

Relationship Investing: Will It Happen? Will It Work?

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I. INTRODUCTION

Sixty years ago, in *The Modern Corporation and Private Property*,¹ Berle and Means explained that the separation of ownership and control in the modern public corporation interferes with the ability of stockholders effectively to monitor corporate decisionmakers. More recently, scholars have elaborated on Berle and Means' hypothesis, explaining that agency costs and collective action problems both limit the ability of shareholders to monitor and reduce the financial incentives to do so.²

Current academic scholarship suggests a possible solution to the problem of inadequate monitoring by shareholders. Responding to ongoing changes in the nature of shareholding, particularly the move from dispersed individual shareholders to an aggregation of holdings in mutual funds, pension funds, and insurance companies, commentators argue that the growth of institutional investors provides the answer to traditional problems of shareholder participation in corporate governance.³

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

² See, e.g., Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 454 n.29 (1991) (summarizing literature discussing collective action problem in the corporate context). For an overview of the problem associated with collective action, see MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (2d ed. 1971).

³ See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 830-49 (1992) [hereinafter Black, *Agents Watching Agents*]; Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991);

Advocates of institutional investor activism assert that institutions, because of their larger investment stake and better access to information, can monitor corporate decisionmaking more easily than individual shareholders, and that the larger proportionate holdings of these investors make monitoring more profitable, overcoming collective action problems.⁴ Using models that portray money spent on monitoring as an investment, these scholars argue that, as the size of an investor's shareholdings in a company grows, the cost of monitoring is more easily justified. Hence the large investor, commonly the institutional investor, is more likely to monitor.

The investment community has most recently focused its attention on a new form of investor activism: relationship investing.⁵ Relationship investing may be described as a large long-term financial commitment by an investor to a portfolio company in exchange for a say as to how it is run.⁶ Promoters of relationship investing tout it as a vehicle for establishing long-term advisory relationships between institutional investors and the companies in which they invest.⁷ They argue that relationship investing will provide accountability for management through the presence of investors with a sufficient stake to monitor.⁸ Because of its long-term

Robert G. Vanecko, *Regulations 14A and 13D and the Role of Institutional Investors in Corporate Governance*, 87 NW. U. L. REV. 376, 381-82 (1992); Bernard S. Black, *Beyond Proxy Reform*, INSIGHTS (Mar. 1993), at 2 [hereinafter Black, *Beyond Proxy Reform*].

⁴ See, e.g., Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Toward Proxy Contests*, 78 CAL. L. REV. 1071, 1081 (1990); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 907; Henry T.C. Hu, *Risk, Time and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 374 (1990).

⁵ See, e.g., Judith H. Dobrzynski, *Relationship Investing*, BUS. WK., Mar. 15, 1993, at 68 (describing relationship investing as "[a] provocative new investment idea"); Felix Rohatyn, Dinner Address at the Relational Investing Conference (New York, May 6, 1993) (on file with author) ("'Relationships' are now in vogue. . . ."). In May, 1993, the Columbia Institutional Investor Project sponsored a two-day conference on relationship investing, which involved the most extensive treatment of the subject to date.

⁶ Martin Dickson, *Crusaders in the Capitalist Cause: U.S. Shareholder Activists Are Gearing Up to Make Underperforming Managements More Accountable*, FIN. TIMES, Mar. 17, 1993, at 17; cf. Dobrzynski, *supra* note 5, at 68 (describing relationship investing as any established committed link between a company and one or more of its shareholders).

⁷ David Vise, *Shifting the Boardroom Balance of Power*, WASH. POST, Mar. 6, 1993, at D1.

⁸ Dobrzynski, *supra* note 5.

orientation, relationship investing is also more palatable politically, as it responds to the common criticism that institutional investors are focused too heavily on the short term.⁹

A few skeptics question the premise that institutional investors will be able to engage in more effective monitoring than traditional shareholders. One issue is whether institutions will accept the limitations on investment flexibility¹⁰ that may result from more active participation in corporate governance.¹¹ Another concern is whether institutions possess the necessary expertise to monitor effectively, even if they are willing to monitor.¹² Political constraints also restrict the activism of many institutional investors.¹³ Finally, various state and federal laws prevent some institutions from active participation in corporate governance, and public concerns about the appropriate role and balance of power for such institutions may limit legal reform.¹⁴

This Article challenges the received academic wisdom in favor of relationship investing from another and more fundamental perspective: it argues that relationship investing is less attractive to the rational investor and hence less likely to occur than its advocates have contended. Relationship investing will be the exception, not the rule, unless the companies concerned are allowed to confer special benefits on the relationship investor. There has been no showing, to date, that such benefits are warranted.

