market.

3. *Realistic Prospects*

Descending from these speculative heights to the realities of the securities industry, it is in fact impossible to assess the prospects, or precise form, of an effective system of representative associations of institutional shareholders. At some point, the influence of rational apathy could be overcome by removing obstacles to concerted action and sanctioning organizational techniques to form shareholder coalitions. But it would be unrealistic to predict a particular scenario. The operation of a system of accountability, based on the interests of shareholder constituencies, would ultimately depend on the strength of the investors' perceptions of their interests and their willingness to act in pursuit of these interests.[125] The goal of shareholder democracy must be to open possibilities for the creation of a self-regulating system of accountability, not to impose a precise model.

G. *Further Legal Impediments to Shareholder Democracy*

For a system of representative shareholder associations to have a

125. There are a number of organizations in the securities industry that would be in a position to take advantage of new opportunities to engage in corporate governance initiatives and might be expected to be active in devising new forms of institutional cooperation. Among trade organizations, the Council of Institutional Investors demonstrates the capacity of Taft-Hartley pension funds and public pension funds to act together. The Social Investment Forum represents the potential activist sector of socially responsible funds, and the Investment Company Institute serves the mainstream interests of the mutual fund industry. Among consulting services in the field of corporate governance, the Investor Research Responsibility Center and Institutional Shareholder Services have a considerable clientele of institutional investors. In the United Kingdom, the British Institute for the Promotion of Non-Executive Directors has long assisted businesses in the search for qualified outside directors. *See* Michael Beckett, *City: Search Is on for the Non-executives*, DAILY TELEGRAPH (London), Aug. 23, 1998, at 29.

fair chance of success, it would be necessary to go well beyond the matters discussed above. This article's analysis has centered on certain central problems of concerted shareholder action, but a system of shareholder associations would flounder unless many other matters were intelligently addressed and resolved.

1. *Nominating Procedures*

The attentive reader may have noted that the idea of giving shareholder associations access to proxy machinery faces a procedural impossibility. The boards of public corporations decide upon nominations for directors in an informal and unregulated manner. Although most corporations have a nominating committee of some kind,[126] shareholder associations would not have a right of access to its deliberations, but would possess only the foredoomed option of making nominations at the annual meeting itself. In addition, shareholder associations would confront obstacles in voting their proxies. State statutes require shareholders to give advance notice of their intent to exercise cumulative voting rights so that other shareholders may adopt counter strategies.[127] An association, seeking to engage a broad segment of the corporate sector, would face a myriad of moving targets with separate scheduling and notice requirements.

Without attempting to sketch solutions to these problems, it should be noted that an effective system of representational voting would require establishment of a nomination committee, guarantees of its independence, formalized rules to allow shareholder associations to place nominations on management proxies, standard notice and scheduling procedures, and designated representatives to vote valid

126. A 1998 survey found that, among corporations with a market capitalization of $10 billion or more, 93% had a nominating committee; and among corporations with a market capitalization of $250-500 million, 53% had a nomination committee. *See* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1279 n.70 (1999). Many of these committees have been formed in the past decade. *See* Millstein & MacAvoy, *supra* note 52, at 1286 n.15. But in testimony before a House committee, Dale Hansen, CalPERS fund manager, maintained, "Nominating committees all too often are a sham, pure and simple." ROBERT A.G. MONKS & NELL MINOW, WATCHING THE WATCHERS: CORPORATE GOVERNANCE FOR THE 21ST CENTURY 182 (1996).

127. Otherwise, a minority shareholder could gain control of the board by conducting a kind of ambush. Consider a corporation with 1,000 shares and a ten-member board and two shareholders, one with 600 shares and the other with 400. If the minority shareholder casts all his votes for six candidates and the majority shareholder distributes his votes evenly among all ten candidates, the minority shareholder will gain control of the board.

proxies.

2. *Board Independence*

Guarantees of board independence are also needed. A variety of state laws provide management with an array of entrenchment devices to thwart a system of shareholder accountability. The most obvious means of management domination is the well-established practice of placing executives and other insiders on the board of directors and on key board committees.[128] Management may also deprive directors of the means of conducting independent monitoring by withholding adequate compensation, information, and access to support staff. While shareholder democracy may ultimately offer the promise of a self-regulating system, some regulatory push would still be required to remove obstacles presented by current practices.[129]

The effective operation of cumulative voting requires other safeguards. Under the common practice of classifying the board and staggering elections over a period of years,[130] a board of nine members could be divided into three classes with three year terms that expire on successive years. Since only three vacancies would be filled in any one year, a shareholder group would need to get one-third of the votes to place a single director on the board. A similar result can be achieved by the simple device of reducing the size of the board.[131] The solution,

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128. Though some surveys show that as many as 74% of directors are outsiders, it is more difficult to determine what percentage actually qualify as being independent in a meaningful way. Traditionally, most directors are chief executives of other companies, who have the same ideological bias as management. *See* Robert W. Hamilton, *Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits*, 25 J. OF CORP. L. 349, 361 (2000); Gilson & Kraakman, *supra* note 85, at 875 n.40.

129. The American Law Institute adopts the modest rule that a majority of the board should be free of "any significant relation with the corporation's senior executive" and defines the term "significant relation" in terms of five categories. AMERICAN LAW INSTITUTE, *supra* note 112, at §§ 3A.01, 1.34. The Council of Institutional Investors recommends a majority of two thirds of independent directors and defines independence in somewhat more rigorous terms. *See* Council of Institutional Investors, *Corporate Governance Policies*, *at* http://www.cii.org/corp_gov_init.asp. Ralph Nader advocates a "purely 'outside' board" with no member who is an executive, attorney, representative or agent of the corporation. *See* RALPH NADER ET AL., TAMING THE GIANT CORPORATION 126 (1976).

130. Although classified boards have been the target of much criticism and shareholder activism, a majority of U.S. corporations still have classified boards, in part because staggering elections are seen to have value as a takeover defense. *See* Richard H. Koppes et al., *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 BUS. LAW. 1023, 1025 (1999).

131. *See* 2 F. HODGE O'NEAL AND ROBERT THOMPSON, O'NEAL'S OPPRESSION OF

however, should also avoid an unduly large board . Beyond a certain size, the board becomes too unwieldy to function as a decision making body, thereby diminishing the prospects of independent monitoring by professional directors.[132] For the large publicly owned corporation, the balance of considerations probably favors nine or eleven members.

3. *Other Management Entrenchment Devices*

Many other practices contribute to management domination of corporate governance of publicly held corporations and would cumulatively frustrate a system of shareholder accountability. A list of necessary reforms might include the following:[133]

(a) A confidential ballot, seen only by an independent proxy tabulator. This practice would avoid direct or indirect pressure on those shareholders who are dependent on the favor of management, including employee shareholders, investment advisors needing access to corporate information, and investors that have actual or potential business dealings with the corporation, such as banks, insurance companies, and pension fund managers.[134]

(b) The principle of one vote per share of common stock. This principle is an essential predicate of shareholder democracy except in those situations where a shareholder, or class of shareholders occupies a stakeholder position in the corporation that is distinct from other shareholders. Current exchange rules pay insufficient respect to this principle.[135]

(c) Avoid conflicts of interest with respect to voting. The fiduciary responsibilities of corporate pension fund managers may often conflict with the pro-manager bias of their corporate sponsors.[136] Astonishingly, a Department of Labor regulation promulgated in 1994

MINORITY SHAREHOLDERS § 6.03 (2d ed 1999).

132. *See* Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 65 (1992) ("When a board has more than ten members, it becomes more difficult for them all to express their ideas and opinions in the limited time available. This contributes to the expectation . . . that directors are not supposed to voice their opinions freely and frequently.").

133. Reforms of publicly held corporations should, of course, be accompanied by parallel reforms of closely held corporations, which account for roughly 20% of corporate equities. *See* Eisenberg, *supra* note 126, at 1286. However, this subject is outside the scope of this article.

134. *See* LOSS & SELIGMAN, *supra* note 75, at 1967 n.133.

135. *See id.* at 1831-49.

136. *See* Coffee, Jr., *supra* note 70, at 1321-22; Rock, *supra* note 68, at 469-72; Black, *supra* note 75, at 596-98.

allows corporate management to require fund managers to vote proxies in accordance with statements of the company's investment policies and to monitor the managers' actual voting of the proxies.[137]

(d) The power of stockbrokers to vote shares held in 'street name,'[138] though already circumscribed by exchange rules, should be further curtailed in the interests of shareholder accountability.[139]

(e) The proper tabulation of ballots often involves judgment calls that should be made by independent tabulators appointed by an audit committee that is itself independent of management.[140]

(f) The establishment of a system of shareholder accountability would call for a return to traditional rules that scrutinize business dealings in corporate assets by insiders and protect shareholders from being forced out of the corporation without their consent.[141] In recent decades, the ultimate form of management entrenchment, a buyout of corporate stock, has gained acceptance on the rationale that it may resolve problems created by the separation of ownership and control.[142]

H. *The Necessity of Federal Standards*

This rapid review of needed reforms serves to highlight a point noted earlier in the discussion of cumulative voting and state anti-takeover legislation. State corporation laws raise enough barriers to concerted shareholder action to assure that shareholder passivity will continue substantially unchanged. This article's inquiry into the possibilities of a self-regulating system of shareholder accountability leads inevitably towards federal standards of corporate governance, which would preempt the competing standards of state corporation laws.

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137. *See* ERISA Interpretive Bulletin 94-2, 29 C.F.R. § 2509.94-2 (2001).

138. Probably 75% of investors keep securities registered in 'street name,' that is, in the name of their brokers. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 398 (1995).

139. *See* J. Robert Brown, Jr., *The Shareholder Communication Rules and the Securities and Exchange Commission: An Exercise in Regulatory Utility or Futility?*, 13 J. CORP. L. 683, 704-07 (1988); LOSS & SELIGMAN, *supra* note 75, at 2109-2120.4.

