Conference Panel Discussion

Federalism Issues in Corporate Governance*

Prof. Ash: First, I wish to welcome all of you to this Conference and particularly to this first of three panel discussions. This afternoon we will begin with the most general of the subjects to be considered, that of federalism issues in corporate governance. Professor Schwartz has clearly set forth for our further consideration the origins and development of the federal approach to corporate governance, including the prominent and controversial ALI effort. Though he stated that he banks a lot on the success of that project as a means of achieving reform, I believe that certain others question the need for any reform at all in the area of corporate governance. Professor Mofsky, perhaps you would share with us your thoughts regarding Don's views of the ALI effort.

Prof. Mofsky: It is indeed extremely difficult within the short time allotted to address the many such issues raised by Professor Schwartz. Let me focus on one or two of them. One is what evidence do we have that all this reform is necessary or desirable. We have two points of focus with regard to that question. One relates to the proposed reforms, and the other relates to the evidence available with regard to the existing federal statutes that Professor Schwartz has mentioned.

First, with regard to the proposed reforms, Don admits honestly that he is not aware of any empirical study that convincingly answers the question of whether more federal laws dealing with corporate governance would improve shareholder or community welfare of the question of whether the benefits of existing federal efforts have outweighed the costs involved. And I think it unlikely that any other advocate of such federal reforms is in a position to advance at this conference such an empirical study. And that's because no such study exists. Yet the proponents of federal laws dealing with corporate governance persist in their assertions that such laws are desirable. It strikes me as perfectly clear that personal and shared experiences do not prove the need for federal law dealing with corporate governance, unless perhaps one is prepared to argue that the logic of a particular proposition such as a rule requiring a majority of independent directors or an independent audit committee is overwhelmingly clear. But if one attempts to analyze such a proposed rule, no such overwhelming logic emerges. At least it doesn't emerge for me.

For example, let's take a look at a popular assumption that independent directors are better able to monitor and assure management success and honesty than is management itself. You have all heard, I am sure, many of the arguments that have been advanced to support this assumption. But maybe you haven't heard some of the other

* The panelists were moderator Barbara A. Ash, Professor of Law, The Ohio State University; Richard M. Buxbaum, Professor of Law, University of California, Berkeley; Jesse H. Choper, Dean, School of Law, University of California, Berkeley; Melvin A. Eisenberg, Professor of Law, University of California, Berkeley; Herbert J. Hansell, Partner, Jones, Day, Reavis & Pogue, Washington, D.C.; P. John Kozyris, Professor of Law, The Ohio State University; James S. Mofsky, Professor of Law, University of Miami; Donald E. Schwartz, Professor of Law, Georgetown University and of Counsel, Williams & Connolly, Washington, D.C.; Nicholas Wolfson, Professor of Law, University of Connecticut.

arguments advanced for the other side of that proposition. Maybe it would be useful to take a look at them for a moment. Nick Wolfson and others have pointed out that senior managers have an incentive to monitor their colleagues of equal rank, and that even junior managers have an incentive to monitor more senior persons, since the success of both their peers and superiors will benefit their own reputation and their own future compensation.

On the other hand, if you look at independent directors, it would appear on the surface at least that they are in a far worse position than are senior managers to monitor employees of the firm. As part-timers, they will have less time to spend on monitoring activities. Additionally, independent directors, unlike managers, have no financial incentive to act quickly and decisively to correct management inefficiency since their compensation and the amount of it is not tied to the success of the firm. Generally speaking, they are paid on a flat fee basis. Indeed, one could draw a sketch of the world where one could expect independent directors to be less entrepreneurial minded than managers, more receptive than managers to the demands of public interest groups than to the interests of shareholders, and in the end less efficient than managers in disciplining ineffieient employees.

Now, my point is not that inside directors are necessarily more desirable than independent ones. In fact, we know very little about the way boards of directors work. Rather, my point is that rational arguments exist on both sides of that question and that the answer depends upon empirical research. Since there is no proof that independent boards are better than ones dominated by insiders, it strikes me as highly inadvisable to impose a requirement for independent boards when we already have a rule that permits boards of such differing composition as may be particularly desirable and effective for a particular firm. Although I have insufficient time to make the argument at this meeting, one could perform with respect to the desirability of independent audit, compensation, and nominating committees the same kind of analysis that I have suggested here today with regard to the question of independent boards. And for each of those issues, as well as for all the other issues at stake in the debate over corporate governance, I would draw the same conclusions. Namely, I conclude that we are dealing with empirical propositions for which plausible arguments can be made on both sides. Accordingly, in my view, the proponents of corporate reform have not proved their case. They have not proved the need for reform. Why change a system if there doesn't appear to be an awfully good reason to do it, especially when the present system has lasted so long and appears to have done so well?

Professor Schwartz correctly points out that there already exists a substantial federal overlay on the prevailing state law system. He discusses a number of federal statutes including the '33 and '34 Acts,[1] which he says have had a profound effect on the corporate governance scheme. Again, I know of no one who would disagree with his conclusion that these statutes have had a profound effect. But the issue is whether the effect has produced net gain for society. On this point, it is not at all clear that the

1. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (1982); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78jj (1982).

answer is yes. And on this point, over the past fifteen years, we have witnessed the emergence of an impressive body of empirical research testing the cost effectiveness of various aspects of these statutes. For example, Professor Benston has demonstrated, among other things, that well before the '34 Act was enacted, large firms, largely as a result of competitive forces at work in the market, were already disclosing voluntarily much financial information, and much more useful financial information, than that ultimately mandated by the '34 Act. He also demonstrated that some of the financial information required by the '34 Act is not at all on balance beneficial. Another significant point that he made is that the amount of fraud since 1934 does not seem to be significantly less than the amount existing before that Act's adoption.[2] And, with regard to takeover legislation, the Williams Act that Don mentioned, there's a rich body of economic literature there.[3] Many persons, Professors West and Smiley, to name just a few, have reported that the Williams Act and the state takeover statutes have materially increased the transaction costs associated with takeovers, thus interfering with the operation of the market for corporate control and making it more difficult to supplant inefficient or incompetent managers.[4]

In short, if one examines the recent empirical data with respect to existing federal laws that deal with corporate governance, one is more likely than not to conclude that such laws are on balance not beneficial. It seems to me that there is no basis to believe, based on the empirical data that we have of existing federal statutes, that a new federal statute dealing with corporate governance will produce net gain for society.

Prof. Ash: Thank you, Jim. Let me next turn to Professor Eisenberg as one of the reporters for the ALI project and ask him to address Jim's doubts about the need for reform in corporate governance through that project or otherwise.

Prof. Eisenberg: Rather than talk about the need for reform generally, I want to talk about specific changes that I think are necessary. The legitimacy of the economic system that we have in this country, that is, the corporate system, rests on several premises, some of which have been referred to by Dick Buxbaum and Don Schwartz. One of these is that placing the control of our national wealth, or a large part of our national wealth, in the hands of privately appointed managers who are accountable for their performance achieves a more efficient utilization of resources than would be achieved under alternative economic regimes. Implicit in this first premise is a second assumption, or a second premise of legitimacy, and that is that corporate managers are in fact accountable for their performance. So to preserve the legitimacy of the system, it is necessary to ensure that those premises are executed. Furthermore, apart from legitimacy, which might seem a theoretical question—although I think that it

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2. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973).