The focus of this Article is on the traditional economic model that explains the investor's decision to monitor in terms of an evaluation of the relative costs and benefits of monitoring. The Article concludes that the traditional model is incomplete because it does not adequately account for the competitive environment in which institutions operate and are

⁹ *Id.*

¹⁰ Long-term activism may require an investor to sacrifice liquidity. See John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991). In addition, certain types of participation in corporate governance, such as board representation, may place additional limits on an investor's freedom to trade by, for example, subjecting the investor to insider trading liability or liability for short swing trading under § 16 of the Securities Exchange Act of 1934.

¹¹ See *id.* (questioning whether institutional investors will sacrifice liquidity for greater control over portfolio companies).

¹² *E.g.*, Vanecko, *supra* note 3, at 406-08.

¹³ *E.g.*, Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

¹⁴ *E.g.*, Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991).

evaluated. The model is premised on the assumption that investors will monitor whenever monitoring increases their profits in absolute terms. It fails to account for the fact that the performance of many institutional investors is evaluated on a comparative rather than an absolute basis. In other words, a rational investor will not monitor if monitoring confers greater benefits on competitors who, as free riders, are able to benefit from the stock price increases caused by the monitoring without incurring its costs.

Judging investments in comparative rather than absolute terms affects the operation of the model and causes the rational institutional investor to invest less in monitoring than traditional theory would indicate. Moreover, in order for an investor to benefit, on a comparative basis, from monitoring, it must increase its relative stake in the target company. This concentration, because it increases the risk of the investment, again increases the cost of monitoring. This Article will demonstrate the effect of this approach on the economic model of monitoring and demonstrate that, because of these additions to the model, institutional activism is less likely to occur than traditional theory would indicate.

The role of competition in the monitoring decision helps explain why few institutions have engaged in relationship investing. This Article also evaluates recent evidence on the extent of institutional activism and argues that the creation of an opportunity for a large investor to obtain private gains¹⁵ better explains the existence of specific relationships than the enhancement of corporate decisionmaking.

The ability to generate private gains operates to counter some of the effects of competition and to make institutional activism more likely. If we wish to see relationship investing play a significant role in the economy, the law will have to facilitate, or at least not hinder, transactions that allow the creation of private gains. Changing the law is appropriate, however, only if relationship investing improves corporate performance. In its final section, drawing on previous critiques of relationship investing, this Article examines the limited evidence on the value of relationship investing.

¹⁵ Private gains are returns from relationship investing that accrue to the activist shareholder in some proportion greater than the shareholder's pro rata interest in the company. See discussion *infra* part IV.C.

II. SHAREHOLDER MONITORING AND THE PROMISE OF INSTITUTIONAL VOICE

Classical corporate theory is, by and large, based on the notion of shareholder primacy.¹⁶ Although state statutes provide that the corporation is to be managed by or under the direction of the board of directors,¹⁷ management decisions are supposed to be made with a view to promoting the interests of shareholders. The justification for this approach is twofold. First, under classical theories of the corporation, shareholders have the legal status of owners.¹⁸ Second, economic theory dictates that management decisions designed to promote the interests of the residual owners of the corporation are most efficient.¹⁹ Accordingly, increasing the

¹⁶ Members of the modern corporate governance community are divided into two camps: the shareholder primacy camp and the stakeholder camp. The former believe that problems of corporate performance can be attributed to a lack of corporate responsiveness to the needs of shareholders and rectified by solutions that reduce the separation between ownership and control. The latter believe that corporations are properly responsive to the needs of a variety of stakeholders, including employees, creditors, and members of the community and that corporations should be less rather than more responsive to the needs of shareholders. Because relationship investing is advocated as a tool for increasing shareholder primacy, it is unnecessary to examine the stakeholder model in further detail here. To the extent that advocates of the German and Japanese governance models have characterized relationship investing as stakeholder-oriented, based on its ability to further the interests of creditors (banks) in the German model, and customers and suppliers in the Japanese model, this process can alternatively be described as the creation, by these "dual role" investors, of private gains. *See, e.g.*, Julian Franks & Colin Mayer, *Corporate Control: A Synthesis of the International Experience* (working paper presented at Columbia 1993 symposium); *see infra* part IV.C (discussing private gains).