140. *See, e.g.*, Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 663-70 (Del. Ch. 1988).

141. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 306-07 (1939); Voeller v. Neilston Warehouse Co., 311 U.S. 531, 536 (1941).

142. *See* David B. Simpson, *The Management Buyout: An Idea Whose Time May Have Passed*, 17 SETON HALL LEGIS. J. 137, 146 (1993).

The choice-of-law rule applying the law of the state of incorporation to internal corporate affairs paradoxically renders the states impotent to adopt meaningful corporate reform.[143] Management may evade undesired state laws by the simple expedient of arranging a merger into a corporation formed in a more hospitable state. In the first decade of the twentieth century, it was New Jersey, not Delaware, that enticed major corporations to incorporate under its law.[144] While serving as governor, Woodrow Wilson believed that New Jersey was pandering to corporate management and persuaded the legislature to adopt what he viewed as a more principled corporations code. The result, of course, was to cause New Jersey corporations to migrate south to Delaware.[145] The same result would follow today from state reforms attempting to curb management autonomy. State legislatures are effectively confined to making minor adjustments into corporate law or adopting measures favored by corporate management, such as anti-takeover legislation.[146] In the field of corporate law, an ideological commitment to federalism is synonymous with defense of the status quo.

The Supreme Court has expressed reluctance to override "established state policies of corporate regulation" by an expansive interpretation of federal securities law,[147] but it has never suggested that there are significant constitutional limitations on federal power to regulate corporate governance under the interstate Commerce Clause.[148] The controversies over the application of sections 14 and 19 of the Securities Exchange Act of 1934[149] to corporate governance issues and the presumption of state law by the Williams Act[150] have

143. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS, §§ 302-10 (1971).

144. *See* NADER ET AL., *supra* note 129, at 44-47.

145. *See id.* at 49-54, 91.

146. For an analysis of corporate charter competition and a proposal for a federally mandated shareholder right to initiate charter amendments, *see* Bratton & McCahery, *supra* note 70, at 1926-47.

147. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977).

148. *See* U.S. CONST. art. I, § 8 cl. 3 ("To regulate commerce . . . among the several States, . . .). *See also* U.S. CONST. art. I, § 8 cl. 18 ("To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers . . . .").

149. *See, e.g.,* The Bus. Roundtable v. SEC, 905 F.2d 406, 411 (D.C. Cir. 1990); Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986); Homer Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 BUS. LAWYER 173, 173-74 (1981).

150. *See, e.g.,* Edgar v. MITE Corp., 457 U.S. 624, 631 (1981); CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 86 (1987). The Williams Act, enacted in 1968, regulates cash tender offers in corporate acquisitions by imposing disclosure requirements and protecting

turned solely on issues of legislative intent.

It is true that *United States v. Lopez,*[151] by invalidating the Gun-Free School Zones Act of 1990, appears to signal a new era of active judicial review of the limits of the interstate Commerce Clause, but the decision left intact the lines of authority recognizing congressional power to regulate the use of the channels of interstate commerce[152] and to regulate activities having a substantial relation to interstate commerce.[153] Congress might reasonably find that corporate governance affects both the economic efficiency and the social impact of enterprises engaged in interstate commerce, as well as the quality of corporate disclosures in interstate trading of stock. Such findings would place federal standards of corporate governance well within the established parameters of the interstate Commerce Clause.[154]

Proposals for federal standards of corporate governance have long been associated with schemes for federal chartering or licensing of corporations whereby a corporation's right to engage in interstate commerce would be conditioned on complying with certain standards of good corporate governance.[155] The idea has a beguiling simplicity that has caught the imagination of populist reformers since the Progressive Era,[156] but it suffers from two defects. First, licensing is a draconian remedy that would be practically impossible to enforce. A corporation is either licensed or it is not. If the license of a large corporation were revoked, it would have drastic consequences on employees, creditors, suppliers, and customers. Secondly, licensing is unnecessary as an enforcement tool. Most avenues for sharing corporate power, which are explored in this article, can be pursued by amendment of existing legislation, such as the Securities and Exchange Act and the Employee Retirement Income Security Act (ERISA). There is no reason to complicate the process of reform by inventing

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shareholders' rights to withdraw stock tenders and to receive a non-discriminatory sales price. *See* 15 U.S.C. § 78n (d) and (e) (2000).

151. 514 U.S. 549 (1995).

152. *See, e.g.*, United States v. Darby, 312 U.S. 100, 118 (1941) (upholding the Fair Labor Standards Act).

153. *See, e.g.*, NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1, 37 (1936) (upholding the power of the National Labor Relations Board to enjoin unfair labor practices affecting commerce).

154. *See Lopez*, 514 U.S. at 558-59.

155. *See* Allen D. Boyer, *Federalism and Corporation Law: Drawing the Line in State Takeover Regulation*, 47 OHIO ST. L.J. 1038, 1048-54 (1986); Donald E. Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71 (1972).

156. *See* NADER ET AL., *supra* note 129, at 65-71.

new enforcement schemes. In cases where new enforcement tools may be needed, more traditional enforcement devices, perhaps involving private enforcement, are likely to be far more effective than corporate licensing in achieving legislative objectives.

In the end, the enfranchisement of shareholder constituencies calls for revision of much of the fabric of corporate and securities law. The process of reform would not involve imposition of a new model of corporate governance, but rather the removal of anomalies that prevent the present model from functioning. Each step of the process would yield some benefits, and even if only partial reform were achieved, the gains would likely endure. Shareholders who find the means of expressing their interests within a self-regulating system of governance would likely not return to the old ways. One may imagine instead that shareholders would recollect with bemusement the primitive era when shareholder meetings lasted five minutes and management proxies offered no choices.

III. SHAREHOLDER DEMOCRACY AND AN EMPLOYEE VOICE

A. *General Policy Considerations*

It should not be surprising that a system of corporate governance, assuring the accountability of management to the shareholders, would provide new vehicles for expression of the employee voice in the publicly owned corporation. Democratic norms and procedures can be put to a variety of uses. But what is the use of introducing the employee voice, distinct from that of shareholders, into a self-regulating system of shareholder accountability? There is, of course, a certain policy justification based on the immense importance of working conditions to the welfare of society. When jobs lead to physical or emotional trauma or fail to provide the support for families or a safety net for illness, disability, or retirement, the public bears the consequences. Karl Klare notes that "many of the most significant aspects of the employment relation are determined neither by market forces, nor by law, but by planning internal to the firm."[157] To the extent that corporations may be induced to take employee interests into account in such planning, the public would benefit.

But these policy considerations do not explain how the employee

157. Karl E. Klare, *Workplace Democracy and Market Reconstruction: An Agenda for Legal Reform*, 38 CATH. U. L. REV. 1, 15 (1988).

voice would serve the *interests* of shareholders in a self-regulating system of shareholder accountability. An answer can, however, be found in the shareholder's interest in establishing institutional arrangements that support trust between management and the work force. Trust is more than an ingredient of psychological well-being and an element of social cohesion;[158] it also plays a part in calculations of self-interest whenever people with common and conflicting interests are joined in the same enterprise. This key role of trust in the industrial enterprise finds support both in game theory and current management strategies for higher productivity.

Game theorists are likely to perceive elements of the prisoner's dilemma in activities where conflicting parties chronically achieve suboptimum results.[159] Labor economist Harvey Leibenstein pursues this theme in analyzing the relations between management and the workforce.[160] In his view, productivity is significantly affected by the quality of performance that workers have discretion to offer or withhold.[161] The optimum outcome occurs when employees provide their best effort in exchange for the best compensation that management can afford. However, this mutually beneficial outcome occurs only when both parties trust that the other will reciprocate in kind.[162] In the absence of trust, both management and employees may calculate that they can achieve the highest individual return by withholding cooperation and exploiting the trusting behavior of the other. If employees expect management to offer better wages and working conditions, they can maximize their utility by accepting these benefits and offering low effort. In this way, they also protect

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158. For a discussion of the elements of trust, *see* Lawrence E. Mitchell, *Trust. Contract. Process.*, *in* PROGRESSIVE CORPORATE LAW, *supra* note 6, at 185.

159. Although it can take many forms, the following example serves as an illustration of the prisoner's dilemma. Two confederates in crime are being interrogated in separate locations. They learn that if both deny guilt they will each receive a one-year sentence—the optimum outcome for both. If both confess, they will each receive an eight-year sentence—a distinctly suboptimum outcome. If one confesses and the other denies guilt, the one who confesses will be released and the other will receive a ten-year sentence. The prisoners do not trust each other. They calculate that the option of confession may bring a favorable payoff of release or an unfavorable payoff of an eight-year sentence. The option of denial may bring a favorable payoff of a one-year sentence or an unfavorable payoff of a ten-year sentence. Therefore, they both decide to confess resulting in a collective sentence of sixteen years, as contrasted to a collective sentence of two years that would have resulted from trusting collaboration by mutual denial of guilt. *See* ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 20 (3d ed. 2001).

160. *See* HARVEY LEIBENSTEIN, INSIDE THE FIRM: THE INEFFICIENCIES OF HIERARCHY 43-59 (1987).

161. *See id.* at 99.