3. 15 U.S.C. §§ 78l–78n (1982). The section was originally added to the Securities Exchange Act of 1934, *supra* note 1, in 1968.

4. Smiley, *The Effect of The Williams Amendment and Other Factors on Transaction Cost in Tender Offers*, 3 INDUS. ORG. REV. 138 (1975); West, *Corporate Governance and the Market for Corporate Control*, in CORPORATE GOVERNANCE: PAST AND FUTURE 46 (H. Manne ed. 1982).

can have very real consequences—we have a national interest in an efficient economic system. And the question is what institutions will tend to maximize that interest and thus assure efficiency?

Now, there are many institutions that work in that direction, and all of them are important. One institution is the shareholder vote, which places some outside constraint on inefficient management. But I think we all recognize that this is a very weak constraint in a publicly held corporation. A second institution is the market, and more particularly, a set of sub-markets, and these are all important and to be encouraged. One is the market for corporate control; another is the commodities market, with the attendant sanction of bankruptcy; and another is the market for corporate capital. Those markets are important constraints on inefficiency. Their importance is not to be minimized. Neither, however, is it to be maximized. A perfect market works perfectly. An imperfect market doesn't. All these markets are highly imperfect. Jim Mofsky himself was just suggesting, and anybody who takes Jim's position I think would say, that we need substantial changes in the market for corporate control. There is a lot of opposition at present to the Williams Act, to the state takeover acts, and to certain defensive maneuvers by incumbent boards. All of those are imperfections in the market for control, and they suggest that this market works very imperfectly. Even if those imperfections were not present, there would be substantial informational impediments to that market's working perfectly. Similarly, the commodities market works very imperfectly as a constraint on management when you have many markets that are oligopolistic in effect, so that there is a lot of slack in the markets.

Therefore, we need another, supplementary constraint on managerial inefficiency, and also on conflicts-of-interest transactions. Let me add that I think it is pretty obvious that markets are not much of a constraint on conflicts-of-interest transactions, because the money involved is usually too small to have an impact on the market. But, these transactions are important, even from a national perspective, because the integrity of our capital markets is critical to the success of our economy. If investors don't have confidence in the honesty of those markets, they are not going to put money into them; and a critical component of the investor confidence is that the markets are fair—that the game is played in a fair way. The markets won't do it, not in themselves. Therefore, some other constraint is needed.

Now, if you look at the corporate statutes of seventy-five years ago or so, I think that they in effect had an accountability scheme built into them. The accountability scheme was this: The board of directors would manage the corporation, and the shareholders would monitor the board of directors. Now, maybe that scheme reflected reality seventy-five or a hundred years ago, but it doesn't reflect reality now, because the management function has dropped one step in the corporate pyramid. The management function has dropped from the board to the executives. Correspondingly, the accountability function or the monitoring or oversight function needs to drop from the shareholders to the board. Yet to get a properly monitoring board, a board that we can count on to oust inefficient managers, I think it's fairly obvious that we need a board that is independent of the managers.

Jim Mofsky was talking about empirical evidence, and he made some statements of quite different kinds. One was that there are rational arguments to be made for and against independent boards and independent committees, and, therefore, the argument for such boards and committees could be determinative only on the basis of, I assume, conclusive empirical evidence. Well, there is a difference between rational and reasonable arguments. I agree that there are plausible arguments, rational arguments to be made, but they are not reasonable arguments. You know, supply-side economics is rational, but it isn't reasonable. Similarly I think the arguments that are made against the concept that the board ought to be independent of management, while they have some rationality, are not forceful arguments. Jim is quite right in saying that you cannot prove conclusively by empirical data that an independent board is more likely to oust inefficient management than a non-independent board. But that's the way life is when we are dealing with social phenomena. It is normally impossible to prove in a conclusive way that one legal rule will function better than another. We have to take as much empirical evidence as we can get—and we are surrounded by empirical evidence, both in the practices of large corporations, which now have very largely tended to its adoption, and in our everyday life. You know we don't have to have conclusive empirical evidence to conclude that judges who are related to the parties should disqualify themselves. We don't have to have a body of statistical data before we say that a judge who is an uncle of a party is likely to be not dispassionate as a judge who is not an uncle of a party. I think that the empirical evidence issue in the form in which it is presented by Jim is—maybe "red herring" is too strong—but it's really an argument against all law. For example, Jim said you can empirically show that the transaction costs imposed by the Williams Act are significant, but I don't think you have any conclusive empirical evidence that investors as a class have done worse as a result of the adoption of the Williams Act than they would otherwise have done, that the economy as a whole has done worse as a result of the adoption of the Williams Act than it would otherwise have done—other than the evidence of the recession, which I don't think you can attribute to the Williams Act.

Now, finally, Jim said, why change a system that has done so well and lasted so long? That is what they were saying in Detroit about American cars until a few years ago. Don talks about reform. I don't think of this situation as one of reform. I think of it as one of modernization. Our system has to be kept in good repair if it's going to work. If you avoided repairs in the past, sooner or later you are going to find you don't have any engine; and I think we have to keep the engine in good repair and make some relatively modest changes.

Prof. Ash: Thank you, Mel. At this point I'd like to turn to Nick Wolfson and give him an opportunity to respond to Mel's very forceful comments.

Prof. Wolfson: I am very glad to see that in our audience we have a very distinguished body of practitioners as well as members of the judiciary. I must confess to you that I have been in a bit of a quandary, in the last hour or two, trying to figure out how I can best portray in the space of four or five minutes the vast new literature about corporate law that's been briefly alluded to. I think that it's important that you know about it for reasons I will develop. Those of you who represent corporations, when asked by your CEO "what's good for our shareholders, what's good for the corporation," have got to realize that the traditional viewpoint so eloquently expounded by Professors Dick Buxbaum, Don Schwartz, and Mel Eisenberg, which in the past represented the predominant legal scholarship, is now confronted by a vast new body of scholarship. I will try to give you some idea of that, which I think you are obligated to be aware of in order to advise your corporate executives and the interests that they represent.

I think perhaps the best way to begin is by telling a story that once appeared in *Science* magazine. I think I can apply it to the foibles and failures of the traditional approach. Some commercial egg farmers were having difficulties with their egg production. After many months of frustration they called in a theoretical physicist to give them an answer. After some study, he called them into a meeting, announced that he had a solution, whereupon he went to the blackboard and said, "Posit a rectangular chicken."[5] I think the problem that we have here is of a similar nature. Nobel Laureate George Stigler has recently looked at the data that had been prepared by the SEC in the early 30's with respect to the executives of those very corporations that Adolph Berle discussed.[6] Berle had concluded that managers' compensation is dependent upon whether the corporation was management controlled or owner controlled. Stigler found no such correlation. He did the kind of empirical testing that Adolfe Berle, a brilliant man, did not do in the 30's, but which Adolf Berle if he were alive today would be doing.

Now there are other such studies that I can mention. As to whether the American Law Institute proposals for a new structure have any bearing on reality, let me tell you what Professor Paul McAvoy did. His study is available, of course, for all of you.[7] He tested whether the structural recommendations of the ALI in Tentative Draft Number 1 for independent directors, really middle-aged CEOs from another corporation with a paunch, although they have begun to slim down lately, would make any difference in the following three areas: (1) profits, (2) compliance with law, and (3) social responsibility. He tested whether the ALI proposed structure as distinguished from other structures had any bearing on those three areas. He found none, no consequence. Conceivably, therefore, the ALI proposals if adopted will have no consequence at all, other than the fact that they may have impoverished the foundation which funded them, I don't know.