¹⁷ *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1991) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . ."); CAL. CORP. CODE § 300(a) (West 1990) ("the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board."); N.Y. BUS. CORP. LAW § 701 (Consol. 1994) ("[t]he business of a corporation shall be managed under the direction of its board of directors . . .").

¹⁸ *E.g.*, *Rogers v. Hill*, 289 U.S. 582, 589 (1933) (describing shareholders as "the real owners of the corporate property"); *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1124 (Del. Ch. 1990); *In re Steinway*, 53 N.E. 1103, 1105 (N.Y. 1899) (citing cases). *See generally* William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives From History*, 41 STAN. L. REV. 1471 (1989).

¹⁹ *See, e.g.*, Jonathan R. Macey, Symposium, *Fundamental Corporate Changes: Causes, Effects and Legal Responses: Externalities, Firm-Specific Capital Investments*,

fideliy of management decisions to shareholder interests will improve corporate performance.²⁰

As Berle and Means recognized, the separation of ownership and control in the public corporation creates a problem with this approach to corporate governance. The separation of ownership and control results in management by nonowners whose interests diverge from those of the shareholders on whose behalf management decisions are made.²¹ This

and the Legal Treatment of Fundamental and Corporate Changes, 1989 DUKE L.J. 173, 180-81; see also Eugene F. Fama & Michael Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983); Oliver Williamson, *Organizational Form, Residual Claimants, and Corporate Control*, 26 J.L. & ECON. 351 (1983).

This efficiency results from two factors. First, specialized management is likely to outperform diversified owners with respect to the quality of corporate decisions. See, e.g., ALFRED D. CHANDLER, JR., *SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM* 232 (1990) (arguing that separation of ownership and control developed as response to increasing complexity of modern business). Second, commentators argue that the interests of the residual owners, in terms of risk and reward, are most closely akin to the long-term interests of the corporation. Accordingly, a structure that maximizes shareholder value is likely to maximize corporate value. See, e.g., Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); see also ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW 2-3* (AEI Press 1993) (explaining that shareholder primacy model provides clear-cut decisional rule for managers, allocates capital resources and "best matches organizational design with incentives"); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1438 (1993) (defending shareholder wealth maximization model of corporate governance as best able to constrain management sin, because other models allow management to "pursue its own self-interest by playing shareholders off against nonshareholders").

²⁰ The call for increased shareholder monitoring to improve corporate performance is based on two fundamental premises: (1) that corporate governance matters in improving corporate performance, and (2) that U.S. corporate performance is declining, either in absolute terms or relative to international competitors such as German or Japanese corporations, and requires improvement. For a more detailed analysis of the first point, see Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124-25 n.1 (1994) (discussing relationship between corporate governance and performance). On the second point, see Ira M. Millstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485, 1487 (1993) (arguing that a general consensus has found U.S. corporate performance to have fallen behind that of our competitors and concluding that corporate governance can have an "obvious" impact on corporate performance and hence competitiveness).

²¹ See generally Jill E. Fisch, *Frankenstein's Monster Hits the Campaign Trail: An Approach to Regulation of Corporate Political Expenditures*, 32 WM. & MARY L. REV. 587, 633-35 (1991) (describing separation of ownership and control and legal

results in agency costs that prevent the corporation from being operated in the most efficient and profitable manner possible.²²

Monitoring is one way to reduce agency costs.²³ The active participation of shareholders in monitoring corporate management, according to traditional corporate theory, can improve the performance of the corporation.²⁴ Corporate law is based on the premise that shareholder monitoring is valuable; it provides a number of mechanisms by which shareholders can review management decisions and correct improprieties.²⁵

Monitoring, however, is not free. Every instance of shareholder

responses designed to minimize the problems of agent malfeasance).