162. *See id.* at 53.

themselves against the possibility that management will renege on its plans. For its part, management comes out ahead by inducing employees to offer their best effort while at the same time withholding benefits. This choice also removes the risk that employees will respond to improved benefits with low effort. Thus, the pursuit of self-interest leads to the worst outcome—low effort and low compensation.[163] Leibenstein reassures us that the game is rarely played in this pure form. Management and employees develop implicit conventions regarding the appropriate amount of work and compensation. In his estimation, however, these conventions usually lead to an outcome that falls well below the optimal solution for both parties.[164]

Under pressure from foreign competition, American corporate management has seen opportunities to reduce supervisory costs and tap employees' knowledge of production methods by adopting a more cooperative organization of front-line workers, such as that found in Japan and Europe. In the 1980s and 1990s, there was a rapid spread of employee-involvement programs that brought workers together with supervisors and engineers to discuss operational problems and to design improved work methods.[165] In 1994, the United States General Accounting Office estimated that 80% of Fortune 500 companies had some kind of employee-involvement program.[166] But this cooperative model of management presupposes a requisite level of trust between management and workers, a quality often difficult to engender in an era of corporate downsizing. Indeed, workers often have reason to treat employee-involvement programs with cynicism, where the programs reflect a concealed agenda of cultivating employee acceptance of work methods that are more stressful, fast-paced, repetitive, and minutely supervised.[167]

The considerations of game theory and employee-involvement programs are not far removed from perennial management concerns

163. *See id.* at 48-58.

164. *See id.* at 52, 77-97.

165. *See* Shannon Browne, Note, *Labor-Management Teams: A Panacea for American Businesses or the Rebirth of a Laborer's Nightmare?*, 58 OHIO ST. L.J. 241, 242 (1997).

166. *See id. See also* Samuel Estreicher, *Employee Involvement and the "Company Union" Prohibition: the Case for Partial Repeal of Section 8(a)(2) of the NLRA*, 69 N.Y.U. L. REV. 125, 127, 134-39 (1994).

167. *See* Michael C. Harper, *The Continuing Relevance of Section 8(a)(2) to the Contemporary Workplace*, 96 MICH. L. REV. 2322, 2357-69 (1998).

about the consequences of poor employee morale—absenteeism, excessive workforce turnover, theft, slowdowns, and shirking of assigned duties. Employers have traditionally sought to enforce minimum standards not only by monitoring and disciplining employees, but by encouraging attitudes of loyalty and personal identification with the firm—attitudes that necessarily involve an element of trust. In the field of motivational personnel management, conventional wisdom is frequently congruent with game theory and new team-management ideas.

Given the importance of a corporation's human assets, the interests of shareholders will be served by corporate practices that boost employee morale and validate management-employee trust.[168] After all, worker salaries and benefits usually constitute the bulk of production costs. An employee voice in corporate governance offers a direct and honest approach to validating employee trust. It is indeed difficult to imagine a more reliable means of assuring employees that their interests will be taken into account in strategic planning and shop-floor issues.[169] The European experience with co-determination, most notably the German *Aktiengesellshaften*, confirms the business realism of the practice.[170]

Shareholder democracy, as noted earlier, yields new procedural vehicles for introducing an employee voice in corporate governance. My purpose here is to explore these specific possibilities without entering further into the broad subject of industrial democracy. The possibilities come under two headings. First, the practice of cumulative voting and the removal of barriers to concerted shareholder action could amplify the importance of employee stock ownership as a

168. In a masterful analysis of employee stock ownership, Alan Hyde concludes that "worker ownership is likely to be highly positive for productivity where local histories of mistrust prevent workers and managers from concluding cooperative arrangements that would in fact improve firm productivity." Alan Hyde, *In Defense of Employee Ownership*, 67 CHI.-KENT L. REV. 159, 163-64 (1991).

169. *See* Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899 (1993) (providing an excellent guide to relevant socio-economic literature, which advocates a form of co-determination based on recognition of the board's fiduciary duty to employees); David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1032-37 (2000) (providing insightful comments on the role of the board in breaking the prisoner's dilemma impasse); Karl E. Klare, *The Labor-Management Cooperation Debate: A Workplace Democracy Perspective*, 23 HARV. C.R.-C.L. L. REV. 39 (1988) (arguing that the goal of worker-management cooperation invites consideration of genuine power sharing).

170. *See* discussion *supra* Part I.

vehicle for an employee voice in corporate governance. Second, the formalization of the nominating process for boards of directors—a necessary detail for an effective system of representative shareholder associations—offers a radically new possibility for directly introducing the employee voice in corporate governance, free of the traditional problems of transaction costs, conflict of interest, and inconsistency with collective bargaining.

B. *Employee Stock Ownership*

Employee stock ownership plans, which represent a significant shareholder bloc throughout a broad segment of public companies, could potentially play an important role in corporate governance under a regime of shareholder democracy, but this possibility is restricted by statutory impediments and the use of the stock ownership plans as an employee benefit linked to retirement income security. I will discuss only 401(k) plans and employee stock ownership plans (ESOPS) since other plans have a minor importance for corporate governance.[171]

1. *401(k) Plans*

The quantity of employee stock ownership in 401(k) plans represents a remarkable phenomenon that was seldom noticed before the Enron bankruptcy. The National Center for Employee Ownership reports that, at the end of 2000, total holdings of employer stock in 401(k) plans had a market value of $340 billion and amounted to approximately 19% of the assets of the plans.[172] The holdings appear

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171. According to a 1997 survey reported by the National Center for Employee Ownership, 30% of the 350 largest U.S. corporations offer stock option plans to 50% or more of their employees, but most employees exercise their options in a same-day buy-and-sell transaction that gives rise to no actual stock ownership. Ed Carberry, *An Overview of Stock Options*, *in* THE STOCK OPTIONS BOOK 1, 9 (Scott S. Rodrick ed., 1998). Employee stock purchase plans, which allow employees to buy company stock at a discount and at prices pegged to specific dates, are more likely to result in some continuing ownership. The National Center for Employee Ownership estimates that over 15 million employees participate in employee stock purchase plans, and reports that nearly all the plans are in publicly traded corporations. But a recent study found that lower-level employees on the average hold the stock for only about a year. Moreover, it seems likely that individual commitments to these plans are small since employees purchase the stock by payroll deductions from their own earnings. There is, however, no statistical data available on this point. *See* Ryan Weeden, Ed Carberry and Scott Rodrick, *Introduction*, *in* EMPLOYEE STOCK PURCHASE PLANS 1-9 (Ed Carberry & Scott Rodrick eds., 2001); Ed Carberry & Ryan Weeden, *Recent Research and Case Studies*, *in* EMPLOYEE STOCK PURCHASE PLANS 151-61 (Ed Carberry & Scott Rodrick eds., 2001).

172. *See* Corey Rosen, *Employer Stock is 19% of 401(k) Plan Assets*, The National

to be concentrated in about 2,000 publicly held companies where they constitute on average a 7% shareholder block.[173]

The various kinds of plans qualifying under Internal Revenue Code section 401(k) have a common feature: they are intended to provide retirement benefits. The large block of employer stock represents a departure from the principle of diversification that otherwise governs retirement benefits. It is, in fact, allowed through a kind of statutory back door. Section 404(a)(1)(C) of the Employee Retirement Income Security Act requires fiduciaries to diversify "the investments of the plan so as to minimize the risk of large losses."[174] Applying this principle to employer stock, section 407(a)(2) provides that the plan may not acquire holdings of employer securities exceeding 10% of the assets of the plan."[175] But sections 407(b)(1) and (d)(3) generally allow plans to avoid this limitation by expressly authorizing investment in employer securities subject to certain restrictions.[176] Section 404(a)(1)(D) directs fiduciaries to discharge their duties in accordance with plan documents, including the document provisions authorizing investments in employer securities.[177]

About one third of 401(k) plans allow employees to choose company stock as one of several investment options, but much company stock in the plans comes directly from employer contributions.[178] For the employer, the use of company stock to fund a

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Center for Employee Ownership, *at* http://www.nceo.org/columns/cr101.html (last updated Dec. 13, 2001).

173. The only reliable statistical study, however, is now dated. *See* Susan Prolman & Douglas Kruse, *Employee Ownership Through 401(k) Plans: the NCEO-Rutgers University Study*, *in* SECTION 401(K) PLANS AND EMPLOYEE OWNERSHIP 9, 13 (Scott S. Rodrick ed., 1998). The study was conducted in 1995 and relied on 1992 filings of Department of Labor form 5500.

174. Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1104(a)(1)(c)(1999).

175. *Id.* at § 1104(a)(1)(C) (1999).

176. *See* ERISA § 407(a), (b), (d), 29 U.S.C. § 1107(a), (b)(1), (d)(3). Section 407(b)(2) further restricts the use of employer securities by requiring that an individual account plan qualifying under section 401(k) meet one of four tests: (1) the investment in employer securities is at the direction of the employee, (2) the asset value of all individual account plans maintained by the employer account does not exceed 10% of all the employer's pension plans, (3) the individual account plan qualifies as an ESOP, or (4) employee contributions required to be invested in employer securities in the plan do not exceed 1% of the employee's compensation. *See* 29 U.S.C. § 1107(b)(i)-(iv) (1999).

177. *See* ERISA § 404(a), 29 U.S.C. § 1104(a). *See generally* 1 QUALIFIED RETIREMENT PLANS §§ 3.33, 16.8 (Michael J. Canan and David Rhett Baker eds., 2002).

178. *See* David B. Graffagna, *Trends and Experience in 401(k) Plans*, *in* 401(K) PLANS AND EMPLOYEE OWNERSHIP 26-28, *supra* note 173.

401(k) plan has various possible attractions—for example, a cashless deduction or a means of cultivating employee loyalty to the company—but, as the Enron bankruptcy recently revealed, the investment of a large portion of retirement plan assets in this single, employer-chosen investment places at risk the employee's assurance of retirement income.

Such a disproportionate investment in company stock is most easily justified in plans that offer no more than a supplemental retirement benefit for employees who are otherwise adequately covered by diversified plans, but it might also gain a certain measure of justification if the plan served as a vehicle for an employee voice in corporate governance. The reality, however, is that the trustee of the plans usually votes the company stock.[179]

The trustee's power to vote company stock ordinarily lacks any strong fiduciary justification. Where the employee makes a discretionary choice of an investment in company stock, the trustee is shielded from liability and therefore does not have a normal fiduciary incentive to monitor the investment.[180] Again, where the employer contributes its own stock to the plan, a management-appointed trustee is likely to exercise a purely clerical role in administering the employer account that does not call for the exercise of voting rights.