Let me conclude with one final note, which is this. There are a number of philosophies about the corporation, in today's age, in Western Europe, as well as in America. One is the neo-Marxist approach which says "the markets don't work to any degree; a corporation as large as General Motors, spanning states and nations, needs extensive government control." I don't agree with that. I think the data shows the markets work. But that argument is not in any way frivolous. It has to be dealt with. Then there is the argument of the school of law and economics to which I have referred. It concludes that the market hypothesis is valid and has strength and the data

5. *See* Shuchman, *Theory and Reality in Bankruptcy: The Spherical Chicken*, 41 LAW & CONTEMP. PROBS. 66 (Autumn, 1977).

6. *See* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

7. McAvoy, *ALI Proposals for Increased Control of The Corporation by the Board of Directors: An Economic Analysis*, in STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" (1983).

shows it. It then tests regulation to see whether it is good or bad. It doesn't have a per se approach to regulation one way or the other. Then there are the traditional approaches, which you heard some variety of today, which say the markets don't work well and, therefore, what is needed to curb the General Motors of today are a few more independent directors and a slightly tougher duty of care. If I believed that the markets didn't work at all and had no impact, then I would not have much faith in a few more independent directors, controlling the likes of General Motors. And if Don thinks that the real agenda of the ALI is to stave off more radical reform, I do think the American public is a little bit more intelligent than that. That is, if they ever believe that the market constraints don't really work, they will go for far more than the ALI is asking for.

Prof. Ash: Thank you, Nick. In light of those comments, I think it only fair to give the advocates of the traditional approach a couple more minutes. Mel, would you like to comment?

Prof. Eisenberg: Where shall I start? Nick, that was very eloquent, but I don't know that you were talking about what I said. I don't recall saying that the markets don't work at all or don't have an impact. On the contrary, I said they are very important and do have an impact. I said they have imperfections and they need to be supplemented. Stigler is famous, among other things, for having done a study of the '33 Act which showed that the '33 Act didn't work or didn't have much of an effect.[8] It turned out that there were twenty-six errors in that study, and twenty-four of them were in the direction of his thesis. That is to say, we have to be a little careful about some of this so-called empirical data. Now McAvoy did a study, which Nick referred to, and which showed empirically, Nick says, that independent boards had no effect on compliance with law.[9] Now just think about that. Just think about how McAvoy figured out the degree of compliance with the law of each corporation he studied. Obviously, there is no way in the world to find out how much compliance is going on. Do you go to the president of the corporation and say, "Check off whether you are in compliance with the law ten percent, twenty percent, or thirty percent?" Nick said he can't refer to all the literature. I can't refer to all the flaws in the literature, but I have not seen a study that is not seriously flawed.

I just want to make one final point simply because I have only two minutes. That is, we are talking about independent boards, committees, and so forth as an outside constraint. I would not conceive this kind of institution as an on-going day-to-day matter, which will affect the profits today of this corporation. Of course it won't. What dramatically affects the profitability of a corporation is the management. The institution is, rather, conceived of as a buffer somewhat short of bankruptcy. If a management is really inefficient we have the bankruptcy provisions, although nowadays that doesn't impose much of a discipline on management; it seems to impose a discipline on everybody but management. But there is an advantage in having some

8. Stigler, *Public Regulation of the Securities Markets*, 19 Bus. Law. 721 (1964) (and mimeographed version at note 68a); *see also* Friend & Herman, *The SEC Through a Glass Darkly*, 37 J. Bus. 382 (1964); Stigler, *Comment*, 37 J. Bus. 414 (1964); *Professor Stigler on Securities Regulation: A Further Comment*, 38 J. Bus. 106 (1965).

9. McAvoy, *supra* note 7.

safety valve short of bankruptcy where you can catch the management that is pretty bad, although not so bad as to drive the corporation into bankruptcy.

Another reason why data is particularly hard to generate is because no one is arguing, or not many people are arguing anyway, that this is an institution which is going to make a difference in every single corporation. Suppose a city has two beaches and only enough money for one lifeguard. It hires a lifeguard for one beach, and for a year nobody drowns at either beach. In fact, the lifeguard never has to get out of his chair—no rescue attempts are required. So now it is argued that the empirical evidence shows that the presence of a lifeguard doesn't make any difference. On that evidence, should the city drop the lifeguard? The independent board and committee structure is like the lifeguard. It is an institution that may make an important difference in the 100th or 200th or 300th case. In most cases, it will not make an important difference, but the fact that it will often not make an important difference does not show that it will never make an important difference. I don't perceive the institution as having significant costs. Some may. I don't. And like a lifeguard, or a life raft on a plane, it is an institution that I think you want for that extra case, that marginal case, where it's going to make a difference and where the difference would have a substantial impact on both the economy and the shareholders of that particular corporation.

Prof. Ash: Let me attempt to get a different perspective on this dispute between those advocating a kind of market approach and those advocating what has been called a traditional approach by turning to Herbert Hansell, our only practitioner on the panel today. Let me ask you, Herb, what your approach might be, a more practical one, perhaps.

Mr. Hansell: First, I want to refer to Don's comment that under existing state corporation laws profit maximization is the sole purpose of corporations. It reminds me of a discussion that I participated in some years ago on whether or not it would be appropriate under the corporation law of this state to file articles providing that the purpose of a corporation was to make money. The conclusion of the discussion was that it probably wouldn't be appropriate because if by any chance the company lost money it would be committing an ultra vires act.

The bottom line I think of Don's brilliant paper is that the ALI project affords the best prospect for achieving the reform that he thinks is needed because while it retains the primacy of state law, it creates national standards of corporate governance that should be implemented by either legislative or judicial federal action or by the SEC. However, I would like to put in flashing neon or perhaps at least in bold capital letters Don's comment that even those who recognize a federal role in corporate governance are required in Don's words to move with a degree of modesty and humility. I think all of us engaged in these numerous revisitations of corporate governance issues that are going on all around us have to exercise great caution and care as we go forward.

In the very limited time that we have, I want to mention several reasons, several primary reasons why I think that we have to raise very high the yellow flag of caution concerning efforts in the name of reform, or to use Mel's term, modernization, to undertake the design of new corporate governance standards that would be mandated through federal legislative or judicial or administrative action. First, I think it is important to note that the federal agenda in respect to the role of major American corporations in the U.S. economy has dramatically shifted since the days when the morality of corporate behavior was topic A. Today the most urgent national policy priority in respect to the American corporate structure is, and I think properly so, restoration of the financial well-being, efficiency, productivity, and global competitive strength of the American economy and re-establishment of American technological advancement and productive capacity. This isn't the forum, of course, in which to discuss the woes of the American economy, massive trade and budget deficits, corporate debt burdens, inefficient cost structures, structural unemployment, and so forth. But I want only to emphasize that the national policy agenda in respect to American business is now shaped very differently and that corporate governance, important as it is, isn't any longer the major federal policy concern that it once was.

Second, many of the issues that gave rise to the broad wave of concern over corporate governance have been addressed by what Don has called surgical legislation, that is, federal laws targeted on the particular issues of concern: environmental, payments to foreign officials, fiscal accounting, employment discrimination, product safety, and so forth. Again, I don't mean to suggest that these problems have been solved or eliminated. I am saying that the surgical targeted legislation approach has been broadly tried, and apparently with considerable success, as a means of addressing many of the federal concerns which have given rise to the focus on corporate governance and maybe they will prove to be the appropriate style of federal response.