²² See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976) (describing agency costs created by separation of ownership from control).

²³ One criticism that might be leveled at the literature on shareholder activism is its frequent failure to define or distinguish between different monitoring activities. See, e.g., Black, *Agents Watching Agents*, *supra* note 3, at 813 n.3 (using the terms "monitoring" and "oversight" "interchangeably to refer to the various actions, direct and indirect, formal and informal, that institutional investors can take to assess corporate manager performance and to influence corporate actions"). Monitoring can run the gamut from actively analyzing corporate information and intelligently exercising the corporate franchise, to sponsoring shareholder proposals or making efforts to influence management policy through negotiations with management, to efforts to obtain board representation or effect a complete change in corporate control. See, e.g., Robert D. Rosenbaum & Michael E. Korens, *Institutional Shareholder Activism and Related Proposals for Legislative and Regulatory Changes to Corporate Governance Rules*, 696 PLI/Corp 621 (PLI June 21, 1990) available in DIALOG (describing different types and degrees of institutional activism through use of recent examples). In addition, the threat or exercise of disciplinary measures, ranging from a full-scale proxy contest to initiation of derivative litigation, may be properly viewed as methods of monitoring management. Distinction between monitoring activities is important because different types of monitoring involve vastly different costs, present different types of risks to an investor, and presumably differ in their effectiveness in enhancing corporate performance.

²⁴ See, e.g., Dent, *supra* note 4, at 907-23 (discussing benefits of returning control of corporations to shareholders); cf. Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967) (explaining that public corporation is designed to separate ownership from management, thereby facilitating specialization).

²⁵ These mechanisms include the right of a shareholder under state corporation law to inspect corporate books and records, the shareholder's right to corporate information under the federal securities laws, the ability to replace directors and initiate changes in corporate governance through the voting process, and the use of derivative litigation to correct wrongdoing or recover damages.

monitoring requires the activist shareholder to spend money.²⁶ It will be rational for an investor to spend funds to monitor only when the expected returns generated by monitoring exceed its costs. In mathematical terms,²⁷ if $r(m)$ is the return from monitoring activity m , and $C(m)$ is the cost of monitoring,²⁸ the investor will monitor only when $r(m) - C(m) > 0$.

The traditional explanation for the failure of shareholder monitoring to produce efficiently run corporations is a collective action problem. The growth of large public corporations and the development of a national securities market have led to an investment norm in which investors tend to diversify, that is, to own a small quantity of stock in a large number of companies. From the perspective of an individual investor, diversification can be justified by a variety of factors, including the reduction of risk. Diversified investors are less likely to encounter situations in which it is rational to expend funds to monitor their investments. This is because, while the return to an investor is a function of the quantity of stock owned, monitoring costs are largely unrelated to the size of the investment.

Accordingly, if an investor has only a small stake in a company, the effect of monitoring will have to be enormous to yield the investor a sufficiently large return to justify the expense.²⁹ This causes shareholders to forgo monitoring activities that would benefit them as a group, because

²⁶ See, e.g., Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1837 (1989) (describing costs associated with effective shareholder monitoring through the voting process as including the investment in the acquisition and processing of information necessary to evaluate the merits of the voting decision); Coffee, *supra* note 10, at 1339 n.235 (describing current cost of conducting a proxy campaign in opposition to management at between \$2 million and \$15 million, depending upon the size of the corporation and the specific proposal). Monitoring entails a variety of indirect costs as well, including, for example, the risk of business reprisals for opposing corporate management. *Id.*

²⁷ Although the mathematical model is of limited utility in explaining this simple preliminary concept, it is introduced here as a basis for subsequent development.

²⁸ Costs are expressed as a function of m because the cost of monitoring varies with the nature of the particular form of monitoring. For example, the cost associated with the intelligent exercise of the corporate franchise is considerably less than the cost of mounting a full-scale proxy contest.