If one accepts the premise that departures from the diversification principle demand a policy justification, it may be argued that 401(k) plans should always allow employee beneficiaries to direct the voting of company stock, thereby offering employees a voice in corporate governance to compensate for a questionable investment practice. Such an assignment of voting rights to employees would in fact be consistent with the fiduciary relationship between trustee and beneficiary, which places risk (and often discretionary choice) on the employee. A regulatory rule might reasonably require plans to give employees voting rights that conform to this fiduciary relationship, except in special circumstances.[181]

179. *See* Corey Rosen, *The 401(k) Plan as an Employee Ownership Vehicle*, *in* 401(K) PLANS AND EMPLOYEE OWNERSHIP, *supra* note 173, at 5.

180. *See* Employee Retirement Income Security Act § 404(c), 29 U.S.C. § 1104(c) (1999).

181. In some existing plans, a regulation conferring voting rights on employees might nullify an explicit reservation of voting rights in an employer's grant of stock to the plan, giving rise to constitutional objections. Such a nullification of a reservation of voting rights would enter into constitutionally suspect territory occupied by the Contract Clause, Takings Clause, and Due Process Clause. Since it would not involve a state-imposed impairment of

2. *ESOPs*

Leveraged employee stock ownership plans, known by the acronym ESOP, account for a somewhat lesser quantity of employee stock ownership in publicly held companies than 401(k) plans. However, they tend to represent larger ownership shares in individual companies—typically holding 5% to 15% of the company stock[182]—and potentially offer the most effective vehicle for employee stock ownership. ESOPs exist under a statutory scheme that sanctions what could be regarded as a form of pseudo-ownership without property rights,[183] but they have still been used to give employees a meaningful role in management.[184] Although no accurate current data is available, ESOP assets probably include over $200 billion in stock of publicly held corporations.[185]

ESOPs exist under statutory exceptions to diversification and self-dealing rules in employee benefit law.[186] The enabling legislation

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contract or a taking for public use, the precise issue would presumably be analyzed under the Due Process Clause. *See* Pension Benefit Guar. Corp. v. R. A. Gray & Co., 467 U.S. 717, 733 (1983). This possible constitutional barrier to regulation would never arise where the plan itself purchases the company stock.

182. *See* Corey Rosen, *An Introduction to ESOPs*, *in* SELLING TO AN ESOP 7, 13 (Scott S. Rodrick ed., 1999).

183. For critical view of the ESOP, *see* William R. Levin, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 YALE L.J. 148 (1985); Stanley R. Pietruska III, *ESOPs: Corporate Advantages Put Taxpayers at a Disadvantage*, 23 W. STATE U. L. REV. 53 (1995); Hunter C. Blum, Comment, *ESOP's Fables: Leveraged ESOPs and Their Effect on Managerial Slack, Employee Risk and Motivation in the Public Corporation*, 31 U. RICH. L. REV. 1539 (1997); Ezra S. Field, Note, *Money for Nothing and Leverage for Free: The Politics and History of the Leveraged ESOP Tax Subsidy*, 97 COLUM. L. REV. 740 (1997).

184. *See* Hyde, *supra* note 168, at 168-69. For the account of an employee struggle to establish an ESOP to thwart a hostile takeover, see MICHAEL E. MURPHY, THE AIRLINE THAT PRICE ALMOST BOUGHT: THE STRUGGLE TO TAKE OVER CONTINENTAL AIRLINES (1986).

185. The only comprehensive study of employee ownership in public companies, based on 1990 data, showed an impressive level of employee ownership. For example, 12.5% of the private-sector workforce then owned stock in companies in which the employee ownership exceeded 4% of total stock ownership. *See* JOSEPH R. BLASI & DOUGLAS L. KRUSE, THE NEW OWNERS, THE MASS EMERGENCE OF EMPLOYEE OWNERSHIP IN PUBLIC COMPANIES AND WHAT IT MEANS TO AMERICAN BUSINESS 13 (1991). During the 1990s, ESOP holdings shrank somewhat in public companies. Nevertheless, the National Center for Employee Ownership reports that, in February 2000, approximately two-thirds of a total of 8.5 million ESOP participants were employees in public companies, and the total assets of ESOPs and stock bonus plans (including stock in both public and private corporations and other forms of investment) amounted to $400 billion. *See* National Center for Employee Ownership, *A Statistical Profile of Employee Ownership*, *at* http://www.nceo.org/library/eo_stat.html (updated Apr. 2002); Rosen, *supra* note 182, at 13.

186. *See* Employee Retirement Income Security Act §§ 406(a), (b), 29 U.S.C.

allows employer companies to make a loan, or guarantee a bank loan, to an ESOP trust, which is used to purchase stock in the company. The trust holds the stock for the benefit of employees and allocates the stock to individual accounts as principal on the loan until it is paid off. Upon an employee's retirement or severance of employment, the trust distributes the employee's beneficial interest in the trust in either stock or cash.[187]

Since the employer appoints the ESOP trustee, this statutory scheme allows the employer to give employees ownership rights in the company without ceding any effective control over day-to-day management. It is true that IRS tax qualification rules require ESOPs in publicly owned companies to give employees the right to direct the trustee how to vote their allocated accounts, and that plan documents commonly instruct the trustee to vote unallocated shares in the same proportion as the votes cast by employees.[188] But these concessions to shareholder democracy seldom lead to an employee voice in selection of the board of directors. Employees lack any access to the nominating process and do not possess the same rights of financial disclosure enjoyed by shareholders.[189] Their voting ordinarily consists of the meaningless act of confirming an unopposed management slate.[190]

The use of ESOPs for purposes of corporate governance presents other problems inherent in relying on a pension plan to achieve objectives unrelated to retirement income security. The foremost problem is that of risk allocation. As Alan Hyde observes, most corporate employees "already are tied to their employer by implicit long-term employment contracts that leave them with a great deal of firm-specific and location-specific investment."[191] Their access to health care may also depend on employer-sponsored plans. Under these circumstances, it may not be in the employee's interest to assume

§§ 1106(a), (b) (providing the rule barring self-dealing between employer and plans); Employee Retirement Income Security Act § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (diversification).

187. *See* 1 QUALIFIED RETIREMENT PLANS, *supra* note 177, at §§ 3.35, 3.36(C).

188. *See* I.R.C. §§ 409(e)(2), 4975(e)(7) (West 2001); I.R.C. §§ 4975(e)(7), 409(e)(2) (West 2001); 1 QUALIFIED RETIREMENT PLANS, *supra* note 177, at § 3.36(B).

189. *See* James G. Steiker, *ESOP Participants and Shareholder Rights*, 6 J. OWNERSHIP EMPLOYEE LAW AND FIN., No. 4, 43, 49-51 (1994).

190. *See* Department of Labor/Pension & Welfare Benefits Administration Letter (Sept 28, 1995), *in* RIA PENSION & PROFIT SHARING § 97,500 (2d ed. 2001).

191. Hyde, *supra* note 168, at 203.

more risk in the employer's financial future by linking a plan providing retirement income security, such as the ESOP, to the vicissitudes of company stock valuation. Analyzed strictly in terms of risk, such an additional stake in the employer's future will be prudent only if it yields a compensating job security.[192]

Other problems relate to cost and the distribution of ownership shares among employees. The burden of funding stock purchases may tend to crowd out spending for other diversified retirement plans as well as other forms of employee benefits.[193] In a small but disturbing fraction of cases, the creation of ESOPs has in fact been associated with termination of other retirement plans.[194] Moreover, the allocations to individual accounts are governed by employee benefit rules that may sometimes generate invidious disparities in employee ownership. At worst, the plans may foment divisions in the work force by creating opposing interests among different employee job categories, as well as between long-term and short-term employees.[195]

In his wise assessment of ESOPs, Alan Hyde concludes that, despite this problematic linking of ownership and employee benefits, ESOPs can sometimes serve the interests of both management and workers by building mutually beneficial relationships of trust. But he suggests that ESOPs often make most the sense if "layered on top of" other retirement and health security plans so as to better "decouple employee ownership from retirement and health security."[196]

The type of beneficial relationship of trust that Hyde envisions could be more easily achieved in a regime of shareholder democracy. By conferring on ESOP beneficiaries the right of cumulative voting and free association with other shareholders, it would be possible to reduce the size of ESOPs without loss of their influence in corporate governance. Smaller ESOPs, with more effective shareholder rights,

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192. The tax qualification rules have certain features to mitigate the element of risk. Most notably, as long-term employees fifty-five years and older approach retirement, they can direct the trustee to diversify, in annual increments, up to 50% of their accounts. *See* I.R.C. § 401(a)(28) (West 2001). But while it serves a prudent purpose, the diversification rule works directly contrary to the objective of corporate governance by reducing the voting rights of the senior employees who have the greatest stake in the company.

193. *See* Michael E. Murphy, *Finding the Cheese: Through the Maze of Employee Stock Ownership*, 56 GUILD PRAC. 169, 171, 177-78 (1999).

194. *See* Field, *supra* note 183, at 84; Rosen, *supra* note 179, at 14.

195. *See* William H. Simon, *The Prospects of Pension Fund Socialism*, 14 BERKELEY J. OF EMP. & LAB. L. 251, 259-64 (1993).

196. Hyde, *supra* note 168, at 208.

could provide an employee voice without seriously distorting a prudent employee benefit structure.