The third reason for counselling caution at this time is that, while there is agreement on the importance of corporate accountability, the criteria against which management is to be measured today are very different from those that we have been thinking about in the past two years and has been noted in this discussion. We now need to judge corporate behavior in terms of productivity, ability to be competitive in world markets, cost efficiency, technological leadership, all of these vital tests of corporate performance that emerge from the current conditions of the American economy. And the federal government which perhaps has done well in setting a social agenda for U.S. business is notoriously ill-equipped to set standards of efficiency and productivity. There are numbers of examples on that point which we don't have time to look at at this time, but perhaps we can get to them during the question period.

Fourth, when we seek to consider the weaknesses in corporate governance and to undertake to consider whether federal activity can rectify them, we can't overlook that there are a great many considerations that could be jeopardized by some of the proposals that have emerged. I have in mind factors such as the need for some reasonable degree of foreseeability in corporate decisionmaking, the importance of foreign and domestic confidence in the stability of the American industrial system, the drive to relieve American business of some of the burdens of excessively heavy legal costs, and the stultifying effects of developing corporate leadership in a fog of actual and threatened litigation to the extent that it discourages innovation and risk-taking.

Lastly, I want quickly to cite the area of tender offer regulation as illustrative of the kinds of pitfalls, legal, political, and economic, that can attend efforts to impose federal legislation to the exclusion of state action in important areas of corporate operation. We have had several references, of course, to the legal issues involved in the conflict between state tender offer laws, in which, as noted, Ohio has been a leader, and the federal legislation. It's noted in some of the materials that have been distributed that there is solid reason to think that Ohio's current law may well survive judicial scrutiny. But my point is not the legal question. It is that the underlying policy tension between the national brokerage and investment communities, which tend to lead the opposition to such laws, and the industrial labor and local political leaderships, which tend to take the leadership in sponsoring them, is unresolved and will continue to fester and erupt. There is much reason to fear that mandating impositions of new federal standards of corporate governance upon existing structures will generate comparable continuing conflict. For these and some other reasons that we don't have time to go into, I urge on those who are involved in this undertaking great caution in suggesting a federal solution. To paraphrase that very well known political slogan, "if it ain't broke, don't fix it."

Prof. Ash: Thank you, Herb. I would now like to turn to another issue. Herb has suggested that Ohio's current law may indeed survive judicial scrutiny, even after the decision in *Edgar v. MITE Corp.*[10] Perhaps Professor John Kozyris would have some comments about that issue.

Prof. Kozyris: Thank you, Barbara. Before addressing your specific question, it is important to sketch out the relevant constitutional background. I have reduced my views on the federalist and internationalist aspects of our topic to seven brief comments. These annotated comments, presented as consecutive syllogisms, are intended not only to sort out the past but to probe the future as well.

I. *Topography of Lines of Authority*

It is important to keep in mind that the issue here concerns allocation of power, not substantive wisdom; authority and not content. Temporal expediency inevitably affects but should not control the lines to be drawn; lines not only between federal and state authority but also between the authority of one state against another and, more broadly, between this nation and the world. In drawing these lines we must heed the commands of the full faith and credit, due process, equal protection, commerce, privileges and immunities, and supremacy clauses of the Constitution and the requirements of international comity.

II. *Multistate v. Local Companies*

The internal affairs as well as the securities transactions in shares of companies which are multistate (or international) in terms of sources of capital, location of assets, business operations, productive and management activities, etc., are within the federal commerce power, and those of local companies are within the domain of the states. In making classifications here, the crucial factor is the source of capital (residence of shareholders) rather than the location of assets, places of doing busi-

10. 457 U.S. 624 (1982).

ness, or situs of headquarters.[11] Trading of stock on the national securities markets should establish a presumption of multistate ownership.

III. *Internal Corporate Affairs: A Matter of State*

Congress has not enacted a federal incorporation law; neither did it act to regulate corporate governance, thus leaving basically to the states the regulation of internal corporate affairs even for multistate and multinational companies. But federal authorities, especially the SEC, have extensive powers under the securities acts to implement reforms impacting on the internal affairs of such companies.

IV. *The Reign of Lex Incorporationis*

The practical necessities of unity—constancy—equality require that, in principle, a single law should govern the internal affairs of a corporation. A liberal climate favoring party autonomy and competition among the states to attract incorporations has enabled multistate companies to choose the law of their governance. While respect for the law of the state of incorporation (*lex incorporationis*) is not clearly mandated by the full faith and credit, due process, or commerce clauses in all instances,[12] deviations from it will probably run afoul of these clauses unless they come within one or more of three exceptions.

Thus, *MITE* is right in (a) bringing into play the commerce clause even where takeover controls appear as internal regulations and (b) considering the burdensomeness of the extraterritorial *effect* of local regulation.[13] *MITE* is also to be applauded for extending the scope of the negative commerce clause from discrimination to interference and overreaching.

V. *The Exceptions*

A state has the power and may properly apply its internal affairs law to foreign corporations, but only in three situations:

(a) To corporations which are local in all important respects.[14]
(b) By requiring that the intrastate operations of a multistate company be locally incorporated.[15]
(c) Perhaps on issues where a strong local interest is present and the specific interference with the corporate structure and governance is minimal (*e.g.*, inspection of shareholder lists).

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11. *Cf.* UNIFORM TAKE-OVER ACT, [July-Dec.] SEC. REG. & L. REP., (BNA) No. 626, at G-1 (Oct. 28, 1981); *SEC Advisory Committee on Tender Offers: Report of Recommendations*, FED. SEC. L. REP. (CCH) Special Report No. 1028 Extra Edition (July 13, 1983); ALI Federal Securities Code (1980).

12. *CF.* Edgar v. MITE Corp., 457 U.S. 624 (1982); Shaffer v. Heitner, 433 U.S. 186 (1977); Order of United States Commercial Travellers v. Wolfe, 331 U.S. 586 (1947).

13. *Cf.* Southern Pacific Co. v. Arizona, 325 U.S. 761 (1945); United States Brewers Ass'n, Inc. v. Healy, 692 F.2d 275, *aff'd* 104 S. Ct. 265 (1983); Martin-Marietta v. Bendix, 690 F.2d 558, 567 (6th Cir. 1982).

14. *See* CAL. CORP. CODE § 2115 (West Supp. 1984).

15. *See* Railway Express Agency, Inc. v. Virginia, 282 U.S. 440 (1931); Paul v. Virginia, 8 Wall. 168 (1868); *see also* Pullman Co. v. Kansas, 216 U.S. 56 (1909).

Thus, a state has the power to exclude Delaware from its corporations but not from the corporations of other states.

VI. *Blue Sky Power Undiminished?*

The protection of local investors through territorial regulation of in-state transactions has been traditionally assumed to be within the domain of state authority, and this received the blessings of the Supreme Court right at the outset.[16] The *MITE* and *Bendix* Michigan cases on the burdensomeness of out-of-state effects of territorial regulation raise a question, at least on the theoretical plane, about the continued viability of this blue-sky power.[17]

VII. *The Fate of the Post-*MITE *Takeover Controls*

Now getting to the specific question, it is my opinion that the new Ohio,[18] Maryland,[19] and similar statutes[20] have a better than even chance to survive a commerce clause challenge for the following reasons:

(a) They adopt a form typical of internal affairs regulations (Ohio: share transfer restrictions, transfers of control; Maryland: mergers, acquisitions, consolidations).
(b) They extend shareholder blocking power rather than institute external administrative controls.
(c) They apply only to locally incorporated companies (Maryland) which also have another major local connection (Ohio).