²⁹ Small individual stakes make shareholder apathy rational because many monitoring activities, if conducted by small investors, will not affect corporate decisionmaking. For example, Professor Dent describes this "rational apathy" by institutional investors in connection with proxy voting by explaining that, if a shareholder cannot affect the outcome of a vote, a rational level of investment in voting is zero. See Dent, *supra* note 4, at 903.

no single shareholder can justify the cost of monitoring.³⁰ Because the problem can be attributed to the inability of a large dispersed shareholder body to apportion the costs of monitoring within the collective group, it is described as a collective action problem.³¹

In mathematical terms, we can see the effect of shareholder dispersion and diversification on the monitoring decision as follows. If a corporation were owned by a single shareholder, the entire return from monitoring, which we can designate $R(m)$, would accrue to that shareholder. Thus, in the single shareholder scenario, $R(m)$ equals $r(m)$, the return to the shareholder. In a corporation with multiple shareholders, however, no single investor reaps the entire benefit of monitoring. Instead, returns accrue to each investor on a pro rata basis, reflecting that investor's ownership interest in the company. An investor who owns ten percent of the company, for example, will receive returns of $(10\%)R(m)$. If we designate as $k(i)$ the percentage ownership by the monitoring investor in company i , we can then distinguish returns to the investor, $r(m)$, from returns to the group as follows: $k(i)R(m) = r(m)$.

The result is a collective action problem because, although an investor will monitor only in situations where $k(i)R(m) - C(m) > 0$, it would be socially beneficial for monitoring to occur whenever $R(m) - C(m) > 0$. If it were possible for shareholders to act collectively and to apportion the costs on a pro rata basis, monitoring would occur more frequently. Thus collective action problems explain the failure of investors to engage in the socially optimal level of monitoring activity.

This model can be used to demonstrate why institutional activism offers the possibility of greater monitoring. Recent years have seen an overwhelming increase in the amount of stock held by institutional investors, both in absolute and relative terms.³² Because institutional stakes

³⁰ For a numerical illustration of this point, see Coffee, *supra* note 10, at 1285–86 n.23.

³¹ The difficulty in apportioning the costs of a collective good among the beneficiaries of that good is the classic collective action problem. Included in this concept is the related problem of free-riding, which results from the fact that beneficiaries of a collective good often cannot be excluded from enjoying the benefit even if they do not share in the costs of producing the good. For an extended discussion of the collective action problems presented by dispersed shareholder efforts to monitor corporate management, see Rock, *supra* note 2, at 454–63.

³² For example, recent data published by the Board of Governors of the Federal Reserve shows that institutions now hold 54.2% of the \$4.96 trillion market value of stock outstanding and that only 45.8% is held by individuals. The greatest relative increase in shareholdings is by private pension funds, and mutual funds, which together now own about a third of the outstanding equity. *Institutions Hold Dominant*

in corporations are typically larger than those held by individuals, institutions will monitor more frequently. Institutions can justify spending money to monitor because the gains that accrue to a large shareholder from monitoring more often exceed the costs of monitoring.³³

Other considerations strengthen this conclusion. It may cost institutional investors less to monitor due to their greater sophistication and superior access to information.³⁴ Because of their size and the quantity of resources they control, they may also have more influence with corporate management, making their monitoring activities more effective. The traditional model suggests that both these factors increase the number of situations in which the benefits of monitoring will exceed the costs.

This model of institutional monitoring has gathered widespread support.³⁵ It has also generated proposals for legislative reform designed both to facilitate large shareholdings by institutions and to reduce the costs of activism.³⁶ The most notable response to these proposals has been the Securities & Exchange Commission (SEC)'s recent liberalization of the federal proxy rules. After two sets of proposed amendments to the proxy rules and an extensive comment process, the SEC substantially amended the rules on October 16, 1992. The amendments were made in direct response to complaints by institutional investors that the proxy rules

Stake in Equities Market, Fed Board Data Show, 25 SEC. REG. & L. REP. 943 (July 9, 1993). The evolution and significance of the institutional investor is fairly new; as recently as 1965, individuals owned 84% of outstanding stock. *Id.*

³³ See, e.g., Rock, *supra* note 2, at 459 (describing how increased institutionalization of shareholdings will allow shareholders to organize more easily to overcome collective action problems).