3. *Shareholder Associations and Employee Ownership*

In theory, the existence of minority blocs of employee shareholders could amplify the democratizing effect of shareholder accountability. Unencumbered by regulatory restrictions, shareholder associations of institutional investors could solicit the votes of employee shareholders for particular director candidates, using telephones, websites, and interactive electronic communication to contact potential supporters. For their part, employee shareholders could form organized shareholder associations that would themselves select director candidates or join in coalitions with other shareholder associations for that purpose. Directors elected by employee shareholders, or by coalitions including employee shareholders, would presumably be attentive to the interests of their employee constituents.

This scenario, however, presupposes further legislative reform. Both 401(k) plans and ESOPs function under legislative schemes that are poorly adapted for corporate governance. It would be necessary to recast extensively the statutory framework for these plans before they could offer employees a role in corporate governance commensurate with the employees' actual ownership interests in the corporation.

C. *The Nominating Process*

In the contemporary corporation, where the management slate for the board of directors goes unopposed, it is obvious that the process of nominating directors is a more important matter than the conduct of the election itself. Yet, while the voting for the unopposed management candidates is minutely regulated by statute, SEC regulations, and by-laws, the nominating process itself is conducted in an informal and unregulated manner within a closed circle of top executives. Although large publicly owned corporations are very likely to form nominating committees,[197] the committees unfortunately lack any guarantee of independence or democratic norm for action.

A system of representative shareholder associations, as noted

197. *See supra* text accompanying note 126.

earlier, could not operate effectively without formalizing the nominating process by requiring independent nominating committees, subject to certain defined duties and procedures. Such a formalization of the nominating process would offer a distinct opportunity of potentially immense importance. It could provide a forum for the expression of the employee voice in corporate governance, steering a wide berth from the reefs and shoals traditionally afflicting employee participation in management—namely, incompatibility with collective bargaining, lack of professionalism, transactional costs of collective decision making, and conflicts of interest.

An employee voice in the nominating process for the board of directors would not interfere, directly or indirectly, with the subjects of collective bargaining (i.e., wages and working conditions). Nor would it usurp the role of union representatives as exclusive intermediaries between management and the workforce with respect to all matters affecting collective bargaining or require an infrastructure that might be regarded as a management-dominated labor organization violating section 8(a)(2) of the National Labor Relations Act.[198] In fact, it might even help to create a corporate culture more congenial to union representation by conditioning management to consider employee interests in strategic and shop-floor planning.

Employee participation in the nominating process would avoid a criticism of direct employee membership on the board—that employees lack the specialized expertise to serve on the board and can therefore be out-maneuvered or ignored.[199] A more active nominating committee would most likely widen the field of prospective director candidates without necessarily decreasing professional qualifications. With the benefit of employee input, the nominating committee could look for candidates with the sophistication to factor employee interests into complex corporate strategies.

This avenue for expression of the employee voice would also steer wide of the potentially debilitating costs of collective decision making. According to Henry Hansmann, these costs are the critical factor in determining the prospects of worker ownership in business enterprises

198. National Labor Relations Act § 8(a)(2), 29 U.S.C § 158(a)(2) (1999).

199. *See, e.g.*, Robert John Schulze, Note, *Can This Marriage Be Saved? Reconciling Progressivism with Profits in Corporate Governance Laws*, 49 STAN. L. REV. 1607, 1614 (1997).

and vary with the homogeneity of the workforce.[200] He argues that where workers are highly homogeneous, as in law firms or small plywood mills, the costs of collective decision making are minimized and worker ownership often succeeds. However, where the workforce has any substantial degree of heterogeneity, the problems of collective decision making prove fatal to the practice of worker ownership. Such heterogeneity is always found in the large publicly owned corporation where employee groups not only have conflicting interests but also disparate skills, information, and privileges.

Hansmann acknowledges, however, one case that defies his generalizations—the phenomenal success of the Mondragon cooperatives in the Basque region of Spain, which have grown from a single workers' cooperative with twenty-three members in 1956 to a federation of cooperatives engaged in manufacturing, retail distribution, and financial services with sales of approximately $7 billion.[201] He argues unpersuasively that the Mondragon cooperatives are managerial in nature and therefore are not a true form of employee ownership.[202] In fact, the Mondragon cooperatives reflect a triumph of intelligent institutional design, which avoids the debilitating costs of collective decision making while preserving ultimate accountability of management to the workforce. A key feature of the system is that workers possess the right to select the entire board of directors, but the board and management then enjoy an opportunity to succeed or fail within their prescribed terms of office.[203]

The lesson to be gained from the Mondragon experience is that

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200. *See generally* Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749 (1990).

201. *See* Mondragon Corporacion Cooperativa, MCC, *A Message from the President*, *at* http://www.mondragon.mcc.es/ingles/mensaje.html (last visited Apr. 30, 2002) (indicating a sales figure that refers to industrial and distribution activities).

202. *See* Hansmann, *supra* note 200, at 1790-94. In a careful critique of Hansmann's thesis, Allen Hyde extends the list of exceptions beyond the case of the Mondragon cooperatives and concludes that "genuine employee-owned businesses succeed in almost any imaginable industry, with all types of employees." Hyde, *supra* note 168, at 168.

203. Directors are directly elected by employees to staggered terms of four years at an annual meeting of the workforce. Usually, the selected candidates are employees in supervisory positions or with specialized skills. The board hires management employees under four-year contracts. In day-to-day operations, workers interact with management through social councils representing particular employee groups. Although the social councils have only advisory power, they work with executives who must ultimately vindicate themselves to employee representatives on the board to secure renewal of their employment contracts. *See* WILLIAM FOOTE WHYTE & KATHLEEN KING WHYTE, MAKING MONDRAGON: THE GROWTH AND DYNAMICS OF THE WORKER COOPERATIVE COMPLEX 35-38, 235 (1991); GREG MACLEOD, FROM MONDRAGON TO AMERICA: EXPERIMENTS IN COMMUNITY ECONOMIC DEVELOPMENT 28-30 (1997).

employees can exercise defined rights to select the board of directors without incurring the fatal transaction costs of collective decision-making. This lesson can be easily applied to the institutional design of an employee voice in the publicly owned corporation. By allowing employees to participate in the nominating process for the board, employees can gain a genuine degree of influence within the corporation, without subjecting the corporation to the transaction costs often associated with an employee role in management.

In a system of employee participation in the nominating process, the problems of conflict of interest between employer and employee could also be reduced to manageable proportions, if not eliminated.[204] The sort of direct conflict that occurs when an employee director votes on matters affecting employee jobs could be avoided by the simple expedient of drawing employee candidates from outside the workforce, but the matter of employee access to information presents a more intractable problem that demands a kind of balancing act. On the one hand, an important reason for creating an employee voice in management is to facilitate the flow of information to the workforce. It is the disparity in information between management and workers that can undermine trust and cause employee-involvement schemes to go awry.[205] But a general policy of confidentiality is probably a necessary condition for effective board deliberations in today's business culture. Rules that would destroy this confidentiality can be expected only to drive the real locus of decision-making away from board meetings into informal caucuses of directors and executives.

The dilemma regarding disclosure of management information could again be negotiated, under favorable conditions, by reaching outside the workforce to choose employee candidates for the board. Employee-nominated directors will know that they must exercise discretion to maintain working relationships with other directors and management. Since the nature of the director's role would inevitably favor a balancing of his working relationship with management and the desires of employee constituents, the director is likely to be amenable to following reasonable conventions allowing limited disclosure. If the nominating committee should nevertheless choose an employee as director, it would have to either live with the inevitable conflict of

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204. *See* Michael E. Murphy, *Workers on the Board: Borrowing a European Idea*, 27 LAB. L.J. 751, 754-56 (1976).

205. *See* O'Connor, *supra* note 169, at 936-40, 961-62.

interest or work out a stipulation for the employee-director's conduct on the board.[206]

The mechanics of employee participation in the nominating process can be easily devised and might take many forms. Charles Craver advocates a system modeled after European co-determination that would assure employee representatives one-third to one-quarter of available board positions.[207] I will sketch a much more modest and conservative scheme. My purpose is not so much to advocate this particular solution as to demonstrate the possibility of avoiding the dilemmas presented by collective bargaining, transaction costs, and conflicts of interest.

Imagine that, under conditions of shareholder democracy, the board would reflect the differing perspectives of shareholder constituencies. The nominating committee might include four directors reflecting the same diversity. The fifth member of the committee might be an employee representative, endowed with full voting rights but without actual membership on the board. Although potentially outvoted, the employee member could effectively advocate particular candidates by exploiting management's desire to maintain a reputation of fairness in the workforce and by bargaining with other members of the committee who would themselves have differing preferences.

Federal regulations might require companies to adopt by-laws choosing one of several options for selecting the employee representative on the nominating committee. Companies with high union membership might choose the representative through collective bargaining units. Companies with employee stock ownership plans might adopt some method of polling employee-owners. Other companies might be authorized to choose the employee representative through a system of employee councils, modeled after the European works councils, a system which has been vigorously advocated for the United States,[208] or some other form of employee association.[209]

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206. *See* Murphy, *supra* note 204, at 761.

207. *See* Charles B. Craver, *Mandatory Worker Participation Is Required in a Declining Union Environment to Provide Employees with Meaningful Industrial Democracy*, 66 GEO. WASH. L. REV. 135, 164-68 (1997).

208. *See* PAUL C. WEILER, GOVERNING THE WORKPLACE: THE FUTURE OF LABOR AND EMPLOYMENT LAW 283-95 (1990); Joel Rogers & Wolfgang Streeck, *Workplace Representation Overseas: The Works Councils Story*, *in* WORKING UNDER DIFFERENT RULES, 97-156 (Richard B. Freeman ed., 1994).

209. There are many models to choose from, including a cooperative employee

Finally, companies might have the option of devising another method of selection subject to regulatory approval.

Variations on this scheme or Craver's more ambitious proposal can easily be envisioned.[210] My point in elaborating this scenario is to show that employees can be given a direct voice in corporate governance through the nominating process with virtually no downside risk to unions or shareholders.