But there is some doubt that they will survive a challenge under the Supremacy Clause, especially if Congress takes action to implement the Recommendations of the SEC Advisory Committee on Tender Offers.

Prof. Ash: Professor Kozyris was suggesting that perhaps "*MITE* is right," that the commerce clause should have an important role to play in this area of state regulation of tender offers versus federal regulation of tender offers. I would now like to ask Professor Buxbaum to comment on what the role of the commerce clause might be or should be in the hands of the Court as a result of the *MITE* decision.

Prof. Buxbaum: I believe that the issues of federalism, as they have been identified by this panel, should be subordinated to the issue of what are good substantive rules. While we obviously did not display agreement on basic principles, and particularly disagreed on the degree to which we can rely on the market to discipline behavior, we cannot avoid that substantive dispute by emphasizing these institutional and constitutional aspects. Only after we assume at least a range of potential agreement on substance can we face the instrumental question of the type of

16. Hall v. Geiger, 242 U.S. 539 (1917).

17. *Cf.* The opinion of the Nebraska Attorney General that a post-*MITE* statute which requires certain disclosures in connection with takeover bids for the shares of any corporation having more than 35 shareholders in Nebraska violates the commerce clause even where the only effective remedy provided is an injunction against transactions with such Nebraska residents. [1982-1984 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 71,845 (April 2, 1983).

18. OHIO REV. CODE ANN. § 1701.831-832 (Page Supp. 1984).

19. MD. CORPS. & ASS'NS CODE ANN. §§ 3-202, 3-601, 3-603, 8-301 (1975 & Supp. 1983).

20. *See, e.g.*, VA. CODE §§ 13.1-528 to 13.1-540 (1978 & Supp. 1983).

lawmaking suited to development of appropriate rules: whether it should be common law, or statutory, state or federal, varied or uniform (especially in the uniform common law rather than the statutory mode which underlies the ALI Corporate Governance Project).

Having said that, however, I do agree that the list provided by Professor Kozyris, and his discussion of the preemption and commerce clause principles, serve to remind us of one important fact. While we debate the legitimacy of federal versus state control of the agenda under a more or less explicit assumption of the desirability of constraining if not actually regulatory substantive rules, we see on the other hand a powerful and quite conscious use of the federal control of the agenda to establish deregulatory and unconstraining rules led by the Supreme Court.

The actual holding is not necessarily the most interesting thing about *MITE*; it is perfectly legitimate to debate whether state takeover statutes have any role to play in that process or whether they simply clutter up the field. Interesting, rather, is the choice of constitutional doctrine on which that result was based, and certain key statements by Justice White used to justify that particular doctrine. You will recall that he starts with a Williams Act preemption argument under the supremacy clause, striking down the Illinois statute on that basis. He did not get the votes on that approach. The votes came when he went in the common law constitutional direction and used the dormant commerce clause as his rationale—the argument that the commerce clause, even without implementation through federal legislation, stood in the way of this sort of state legislation. This, and particularly this sequence, was an astonishing way to go at the problem. He was joined by others who apparently agreed with, if they did not put it quite so bluntly as, Justice Powell when he said, basically, "I join, under Commerce Clause rather than under supremacy clause principles, because they give me more room for prudential reaction on a case by case basis;"[21] in other words, he was joined by some who stated a wish to retain maximum discretion in the Court.

That raises an interesting substantive connecting point. In his 1937 lectures Justice Frankfurter, before joining the Court, provided a provocative aphorism about the dormant commerce clause: that until Congress speaks, from the perspective of the states, *laissez faire* is the regulator.[22] Characterizing the Supreme Court's role in the federal system in the 1930's, he suggested that it was on record as saying, in essence, that the states had no place in our system for anything but classical liberal and facilitative lawmaking. They could not experiment with mercantilist or other interventionist types of economic law. For his purpose of demonstrating the need for a maximally expansive affirmative federal commerce clause power, that was a useful characterization. *MITE* is a very powerful but in a sense also a very dangerous reaffirmation of this then-persuasive point. At the critical juncture in Justice White's opinion as to why the Illinois act fell afoul of the dormant commerce clause, he says, quoting the Easterbrook-Fischel thesis,[23] that it is bad because it interferes with the

21. 457 U.S. 624, 646 (1982) (Powell, J., concurring).

22. F. FRANKFURTER, THE COMMERCE CLAUSE UNDER MARSHALL, TANEY AND WAITE 100 (1937).

23. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1173–74 (1981).

ability of target company shareholders to enjoy free and flexible access to the stock market for investment transactions and thus interferes with or inhibits the efficient allocation of resources.[24] If that isn't a modern version of Herbert Spencer's *Social Statics*,[25] I don't know what it is.

The interesting issue of today, therefore, is that such a free-wheeling agenda power has been left in the hands of, or seized by, the Court. While we struggle with the federalizing of the minimum standards of corporate governance in the constraining/regulatory direction Professor Kozyris mentioned, we find a much stronger opposite use of federalization for the substantive purpose of dismantling such governance rules as traditionally have been located at the state level. There is presently pending before the Supreme Court—though as a preemption, not as a dormant commerce clause matter—a California case which had upheld the state statutory prohibition of arbitration of certain types of franchising disputes. Certiorari was granted to test the scope of the Federal Arbitration Act on this preemptive issue.[26] I have always thought of that statute as a procedural one that provides a sympathetic framework for arbitration but does not mandate arbitration in areas which any given jurisdiction, state or federal, chooses to identify as a public law area not suitable for arbitration.

It is, overall, an amazing development. We have had the inspection of a foreign corporation's shareholder list seriously challenged as a dormant commerce clause violation.[27] Professor Kozyris mentioned section 2115 of the California Corporations Code,[28] which applies substantive California corporation law to companies incorporated elsewhere whose vital signs—percentage of shareholders, revenues and payroll—are Californian. The major attack that Justice Grodin had to deal with in the case upholding that section[29] was not a full faith and credit challenge, which is trivial in this context, but a dormant commerce clause attack. It was argued that the statute would interfere with shareholders' investment decisions if California law now followed them to this minimal degree as they moved out of California (through foreign incorporation). I think it is an inane argument, and that it is absurd to have to waste time on its rebuttal. It is a kind of "Princess and the Pea" argument. I am supposed to feel the constraint on commerce through a twenty-mattress layer of effects from this original statutory cause.

These are important agenda items of today, and we should not lose sight of them as we look at the items posed by Professor Schwartz in his address. How they will be settled we don't yet know; but in any event the large issue for us is not that of federalism per se, but that of the substantive law—when is the federal approach the

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24. Edgar v. MITE Corp., 457 U.S. 624, 643 (1982).

25. H. SPENCER, SOCIAL STATICS (1890).

26. Southland Corp. v. Keating, 104 S. Ct. 852 (1984), decided following this Conference, in which the Supreme Court said that the Federal Arbitration Act rested on Congress' commerce clause authority to enact substantive law, applicable in state as well as federal court. The Court held that the California Franchise Investment Law, which provides for only judicial resolution of claims arising under that statute, directly conflicts with the Federal Arbitration Act and so violates the supremacy clause.