³⁴ One way in which institutions have already explored this process is by pooling information and monitoring activities through organizations like Institutional Shareholder Services. Professors Gilson and Kraakman urge an expansion of this approach, suggesting that institutions can significantly reduce collective action costs by joining together to support a new class of professional independent directors. Gilson & Kraakman, *supra* note 3.

³⁵ See, e.g., Black, *Agents Watching Agents*, *supra* note 3, at 830-49; Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988); Dent, *supra* note 4; Gilson & Kraakman, *supra* note 3; Vanecko, *supra* note 3, at 381-82; Black, *Beyond Proxy Reform*, *supra* note 3, at 2.

³⁶ See, e.g., Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1, 49-52 (1992) (suggesting reforms to federal proxy rules to remove obstacles to institutional shareholder activism); Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985, 1010 (1993) (proposing exemptions from Investment Company Act of 1940 to allow development of Managerial Strategic Investment Companies to engage in monitoring of publicly held corporations).

prevented them from communicating with one another and participating effectively in corporate governance.³⁷ Among other things, the amendments eliminated the requirement that shareholders who actively participate in the proxy solicitation process report their participation to the SEC.³⁸ According to the SEC, the amendments were "intended to facilitate shareholder communications and to enhance informed proxy voting, and to reduce the cost of compliance for all persons engaged in a proxy solicitation."³⁹

III. RATIONAL CHOICE AND THE INSTITUTIONAL INVESTOR: THE COMPLICATION OF COMPETITION

The foregoing analysis suggests that institutional investing is likely to provide a response to the collective action problem because it allows investors to overcome the cost barrier to active investing. This analysis has led many to predict an increase in relationship investing. This section suggests that, in spite of the advent of increased numbers of institutional investors with large ownership stakes, there is unlikely to be a revolution in corporate governance. Rather, the mathematical model, as described above, is deficient. It overstates the likelihood that institutional investors will expend significant resources on monitoring because it fails to capture accurately the rational decisionmaking process of some institutional investors.

The central flaw with the model is that it assumes institutional investors seek to maximize absolute returns in making investment

³⁷ Indeed, the comprehensive reexamination of federal proxy regulation, which culminated in the proxy rule amendments, was initiated by a series of letters to the SEC from some of the most activist institutional investors. See Letter from Richard H. Koppes, CalPERS General Counsel, to Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission (Nov. 3, 1989), reprinted in *INSTITUTIONAL INVESTORS: PASSIVE FIDUCIARIES TO ACTIVIST OWNERS*, at 454-76 (1990); Letter from United Shareholders' Association to Edward H. Fleischman, Commissioner, Securities and Exchange Commission (Mar. 20, 1990) reprinted in *INSTITUTIONAL INVESTORS: PASSIVE FIDUCIARIES TO ACTIVIST OWNERS*, at 485 (1990).

³⁸ See Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992). For a description of the changes in proxy regulation effected by this release, see Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 *VAND. L. REV.* 1129, 1165-70 (1993).

³⁹ Regulation of Communications Among Securityholders, Exchange Act Release No. 30,849 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,002 (June 24, 1992).

decisions. For many institutional investors, however, this assumption is not accurate. Many institutions are driven by competitive forces. Their performance is evaluated not in absolute terms, but based on whether they are able to generate a higher rate of return than the competition or than the market.⁴⁰ It may be better, in terms of competitive advantage and thus the ability to command future commitments of resources, for a firm to beat its competitors than to show some steady rate of return, even if absolute returns in each year are thereby reduced.⁴¹

Although successful relationship investing may increase net present value, it leaves comparative performance unchanged. When investors decide whether to commit resources, they are more concerned with whether an institution performed better than others than with the return realized by the institution. If relationship investing does not create a competitive advantage, an institution has little incentive to engage in it, even if it creates net present value.

The focus on beating competitors operates at two levels. First, some institutional investors are evaluated—by customers, the market for their products, etc.—on the basis of their return relative to their competitors. A mutual fund presents the classic example of this phenomenon. Mutual funds are evaluated almost exclusively on the basis of their relative total

⁴⁰ Mutual funds, for example, frequently advertise their performance in various fund rankings which assess performance on a competitive basis. This practice has recently led the National Association of Securities Dealers to issue guidelines for the use of such rankings in advertisements. *See, e.g., NASD Hopes to Have Guidelines for Mutual Fund Rankings in Place Shortly*, 26 Sec. Reg. L. Rep. 664-65 (May 6, 1994).