IV. THE CORPORATION AND THE COMMUNITY GENERALLY

A. *Fiduciary Issues*

The broad topic of the relation between the corporation and the community plainly leads outside the sphere of corporate governance and calls for consideration of external controls, such as government regulation, taxation, and lawsuits, addressing a myriad of distinct issues from public health to consumer protection.[211] Nevertheless, since the famous exchange between Dodd and Berle in the Harvard Law Review,[212] a much-contested school of thought has insisted that management's fiduciary duties extend to constituencies other than shareholders. These expansive views of management's fiduciary responsibility have usually been associated with the idea of stakeholder entitlements, giving suppliers, customers, creditors, and affected groups in the community a right to be considered in corporate decision making, and have led to what is known, at least to its detractors, as the "multi-fiduciary model" of managerial responsibility.[213]

Critics object that, for all its ethical good intentions, the stakeholder concept can have the practical effect of sanctioning

association at Filene's Department Store in Boston devised by Justice Louis Brandeis early in his career. *See* ALPHEUS T. MASON, BRANDEIS, A FREE MAN'S LIFE 147 (1946).

210. *See* Craver, *supra* note 207 and accompanying text.

211. *See* Alfred F. Conrad, *Reflections on Public Interest Directors*, 75 MICH. L. REV. 941, 946, 960 (1977); Schulze, *supra* note 199, at 1642.

212. *See* Dodd, *supra* note 20, at 1145; Adolf A. Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

213. *See, e.g.*, Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1419 (1993); Wai Shun Wilson Leung, *The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-Shareholder Interests*, 30 COLUM. J.L. & SOC. PROBS. 587, 620-24 (1997); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1252-53 (1991). For an interpretation of stakeholder statutes, see Gary van Stange, Note, *Corporate Social Responsibility Through Constituency Statutes: Legend or Lie?*, 11 HOFSTRA LAB. L.J. 461 (1994); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992); David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991).

managerial irresponsibility.[214] It may be so difficult to enforce complex and conflicting fiduciary duties to multiple stakeholders that such multiple duties may actually encourage managerial discretion and autonomy. It was this consideration that Adolf Berle ultimately found to be decisive.[215] It is seldom noted that a concluding passage in Berle's famous study, coauthored by Means, comes close to espousing a fiduciary duty toward the community.[216] But Berle soon thereafter rejected this view in his debate with Merrick Dodd and maintained instead that an effective system of accountability called for clearly defined fiduciary duties.[217]

There is, however, a middle ground avoiding the pitfalls of the multi-fiduciary model, which is suggested by the Delaware takeover litigation. In the *Unocal Corp. v. Mesa Petroleum Co.* decision, the Delaware Supreme Court stated that a defensive measure to defeat a takeover must be analyzed in terms of the threat posed to "the corporate enterprise."[218] Valid concerns might include "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally.)"[219] In the later *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* decision, the court explained that "[a] board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."[220]

The *Unocal* and *Revlon* decisions reflect the common sense view that a corporation needs to have good relations with those on whom it depends for its long-term success. These include not only employees, creditors, and suppliers, but also those in the general community that have the capacity to influence government policies affecting the corporation and the goodwill of its customers. This principle can logically be extended to the health of the environment since environmental sustainability is a necessary condition for long-term

214. *See* Schulze, *supra* note 199, at 1612; Rima Fawal Hartman, Note, *Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?*, 50 WASH. & LEE L. REV. 1761, 1763 (1993).

215. *See* Berle, *supra* note 212, at 1367-69.

216. *See* BERLE & MEANS, *supra* note 10, at 312.

217. *See* Berle, *supra* note 212, at 1367-69.

218. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

219. *Id.*

220. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

business survival.[221]

In recent years, this broad understanding of management's fiduciary responsibility has entered securely into business consciousness. In an official guideline on corporate governance, The Business Roundtable, an association of chief executive officers of major corporations, stated that a fiduciary duty to shareholders can be reconciled with consideration of the interests of other stakeholders:

> It is in the long-term interests of stockholders for a corporation to treat its employees well, to serve its customers well, to encourage its suppliers to continue to supply it, to honor its debts, and to have a reputation for civil responsibility. Thus, to manage the corporation in the long-term interests of the stockholders, management and the board of directors must take into account the interests of the corporation's other stakeholders.[222]

To the extent that management's fiduciary duty extends to matters affecting the interests of the larger community, this duty becomes a factor in the success of shareholder initiatives pertaining to these interests. A modest amount of shareholder pressure may be enough to prompt action that comports with management's fiduciary duty. To explore this point, I will turn to the subjects of social reporting, foreign contracting, and corporate political involvement.

B. *Social Reporting*

Among the various directions of the debate over management's fiduciary responsibilities, the matter of disclosure bears a particularly close relationship to the subject of this article—shareholder democracy. Although disclosure is designed for the protection of investors, its chief value often lies in its impact on corporate governance.[223] By assembling data for disclosure to shareholders, management is *forced* to confront business realities and incorporate them into its decision-making. Louis Lowenstein observes that, apart from informing

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221. *See infra* discussion Part IV.B.1.

222. BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE 3 (Sept. 1997). For similar statements, see AMERICAN LAW INSTITUTE, *supra* note 112, at § 2.01(a); AMERICAN BAR ASSOCIATION, *supra* note 112, at 5.

223. *See generally* Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335 (1996); Merritt B. Fox, *Required Disclosure And Corporate Governance*, 62 LAW & CONTEMP. PROBS., No.3, 113 (1999).

investors, financial disclosure may have "the quite independent effect of forcing managers to confront disagreeable realities in detail and *early on*."[224] Disclosure may serve precisely the same function with respect to the long-term social and environmental impacts of the corporation's activities, which managers may be inclined to deny or eschew in favor of short-term objectives.

1. *Environmental Reporting*

Under favorable circumstances, disclosure may prompt management to devote imagination, energy, and systematic attention to matters that would otherwise be ignored. The creative potential of disclosure has particular relevance to the long-term interdependencies between the corporation and environmental sustainability.[225] As a personal illustration, my grandfather, Michael Flatley, was a small-town doctor in Antigo, Wisconsin, not far from Wisconsin Rapids, the site of a flourishing specialty paper company known as Consolidated Paper. Before his death, he had invested enough of his savings in Consolidated Paper to pay for the college education of three generations of his descendants. Two years ago, Consolidated Paper was acquired by Stora Enso, a Finnish paper company with $13 billion in sales and operations in several European countries.[226]

As a new Stora Enso shareholder, I received last year, with the corporation's 2000 annual report, a separately bound 40-page environmental report, verified by a European division of Price Waterhouse, which measured environmental impacts in five areas: wood procurement, energy use, waste management, recycled fiber use, and transport.[227] In each area, the data for the year 2000 revealed significant improvement over the preceding year. An already high use of biofuels increased from 62 to 64% of total fuel consumption in production.[228] Despite a 4% increase in pulp, paper, and board

224. Lowenstein, *supra* note 223, at 1342.

225. *See* Daniel J. Fiorino, *Rethinking Environmental Regulation: Perspectives on Law and Governance*, 23 HARV. ENVTL. L. REV. 441, 445-50 (1999); Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?*, 89 GEO. L. J. 257 (2001).

226. *See* Stora Enso, *Stora Enso's History*, *at* http://www.storaenso.com/CDAvgn/main/0,,1_-2083--,00.html (last visited Nov. 11, 2002).

227. *See* STORA ENSO CO., ENVIRONMENTAL REPORT (2000), *available at* http://www.storaenso.com/CDAvgn/showDocument/0,,1279,00.pdf (last visted Nov. 11, 2002).

228. *See id.* at 2.

production, the company experienced reductions, in absolute quantities, of waste disposal (3%), atmospheric emissions of sulfur dioxide, (4%) and nitrogen oxides (5%), and water pollution—whether measured by chemical oxygen demand (2%), or by the presence of organic compounds containing chlorine (4%) or nitrogen (4%).[229] Water pollution by phosphorus compounds increased 2% in absolute terms, while decreasing slightly on a unit of production basis. Stora Enso facilities accounting for 80% of production also prepared site-specific audits conforming to the European Eco-Management and Audit Scheme (EMAS) or the ISO 14001 system sponsored by the International Organization for Standardization.[230] The environmental report listed addresses where shareholders could order the EMAS reports and expressed a commitment to complete an environmental audit of the former Consolidated Paper operations by the end of the year 2002.

When Consolidated Paper was acquired by Stora Enso, it clearly entered into a quite different universe of corporate decision-making, which systematically took environmental goals into account in business planning. The announced objective of the EMAS reporting standards is "to promote continuous improvement in the environmental performance of industrial activities."[231] In the case of Stora Enso, this objective appears to be satisfied.

On this side of the Atlantic, the practice of environmental reporting lags well behind the level of acceptance it enjoys in the European Union.[232] Many American companies complain that such reporting places them at risk of disclosing liabilities or assembling discoverable caches of documents for potential plaintiffs.[233] Nevertheless, environmental reporting has made some important inroads.[234] The Toxics Release Inventory program, which requires

229. *See id.*

230. *See id.* at 12.

231. Eric W. Orts, *Reflexive Environmental Law*, 89 NW. U. L. REV. 1227, 1290 (1995).

232. For a history of the EMAS reporting system and assessment of its prospects, see Orts, *supra* note 231, at 1290-1312. For background on the parallel, but somewhat less stringent, reporting system of the International Organization for Standardization, see Naomi Roht-Arriaza, *Shifting the Point of Regulation: The International Organization for Standardization and Global Lawmaking on Trade and the Environment*, 22 ECOLOGY L.Q. 479, 502-518 (1995).