27. Valtz v. Penta Investment Corp., 139 Cal. App. 3d 803, 188 Cal. Rptr. 922 (1983).

28. CAL. CORP. CODE § 2115 (West Supp. 1984).

29. Wilson v. Louisiana-Pacific Resources, Inc., 138 Cal. App. 3d 216, 187 Cal. Rptr. 852 (1982).

best one with which to achieve good legal rules, and when is the state approach better.

Prof. Ash: Thank you, Professor Buxbaum. Our last speaker this afternoon will be Dean Jesse Choper. Richard has just suggested that we not worry about the issues of federalism as such and that we concentrate perhaps more on policy. Let's take this opportunity to turn to Jesse as a constitutional lawyer and try to get some feel for what this concept of federalism is. How is it really applicable to this corporate governance situation?

Dean Choper: As the last speaker this afternoon, let me play the spoilsport. I'll follow up on what Dick Buxbaum said by observing that not only *should* we not be too concerned with federalism issues on this panel, which is entitled "Federalism Issues in Corporate Governance," but indeed that in fact we *have not* been very much concerned with federalism issues. Although we have had a splendid paper by Don Schwartz and some very valuable and controversial discussion, I think that its relationship to federalism has been remote at best. I would like to make three points that relate to the issue of federalism as normally conceived—that is, the allocation of power in our system between the national government and the states. They concern (1) the power of Congress, (2) the power of the Executive Branch acting through its quasi-independent agency, the Securities and Exchange Commission, and (3) the power of the federal courts.

First, I think it is important to understand that the issue of the power of Congress in respect to corporate governance is not whether Congress has the power to pass a federal corporation law that regulates all of the topics that have been traditionally covered by state law. (I would like to add a fairly long footnote saying that I have little doubt that under existing doctrines of congressional power, Congress would have authority to do that—to cover *all* corporations, not simply those presently within the jurisdiction of the Securities and Exchange Commission. I think that the so-called "national economic effect" branch of Congress' power under the commerce clause would permit it to do so. Under this branch's rationale, even if an individual entity covered by the reach of federal legislation does not itself have a substantial effect on interstate commerce, so long as all of those covered in the aggregate have that sort of effect, Congress has the power to regulate. Moreover, Congress could use another branch of its commerce power—its authority over those who use the facilities of interstate commerce. Even one-person corporations use interstate facilities, as is plainly evidenced by the application of the federal Rule 10b-5[30] to very small businesses.) But that is not the issue so far as our consideration of corporate governance goes. We are not concerned—Mel, even you are not concerned—with outside directors for wholly owned corporations. The issue here concerns governance of public corporations. If they are not giant corporations, they are still relatively large, and I am sure the Supreme Court would have no difficulty confirming a congressional judgment that these kinds of corporations have a substantial impact on interstate commerce. So, my first point is that Congress plainly has the power to mandate all of

30. 17 C.F.R. § 240.10b-5 (1984).

the solutions that are being proposed; and so far as its ability to preempt any contrary state law, that is really not an issue of constitutionality but rather a question of policy. Congress has the authority to mandate these reforms, and it has the concomitant power to preempt all inconsistent state law.

Second, what is the power of the executive-administrative branch of the federal government in this respect? That concerns the SEC. Again, there is no real constitutional question here. Don Schwartz's paper suggests a number of quite ingenious tactics that the SEC might employ, and the issue so far as federalism is concerned is only whether these tactics are within its statutory authority. As Don pointed out, the issue is simply whether Congress granted the SEC the specific or general authority to engage in this sort of conduct.

The third point I think is the most interesting from the standpoint of constitutional structure. It involves the power of the federal courts, which have taken an enormously activist role on issues which were traditionally state corporation law matters. This began in the 1940's with the implication of a civil damages remedy under Rule 10b-5 despite serious difficulties. We have essentially come to forget about those difficulties—the provision of specific remedies in other statutes, and so forth. Indeed, the issue didn't reach the Supreme Court for a quarter of a century after the principle was first announced. I would venture to say that had that issue not first been decided back in 1946, in *Kardon v. National Gypsum Co.*,[31] the present Supreme Court would have thought very, very seriously about holding that there is no implied civil damages remedy under Rule 10b-5. Indeed, I think that even the prior Supreme Court, when it decided the *Bankers Life*[32] case in 1971, might have had substantial difficulty were it not already the doctrine in every circuit that there was an implied civil remedy under Rule 10b-5. So the federal courts have been very activist here. That really, however, is not so much an issue of federalism from the standpoint of constitutional structure, although it has a very substantial impact on federalism issues because the federal courts have been regulating what was traditionally handled by state law.

I think the constitutional structure issue of greater importance is one of separation of powers. That is, given the proposition that the national government plainly has the power to do this, should it be done through the politically irresponsible vehicle of the federal judiciary rather than by Congress?

However, I was taken, Don, by what I am sure you considered to be a very minor point in your paper, but a very interesting one. It dealt with the question of whether federal courts ought not to employ the doctrine of abstention to a greater degree when confronted with a mixed federal and state law issue. You suggested that when a federal court is asked to determine—as it is asked under the shareholder proposal rule,[33] and as it is often now asked in post-*Santa Fe*[34] Rule 10b-5 cases—what state law is, it might, as it does in other areas with some frequency, say to the

31. 69 F. Supp. 512 (E.D. Pa. 1946).
32. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).
33. 17 C.F.R. § 240.14a-8 (1984).
34. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

parties that they should go off to state court and get an authoritative state interpretation of this question before it can resolve the federal issue. To this extent, the action of the federal courts does relate to the overall question of federalism in corporate governance. But I think it is largely and more interestingly a separation of powers issue.

In summary, I don't think that the topic that we are talking about—corporate governance—presents any significant federalism issues as a matter of constitutional law and structure. I think that there are some issues of federalism as a matter of policy, but the great policy issues are not ones of federalism. They are of substance. At the extreme, they are whether we are to have regulation or no regulation. They are whether regulation ought to come through bodies such as the stock exchanges or whether it ought to come by legislation—not federal versus state legislation so much as legislation by some governmental body versus regulation by some non-governmental body.

Finally, let me read one short paragraph from Don's paper, which is probably the only thing that I don't agree with. He says, "Determining the proper role for federal law in corporate governance is not simply, or primarily, an analysis of the power of the congress, federal agencies and federal courts."[35] I agree. Don goes on to say it is mainly a consideration of whether and how these bodies should act. "Policy, not power, is the main federalism issue in corporate governance."[36] No, I don't think so. Policy *is* the main issue in corporate governance, but not the main *federalism* issue. Therefore, I think that despite the discussion here of very important issues, the discussion has had little to do with federalism. I would end by saying that despite Don's heroic efforts to make federalism an issue—for example, by characterizing the American Law Institute proposals as raising issues of federalism because they have some national impact—I think maybe we ought to put the federalism issue to rest and go on to more important things.

Prof. Ash: Thank you, Jesse. At this point let me give Don one or perhaps even two minutes to make a few concluding comments.

Prof. Schwartz: Jesse, I agree with you. I was looking for the paragraph in the paper because I am striking the word federalism from the final version. You are absolutely right. I agree with just about everything else you had to say too. But I addressed federalism, Jesse, because that is what they paid me to do.