233. *See* Linda Richenderfer & Neil R. Bigioni, *Going Naked Into the Thorns: Consequences of Conducting an Environmental Audit Program*, 3 VILL. ENVTL. L.J. 71 (1992); Terrell E. Hunt & Timothy A. Wilkins, *Environmental Audits and Enforcement Policy*, 16 HARV. ENVTL L. REV. 365 (1992).

234. *See* Joel Makover, *The Power of Ten*, GREEN BUSINESS LETTER (June 2001) at 3

industrial firms to disclose releases of 654 specified toxic chemicals, is widely given much of the credit for reducing these toxic releases by almost half since 1987.[235] The EPA officially encourages comprehensive environmental reporting[236] and has enlisted thousands of firms in an array of voluntary programs that may entail certain reporting duties.[237] A private group dedicated to environmental auditing and disclosure, the Coalition for Environmentally Responsible Economies (CERES) now counts some fifty companies among its members, including several major corporations.[238]

The goal of encouraging a proactive corporate policy of environmental self-evaluation requires consideration of incentives and disincentives that are outside the scope of this article,[239] but one important point is relevant here: pressure from within the processes of corporate governance, generated by minority shareholders, can lend a significant, and perhaps even decisive, impetus to the faltering development of environmental reporting in this country. It is safe to say that most Americans would favor the level of environmental responsibility displayed by European reporting practices. The enfranchisement of minority shareholders, outlined earlier in this article, would help to bring this popular preference to bear on the nomination and selection of directors. While one cannot predict a precise scenario, it is worth noting again that environmentally committed institutional investors in the field of ethical investing are large enough to play a catalytic role in forming shareholder coalitions.

Even the best designed scheme for environmental reporting would be clouded by imponderables but if necessary, it would be possible to

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and 8, *available at* http://www.GreenBizLetter.com.

235. *See* Karkkainen, *supra* note 225, at 286-88; John W. Maxwell, et al., *Self-regulation and Social Welfare: The Political Economy of Corporate Environmentalism,* 43 J.L. & ECON. 583, 604 (2000).

236. *See* Environmental Protection Agency, Environmental Auditing Policy Statement, 51 Fed. Reg. 25,004 (July 9, 1986) and Environmental Protection Agency, Voluntary Environmental Self-Policing and Self-Disclosing Interim Policy Statement, 60 Fed. Reg. 16,875 (April 3, 1995).

237. *See* Julio Videras & Anna Alberini, *The Appeal of Voluntary Environmental Programs: Which Firms Participate and Why?,* 18 CONTEMP. ECON. POL'Y 449, 551 (2000).

238. *See* Orts, *supra* note 231, at 1289; CERES, *About Us, Who's in the Network, at* http:// www.ceres.org/about/main.htm (last visited December 4, 2001).

239. *See, e.g.*, Eric W. Orts & Paula C. Murray, *Environmental Disclosure and Evidentiary Privilege*, 1997 U. ILL. L. REV. 1 (1997); David Hess, *Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness*, 25 J. CORP. L. 41 (1999); Heather L. Cook & Robert R. Hearn, Note, *Putting Together the Pieces: A Comprehensive Examination of the Legal & Policy Issues of Environmental Auditing*, 7 TUL. ENVTL. L.J. 545 (1994).

strengthen the hand of minority shareholders who desire such reporting. Cynthia Williams suggests the alternative of an opt-in system of social reporting whereby a certain percentage of shareholders could demand management to institute a program of auditing and disclosure on a particular subject.[240] In the context of cumulative voting, the percentage might be set at the number of shareholders capable of electing a single director of a board of minimum size. An opt-in system of environmental reporting would rely on a sponsoring director, or a sponsoring coalition of shareholders, to monitor management's commitment to the program. Though involving an element of compulsion, it might still promote the sort of systematic and reflective search for environmental improvement that is the *desideratum* of environmental reporting.

2. *Reporting of Family-Support Practices*

A shareholder-driven system of social reporting could be an effective means of dealing with other social concerns that enjoy widespread public attention and affect matters within the scope of management's fiduciary duties. I will confine my comments to a subject of great potential interest not only to social investors but also to labor pension funds—family-support practices. In this area, there is in fact a strong case for a mandatory rather than voluntary system of reporting, but in either case, the monitoring of the disclosures by an organized shareholder bloc would help assure that the reporting would inform actual corporate decision-making.

In the past forty years, the historic increase in families with single parents or two working parents has created new pressures and obstacles for balancing workplace demands and family life.[241] In an extensive nationwide poll, Sylvia Hewlett and Cornel West found that 90% of working parents would like access to compressed work weeks, flextime, job-sharing, and benefits for part-time work; 87% favored a "law guaranteeing three days of paid leave annually for child-related responsibilities such as attending a parent-teacher conference or taking a child to the dentist;" and 71% wanted legislation allowing workers "to trade two weeks' pay for an extra two weeks of vacation time per year."[242]

240. *See* Williams, *supra* note 43, at 1303.
241. *See* SYLVIA ANN HEWLETT, WHEN THE BOUGH BREAKS 15, 72-83 (1991).
242. *See* SYLVIA ANN HEWLETT & CORNEL WEST, THE WAR AGAINST PARENTS 217 (1998).

While the poll focused on legislation, the parenting dilemmas of corporate employees do not always lend themselves to regulations of general application. In part, they call for the sort of individual solutions that can only result from management efforts seeking actively to address employee needs. For example, a particular employer may not be able to offer flextime to most employees but may have a suitable place for an on-site day care facility. A standardized disclosure of family-support practices could prompt management to periodically examine a range of options to accommodate parental needs, while also serving to inform job applicants about the company.

There can be no doubt that family-support policies lie within management's fiduciary responsibilities to shareholders. By satisfying the needs of parents, management may hope to reduce absenteeism, improve employee recruitment, and enhance workforce loyalty and trust. The public policy interest could not be more compelling. From an anthropological perspective, child rearing is a critical function for the survival of any culture. Yet, while some companies have offered innovative assistance to parents, others have responded with unreflecting rigidity and demands for longer hours of work.[243] A disclosure system, with the support of a shareholder bloc, could stimulate a better response to the nurturing of future generations.[244]

C. *Respect for Human Rights in Foreign Contracting*

There may be occasions when the self-interest of U.S. corporations engaged in foreign contracting calls for attention to human rights.[245] Using the example of a proposed gas pipeline in Afghanistan, Blaine Townsend of Trillium Asset Management, an ethical investment fund, argues that human rights violations often signal risks that should be heeded in investment decisions.[246] For

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243. *See* HEWLETT, *supra* note 241, at 21-23, 203-13.

244. In addition to the flexible time issues mentioned above, a reporting system might call for disclosure of such matters as: (1) on-site child care, (2) information and referral service for child care, (3) health care coverage for dependents, (4) coverage of pre-natal care, (5) maternity and paternity leave policies, (6) sick leave for children's illnesses, (7) telecommuting and work-at-home alternatives, and (8) a dependant care plan offering shorter hours and reduced salary.

245. *See* WILLIAM F. SCHULZ, IN OUR OWN BEST INTEREST, HOW DEFENDING HUMAN RIGHTS BENEFITS US ALL 66-104 (2001).

246. *See* Blaine Townsend, *A Tip for Wall Street—Don't Help the Bad Guys*, S.F.

companies with valuable corporate or brand images, the most immediate and obvious of these risks is the threat of adverse publicity of labor rights violations. Spurred by disclosures of labor abuses, major distributors of consumer goods have almost universally adopted codes of conduct governing suppliers in developing countries, and, at least in the apparel industry, pursued plans for a label system certifying to fair labor practices.[247]

Will these public relations efforts of image-conscious companies actually serve the cause of labor rights? In the past five years, there has been impressive progress in creating standards for acceptable labor practices in developing countries. Social Accountability International, an organization of non-governmental organizations (NGOs), unions, and corporations, including Toys 'R' Us, promulgated a set of labor standards, known as SA8000, in nine core areas, which seeks to build on the quality assurance auditing system of the International Organization of Standardization.[248] A task force sponsored by the Clinton Administration in 1996, the Apparel Industry Partnership, established a similar Workplace Code for the apparel industry.[249] Other codes of conduct have been adopted by the Collegiate Licensing Company for products bearing university logos, by the Federation Internationale de Football Association (FIFA) for soccer balls bearing the FIFA logo, and by an Indian foundation that authorizes use of the RUGMARK label for carpets manufactured without the use of child labor.[250]

Unfortunately, these private codes of conduct rely on monitoring programs of questionable efficacy. Although the SA8000 and Apparel Industry Partnership require audits by accredited outside firms, these

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CHRON., Nov. 20, 2001, at A23.

247. *See, e.g.*, Jorge F. Perez-Lopez, *Promoting International Respect for Worker Rights Through Business Codes of Conduct*, 17 FORDHAM INT'L L.J. 1 (1993); Ryan P. Toftoy, Note, *Now Playing: Corporate Codes of Conduct in the Global Theater. Is Nike Just Doing It?*, 15 ARIZ. J. INT'L & COMP. L. 905 (1998).

248. *See* Williams, *supra* note 43, at 1202 n.11, 1304-05; SOCIAL ACCOUNTABILITY INTERNATIONAL, AN OVERVIEW OF SAI AND SA8000 *at* http://www.cepaa.org/introduction.htm (last visited Dec. 26, 2001).

249. *See* Maria Gillen, *The Apparel Industry Partnership's Free Labor Association: A Solution to the Overseas Sweatshop Problem or the Emperor's New Clothes?*, 32 N.Y.U. J. INT'L L. & POL. 1059, 1062-63 (2000); *see generally* Heidi S. Bloomfield, Note, *'Sweating' the International Garment Industry: A Critique of the Presidential Task Force's Workplace Codes of Conduct and Monitoring System*, HASTINGS INT'L & COMP. L. REV. 567 (1999).