I just have a very few comments to make. The real issue is, of course, a policy question and not a power question, but that is only after you are satisfied that the power question is not an issue. Analytically, I think we owe it to ourselves to see what the issue is, and it sort of disappears as you look at it closely. This kind of a program held a number of years ago would have looked at this subject from a very different point of view. Although I don't have time to take up everybody's comments, I just want to make one reference to what Herb Hansell had to say regarding the notion of caution as being important in this. It certainly is. That is the way I perceive the ALI approach. It doesn't attempt to limit management's substantive

35. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 584 (1984).
36. *Id.*

conduct. It doesn't create federal standards as to what managers ought to do. I think it essentially designs the bottle; it doesn't pour any substance into it. That is for the managers to do themselves. It just wants to design the bottle so it will stand up under pressure in the kind of changing economic climate that we are moving into.

As to the economic arguments, obviously these are relevant and important and make a useful contribution to the subject, but we are sort of told of the dispositive empirical studies that have been made. Nick Wolfson in his characteristic way of understating his proposition talks about a number of studies having *established* and *proved* certain principles, but I think there ought to be a little more modesty and humility in the way these studies are presented to us. Some of us believe that the studies cannot be so cocksure of themselves and that they are dealing with phenomena that cannot be proved with the same kind of confidence that you can prove something that you can pour into a test tube. We can't strictly control these experiments that come up with this data. Therefore, I conclude not that these things are irrelevant, because they certainly are not, and I have been fortunate to listen to Nick and to Jim over the years and to learn a lot from them, but that judgment and experience are also relevant and cannot be discarded despite the fact that *some* economic studies indicate to the contrary.

Nick has raised the question as to what is the hidden agenda of Mel Eisenberg and his cohorts. One can ask the same question about George Stigler's and Paul McAvoy's hidden agenda. McAvoy's wasn't so well hidden, because he was retained by the Business Roundtable to come up with a document that would disprove the ALI proposals.[37] They didn't study this thing with the question of whether they wanted or didn't want it. They started with the proposition "tell us this isn't any good, McAvoy and some others, and we will pay you for your research." Now I'm sure McAvoy's an honest person and that if his own analysis would have shown he couldn't come up with a response that would favor his client, then he wouldn't have done so. But at the same time I think that all this has to be viewed in perspective, that these were people who were retained to disprove the proposition. Again, I think that the proposals offered by the ALI are useful, but I don't think that they conclude the issue.

Prof. Ash: Thank you. At this point the participants would be willing to entertain any questions or comments from the audience or from other members of the panel. I think, Nick, you wanted to raise a question.

Prof. Wolfson: Yes. I wanted to. Maybe we can make some news today rather than non-news. I wondered if Don and Mel could advise us on the following. I assume that the ALI draftsmen are going to address the issue of whether the duty of loyalty and/or care should circumscribe target management when target management defends against takeovers? What's their current thinking? Will they address it, and how will they approach it? Will they approach it through their common sense gut intuition, or will they use any other methods in attempting to answer that question; and will the answer have some interesting political ramifications; because, I needn't spell it out, to the extent that incumbent management is defended by some new duty

37. McAvoy, *supra* note 7.

of loyalty, that may have an impact on the acceptability of the project. I wonder if there is any thinking on that at this particular point?

Prof. Ash: Mel, would you care to address that?

Prof. Eisenberg: There is a story about the Defense Department. It has its scientists program a computer to determine whether there will be a war, and they put in all the data over a one year period, and finally they ask the computer the question, "Will there be war or peace?", and the computer answers, "Yes." So they put in another question—"Yes, what?" And the computer answers, "Yes, Sir!"

Yes, we will address those issues. I am not the draftsman of those parts and I therefore can't say what they will look like. My own personal view is that I would give wide scope to tender offers. But to say you are going to give wide scope is one thing; to operationalize it is another. I would also say that, as everybody knows, this is not only a very controversial issue, but an issue which involves a lot of emotion and a lot of economics. I think that the views of the draftsmen, who will probably be Marshall Small and Harvey Goldschmid—and Harvey will be on the panel tomorrow—would be more appropriate. So maybe Harvey should be addressed. But the views of the draftsmen, whatever they are, are going to come under the most searching inquiry.

Prof. Ash: I will recognize from the audience first Professor Painter.

Prof. Painter:[38] I have an observation—I think a question—with respect to Professor Buxbaum's keynote address and also something that Mel Eisenberg said.

They both mentioned that the shareholder today is relatively powerless in the sense that he holds a relatively small amount of shares and doesn't play a very active role in monitoring the corporation. That view seems to me not to take into account a phenomenon of which I am sure both speakers are aware, and that is the growing institutionalization, very heavy institutionalization, of the market, which highlights the fact that if you have large institutional investors with increasingly large blocs of stock, it could well be that these institutional investors (in fact, I think there is increasing evidence of this) will not vote with their feet and follow the Wall Street Rule, because they have enormous blocs of stock which are relatively difficult to unload at a decent price without upsetting the market. So they are increasingly sensitive to what should be their responsibility as shareholders to perform their monitoring function. So it seems to me that perhaps the influence of this argument in favor of the market for corporate control should be evaluated in that light.

The second thing, and I'd like to pose this to Mel Eisenberg or those who are generally backing the ALI project and I think I do myself, is the general approach. There is a great deal of stress upon the importance of the independent directors. Now the problem I have with that concept, that is without analyzing it further, is that I have a difficult time determining just what is meant by the term "independent director." In the ALI Draft No. 1, they define that in terms of a significant relationship with the senior executives of the corporation—in Section 1.24, as I read that definition.[39] If I

38. William H. Painter, Professor of Law, University of Illinois.

39. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 1.24 (Tent. Draft No. 1, 1982).

were the chief executive officer of a corporation and I wanted to have people who complied with that definition, that is, so-called outside directors having no significant relationship, I wouldn't have much difficulty, frankly, myself—which raises the question why so many people, opponents of the project, seem so sensitive on this in finding people with a similar business philosophy to be appointed to the board. They would be of the same income level; belong to the same clubs, dress more or less the way I dress, and they would be highly compensated with the implicit understanding that if they didn't go along with management the management could withhold the nomination. They just wouldn't be there next year. Which reminds me of a story that was told me by a colleague who was serving on a judicial ethics committee in one of our states. He said that the minute he really tries to do his job (and he wasn't highly compensated) he found that he just wasn't up for appointment next year. I just wonder whether some of these concepts should really be evaluated in terms of what the realities are—first the reality of the institutionalization of the market and second this concept that would seem to me to be a very difficult thing to pin down—when do you really have an independent director?

Prof. Ash: Dick, would you address the first point?

Prof. Buxbaum: Let me just address the institutional investor issue, which of course is important. Until recently, there might have been a hope, if not yet a demonstration, that the institutional investors indeed would vote not with their feet, but, being locked into their market positions as they were, would have no choice but to fight by really using their vote. That, of course, was never really true of the mutual fund type of institutional investor, which itself is hostage to the value of its own shares and cannot afford to stay and fight; rather, it has to move fast and at worst cut its losses. Even as to institutional investors of the pension and insurance company type, however, investors which could take the long view and use the vote, the invention of off-board bloc trading during the last decade has, it seems, substantially ended that developing effort to stay in.

Questioner: Isn't there some evidence that institutional investors are becoming less responsive to management suggestions to vote for shark repellent amendments and that type of thing?

Prof. Buxbaum: I think there is one specific area in which institutional investors do have their own vested position, and that is exactly this anti-takeover protection area. That is explicitly one in which they want maximum freedom to do the best investment job in terms of bloc sale profit, and do not wish to leave such decisions to a management that may only want to position itself for the best possible negotiations as to its own treatment. They need to make up their own minds. But as to all other voting matters concerning corporate governance, it seems the recent article by Professor Lowenstein[40] has a fairly nice demonstration that the hope that these investors would stay and fight rather than vote with their feet simply did not survive the introduction of bloc trading.

40. Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983).

Prof. Eisenberg: Well, let me address both issues. To a large extent these are questions of nuance. Nick and I were talking just now, and agreed that if we had time to have a long discussion even we might agree—that is, in a sense even the questions between us are questions of nuance. I do think that institutional investors are a constraint, and the question is how much of a constraint. I think that, as Dick suggested, they are more likely not to vote with their feet on issues of certificate amendment, or perhaps merger, than on issues of ousting an incumbent board. I think if they don't like management the general tendency is to sell rather than try to change the management. I would say that this is not always the case. The GAF fight is an example where institutional investors got behind a proxy fight and voted to change management.[41] So again I want to say this is a constraint, and my own feeling would simply be, "good, let's strengthen it." But, it is, like the markets, a constraint which will not do the job in itself.

On the second point, again I don't want to overemphasize how much good independent directors will do. I think the main issue really has to be how well managers perform, in terms of efficiency. Much of what you said about the limitations of independent managers is forceful in terms of the past. Hopefully, the institution of nominating committees will alleviate this problem. Another element that may alleviate this problem lies in the sociology of management, which is that the tenure of a chief executive officer is frequently around five to seven years before retirement, as I understand it, and a board which consisted of friends of the outgoing chief executive, and which was hand-picked by the outgoing chief executive, may not feel quite the same relationship to the incoming chief executive. So that once this concept gets off the ground, it may not be as subject to the kinds of criticism you mentioned. Finally, I think there has been a change in the culture of the board, so that directors are now trying harder to create an atmosphere of independent oversight. Again, the board has to work cooperatively with the management. You can't have an adversarial relationship, but it has got to be, as I have sometimes said, the kind of relationship you have between a dean and a faculty member, which is supportive but yet somewhat dispassionate—and mostly supportive for you, Jesse, of course. So, I think putting these kinds of provisions into effect would help create that atmosphere, but I think the dangers you point to are real ones and I am not going to say they are not.

Prof. Ash: Nick, did you wish to comment on that point?

Prof. Wolfson: Yes, I think that Bill's question and the replies, particularly Dick's reply, renew again a point that I want to emphasize anew, the parable of the rectangular or spherical chicken.[42] It is one that I have been sensitized to over the last ten or twelve years. Bill asked whether institutional investors are walking or fighting. He asked a relevant significant empirical question. Now if you and I are in a war zone, and we have to make a decision instantly, we won't commission even Professor McAvoy for a long study. And when I make decisions during the day I do the same, and you do the same in your busy practice. But that question that he asked is a

41. *See* GAF Corp. v. Heyman, 724 F.2d 727 (2d Cir. 1983).

42. Shuchman, *supra* note 5, at 66.

significant empirical question, and it can be approached in two ways. We can approach it in the typical unfortunate manner in which a few people get together and they kick it around and they say, "I think they're walking, what do you think?" "I think they're walking, well I guess they're walking. We better have a law." Or we can do some research. Now lawyers, I include myself, are not trained in those forms of research and hence we're naturally hostile to them, although in litigation we're smart enough to use them. But I'm not talking about a litigation context. I'm talking about an objective mode. You can't do it casually; you've got to have some model and test the model. Unfortunately there is a dearth of that. There's the usual instinct of lawyers to say: (a) it takes too much time or (b) it can't be done and (c) when it's done I don't trust the data. I suggest that one of the things we have to learn is that there can be a fruitful dialogue between lawyers and law professors and economists and other practitioners of the social arts, some of us perhaps would call them the social mysteries, and that there is fruitful dialogue that we can engage in, in which we contribute our respective strengths in all of those areas where the exigencies of the moment do not require instant decisions. I think the question whether Detroit is going to meet Japanese production efficiency is fairly urgent. I don't think independent directors are going to help. I really don't think that the addition of a few independent directors is going to solve, or begin to solve, or have any relationship to the competitive pressures between Detroit, Japan, and Western Europe.

Prof. Ash: Professor Painter's questions have elicited even another response. Professor Kozyris.

Prof. Kozyris: My response relates to Dean Choper's spoil-sporting, and I'd like to question it a little with a very brief observation. I think he is right, and all of us agree that there is federal power to do the job. But Professor Buxbaum has a point when he argues that if that power is not exercised then the issue becomes one of the authority of one state versus that of another, which is still an issue raising federal concern. Thus, we have two federalism issues here. One involves the implications of Congressional inaction in corporate governance, and another relates to the constitutional limits on state power resulting from the co-equal sovereignty of the other states. Both have practical consequences. The state takeover statutes, where all the fighting is taking place, involve both these federalist concerns. So respectfully, since I am not a constitutional lawyer, I register an objection to the Choper challenge.

Prof. Ash: Does the audience have any further questions?

Prof. Shipman:[43] Yes, I'd like to take the same tack as Professor Kozyris. I think it is a very significant policy when Congress decides not to go into an area, as well as when it does go into an area; and, as Richard has pointed out, the negative side of the commerce clause has inevitably cast Congress into this in a big way. To decide not to go in is a major decision that leads me to a question. Mel, this may be controversial, but it ought to be asked; if the ALI approves this draft, do you really think each state would adopt it one by one, the way things have gone before, or is it really a draft addressed to Congress for a minimum standard legislation?

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43. Morgan Shipman, Professor of Law, The Ohio State University.

Prof. Eisenberg: Right now, as the Draft has been revised, the only requirement for corporate structure is for an audit committee in corporations equivalent to Big Board corporations, and that would not be worth fighting about for federal law. Let me go back to a federalism issue, Morgan, and that is the conflicts rule we have now. I guess my first impetus as a corporate law scholar is to ask the question that we have heard talked about: Is a rule of corporate law a good law or bad law? And the second question is the one you raised—how would the rule get effected? There is an alternative between what we have now, the race to the bottom, and a minimum standards act. That alternative is a conflict of laws rule that does not make the law of internal corporate affairs depend on the state of incorporation, but makes it depend, for example, on principal place of business—which is not as easy to select as a state of incorporation, because a lot of businessmen don't want to live in Delaware. We have one state, Connecticut, that has adopted an audit committee provision. I have at least modest hopes that you could accomplish some changes on a state level. I think the states, many states, simply haven't had alternatives before them, because the political process of corporate law is such that when they came to modernize their statute they tend to have before them only the Model Act as a possibility. California, which is a major commercial state and with a Bar that doesn't differ significantly from, is as conservative or liberal as, any other Bar, adopted a lot of good provisions that are still absent in other states. So while a minimum standards act is one sort of solution, I don't think it is the only possible solution.

Prof. Ash: We have time for just one more question. I will recognize the gentleman on the aisle to ask that last question.

Questioner: I would like to make a statement. I happen to be a congressman—and relax, gentlemen—because most econometric studies are all based on a system of assumptions. And according to which assumption one builds into one's model, one will get different conclusions. And so we can't simply appeal to the facts. Facts are too complex in the social world and that is a reality.