250. *See* Robert J. Liubicic, *Corporate Codes of Conduct and Product Labeling Schemes: The Limits and Possibilities of Promoting International Labor Rights Through Private Initiatives*, 30 LAW & POL'Y INT'L BUS. 111, 130-32 (1998).

firms lack any profit motive for zealous enforcement of labor standards and suffer from identification with the company in seeking the confidence of workers. All private monitoring schemes—even the relatively credible RUGMARK program—operate in varying degrees of secrecy and fail to disclose information about violations and violators.[251]

Time will tell whether these private initiatives of image-conscious corporations will ultimately be regarded as a public-relations ruse[252] or the leading edge in the development of an effective global system of labor rights.[253] The matter is of great importance to the ethical investment community. A 1999 poll indicates that 84% of Americans think that manufacturers that employ contractors or workers are responsible for preventing sweatshop conditions.[254] A system of shareholder democracy would enable ethically motivated investors to better exert pressure for effective monitoring of overseas labor practices, reflecting the strong support for such monitoring in the American public.

D. *Corporate Political Activities*

The most inveterate foe of corporate power must concede that there is an important difference between political activities directed at laws and governmental policies impinging immediately on a corporation's business operations and political activities that serve only to promote management's social biases. The former lies within management's fiduciary duty to oversee the conduct of the business and often draws on specialized knowledge and business experience of importance to the public. While environmentalists may disagree with timber companies, they cannot deny that the companies possess expertise in forestry practices that should be taken into account in framing policy. But to the extent that management's political

251. *See id.* at 134-39.

252. In *Kasky v. Nike, Inc.*, 27 Cal. 4th 939, 969-70 (2002), the California Supreme Court held that the public relations campaign of Nike, Inc. defending the labor practices of its foreign contractors, constituted commercial speech that could be regulated to eliminate false and misleading statements. *See id.*

253. For an analysis of how limited private initiatives may stimulate the later development of effective public laws, see Liubicic, *supra* note 243, 149-58; Steven R. Salbu, *True Codes Versus Voluntary Codes of Ethics in International Markets: Towards the Preservation of Colloquy in Emerging Global Communities*, 15 U. PA. J. INT'L BUS. L. 326, 353-68 (1994).

254. *See* Marymount Univ. Ctr. for Ethical Concerns, *The Consumer and Sweatshops*, *at* http://www.marymount.edu/news/garmentstudy/question5.html (last visited Dec. 27, 2001).

initiatives stray from the company's own operations and lose a direct connection with management's fiduciary responsibilities, they may pose a threat to democratic processes by allowing management to use corporate treasuries to promote personal agendas.

A badly flawed Massachusetts statute seeking to enforce this vital distinction through criminal sanctions fell prey to a constitutional attack in *First National Bank of Boston v. Bellotti*.[255] The statute punished corporations and corporate officers for making any contribution or expenditure in support of a state referendum measure unless it was "one materially affecting any of the property, business or assets of the corporation."[256] The statute was both too harsh and too narrow. Criminal penalties should not be used to enforce a distinction that is inherently difficult to draw; a large gray area is likely to exist between those political measures pertaining to business interests and those unrelated to the business. Again, the statute applied only to state ballot measures, but the rationale for the distinction applies equally to contributions to political candidates, public relations expenditures, membership in politically active organizations, and monetary support for foundations indirectly serving a political cause.

The plaintiffs who challenged the statute were two banks and three business corporations that wished to spend corporate funds to publicize their opposition to a ballot measure imposing a graduated income tax on individuals—a matter having no direct relation to banking or the other businesses.[257] In a 5-4 decision, the U.S. Supreme Court held that the statute abridged freedom of speech in violation of the First and Fourteenth Amendments.[258] The majority characterized the statute as creating "an impermissible legislative prohibition of speech based on the identity of the interests that spokesmen may represent in public debate over controversial issues and a requirement that the speaker have a sufficiently great interest in the subject to justify communication."[259] In a dissenting opinion, Justice White observed that the statute itself was designed to serve a First Amendment interest, that is, to prevent corporate management from exerting an undue influence in the political process by reason of its

255. 435 U.S. 765 (1977).
256. *See id.* at 768.
257. *See id.* at 767-69.
258. *See id.*
259. *Id.* at 784.

control of the corporate treasury. In his view, the state legislature was free to strike any reasonable balance between this constitutional interest and the competing constitutional interests protecting corporate speech.[260]

My purpose here is not to critique the merits of the *Bellotti* decision, but rather to note that, under a regime of shareholder democracy, it would be possible to create a self-regulating system, which would avoid the practical and constitutional difficulties of the Massachusetts statute. An audit committee with genuine accountability to investors is the key. In the wake of the recent Enron and WorldCom scandals, an independent audit committee has emerged as a vital tool to curb accounting abuses,[261] but such an audit committee can also oversee other forms of corporate disclosure. In particular, an independent audit committee could assume the function of assuring that political expenditures are confined to those closely pertaining to the conduct of the corporation's business—the objective of the Massachusetts statute.

With effective shareholder accountability, it becomes possible to imagine that a board of directors would appoint an audit committee charged with monitoring politically-related corporate activities so as not to offend any shareholder constituency. The monitoring system would presumably require detailed disclosure to shareholders of corporate political expenditures[262] and would provide an internal procedure allowing shareholders to challenge certain expenditures before a representative of the audit committee.

The system could be either voluntary or mandatory. A voluntary system would rely on the enhanced influence of the same coalition of institutional investors that favors other corporate governance measures. A mandatory system would proceed from a statutory or regulatory rule requiring shareholder approval of spending on political measures having no direct and material effect on the business. Any

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260. For an illuminating theory of constitutionally protected corporate communications that is generally consistent with Justice White's analysis, see Meir Dan-Cohen, *Freedoms of Collective Speech: A Theory of Protected Communications by Organizations, Communities and the State*, 79 CAL. L. REV. 1229, 1247 (1991).

261. An independent audit committee has long been an objective of institutional shareholder activism. *See, e.g.*, the TIAA-CREF website, *at* http://www.tiaa-cref.org/siteline/gen0206_051.html (last visited July 29, 2002).

262. Cynthia Williams suggests that the SEC proxy form could consolidate all required disclosures of politically related expenditures. *See* Williams, *supra* note 43, at 1203 n.14.

constitutional issue relating to freedom of expression would arise in a context of autonomous corporate decision-making, which would probably lead to a different result than in the *Bellotti* decision.

Apart from the issue of constitutionality, a self-regulating system of private controls would again have practical advantages: (1) it could make difficult and elusive distinctions that would represent an impossible burden on a system of external controls, and (2) it could extend to the full range of politically related activities, including association memberships, lobbying initiatives, charitable contributions, public relations expenditures, PAC sponsorships, and even corporate communications. It is, of course, impossible to know whether shareholder constituencies would lend enough support to such a system to make it work effectively. But one can safely say that, in a system of shareholder democracy, a self-governing system to guarantee strict corporate political neutrality could be seriously contemplated.

E. *Overview*

A common theme runs through these distinct topics: there may be pragmatic opportunities for shareholder action when matters lying within management's fiduciary obligations affect social goals with strong public support. These opportunities would be greatly enhanced by a system of shareholder democracy giving a more effective voice to constituencies representative of the American public.

V. CONCLUSION

At the beginning of this article, I cited Chancellor Allen's observation that people have difficulty imagining any alternative to a "truly dominant intellectual paradigm."[263] My purpose has been to engage in an imaginative exploration of the outer limits of shareholder democracy for the publicly held corporation. The article seeks to show that the current paradigm of shareholder passivity and management autonomy is embedded in a complex of regulatory laws. A comprehensive revision of these laws—which necessarily implies federal standards of corporate governance—would open opportunities to create a meaningful system of shareholder democracy based on representative associations of institutional shareholders. In addition to cumulative voting, two procedural innovations are needed—the right of

263. *See* Allen, *supra* note 1, at 1401.

shareholder associations to place director nominations on corporate proxy cards, and the right of indirect shareowners to give voting instructions to the fiduciaries of self-directed and defined-contribution retirement plans.

An assumption runs through this article that should be reiterated here: corporate decisions would often take different and more socially constructive forms if they were framed in terms of a broader set of relevant considerations. Twenty years ago, Christopher Stone observed:

> In the life of the enterprise, there are many occasions on which the managers have no 'most profitable' option lying on their desks. Considering the uncertainties in any business environment and the limited data available to it, there will be some range of choices all equally consistent with that ill-defined and elusive favorite of the economics textbooks, the investment uniquely calculated to maximize the shareholders' wealth.[264]

Stone saw opportunities for corporate managers to take social criteria into account within "this profit-undifferentiable range."[265] By doing things that "present clear gains for the public and do not really conflict with, and perhaps advance, the firm's own economic interest," the managers are like to "identify possibilities of profit" they would never discern if they "thought exclusively in terms of profit."[266]

By first surveying the range of shareholder constituencies, I sought to show that shareholder democracy would cause corporate decisions to be considered in a more open forum, having some similarities to the German *Aktiengesellschafte*, which would give expression to institutional shareholder groups with interests and perspectives reflecting those of important segments of the American public. Even though some of these groups may control a relatively small share of voted stock, they could still influence the selection of directors, with the aid of cumulative voting, by forming alliances with other institutional investors and utilizing avenues of communication with individual shareholders.

Paradoxically, the most significant implications of shareholder

264. Christopher D. Stone, *Corporate Social Responsibility: What It Might Mean, if It Were Really to Matter*, 71 IOWA L. REV. 557, 568 (1986).

265. *Id.*

266. *Id.* at 569.

democracy may concern the interests of employees and the community at large. The forms of shareholder democracy could be used to add an appropriate employee voice in corporate decisions through employee stock ownership plans or by direct participation in the nomination process. Shareholder democracy would also afford activist shareholders pragmatic opportunities to pressure for change in those areas where social policies with strong popular support lie within the scope of management's fiduciary responsibilities.