⁴¹ The degree to which the search for competitive advantage influences investment patterns is substantial. Because the efficient capital market hypothesis explains that, over the long run, stock-picking techniques are unable systematically to outperform the market, and because stock trading generates greater transaction costs than an index-based buy and hold strategy, it appears irrational for institutional investors to engage in active trading strategies. *See, e.g., Lynn Stout, Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation*, VA. L. REV. (forthcoming 1995) (describing stock trading as a negative sum game resulting from market failure). Nonetheless, the proliferation of mutual funds and other institutions that persist in active trading suggests that the effort to beat rather than simply mirror market rates of return remains considerable. Moreover, the practitioner literature suggests that active selection can be profitable. *See Darryll Hendricks et al., Hot Hands in Mutual Funds: Short-Run Persistence of Relative Performance, 1974-1988*, 48 J. FIN. 93 (1993) (recounting prevalence of stock-picking activity among mutual funds and evaluations of such funds based on relative performance).

return.⁴² Individual investors may be concerned about mutual fund return in absolute terms in deciding whether to invest at all, but in choosing which fund, they focus on criteria such as a firm ranking near the top of its category or beating the relevant market indicators. Indeed, the relative performance of mutual funds is compiled on a regular basis, and many investors base their choice of mutual funds on a fund's relative performance.⁴³

The same premise is used to evaluate the performance of the individuals who make decisions on behalf of an institutional investor. A mutual fund manager may be evaluated directly on the basis of whether the fund outperformed comparable funds, or indirectly on the extent to which the fund attracted customer investment. Even if managers are compensated based on the volume of money attracted rather than the profitability of the fund, the ability of customers to shift their assets continually to top performing funds will cause the rational fund manager to strive for short-term superior relative performance.⁴⁴

Other types of institutional investors are also susceptible to concerns about relative performance. Although the investor itself, such as a pension fund, may have no need to evaluate its returns on a relative basis, those who manage the investments of that institution may be judged by their performance relative to the market. For example, a public pension fund may have no need to beat market indicators in order to win investors/beneficiaries. If, however, the manager of that fund consistently achieves returns that are lower than relevant market indicators, he or she is likely to be replaced. Thus, in terms of the individual investment decisions, the manager is again influenced by considerations of relative return.

Thus, many rational institutions will make investment decisions not with the goal of maximizing absolute return but rather of maximizing return relative to market indicators or other firms in the industry. This concern for competitive success creates a problem with activism. If an investor improves corporate performance by monitoring, it increases

⁴² See Hendricks et al., *supra* note 41 (describing evaluation of mutual funds based on performance).

⁴³ See, e.g., *id.* at 94 ("investors steer their money to funds that have performed well recently [relative to the competition]"). Indeed, customers can and do shift their money from fund to fund in response to reports of relative performance. This steers a larger quantity of assets to those managers who have performed well in the recent past.

⁴⁴ See *id.*; see also Coffee, *supra* note 10, at 1319 (describing continual ability of investors to shift their funds from one mutual fund to another, with little notice, in search of the fund able to outperform its competitors).

returns to all other investors in the target company. This is the typical free rider problem with respect to those other investors who benefit from the fund's monitoring activity at no cost. But the problem goes beyond the collective action problem.

An institution that invests monitoring resources in order to increase return will benefit less than its competitors because its total return is tempered by the expenditure of the costs of monitoring. Therefore, on a percentage basis, monitoring increases returns to the monitoring institution less than to passive investors and the market as a whole. By monitoring, the firm directly reduces its rate of return relative to other investors. Monitoring by a firm or an individual investment advisor that is judged on the basis of relative returns therefore may not be a rational economic choice.

It is important to remember that spending money to monitor is primarily logical for those investors who seek to exceed market rates of return. If an investor can meet its investment objectives by duplicating the market rate of return, it can minimize both costs and risks through an appropriately diversified passive investment strategy such as indexing.⁴⁵ Accordingly, monitoring only makes sense as an effort to outperform the market. The question is whether, in the case of investors who are judged on a relative basis, monitoring can be a rational choice.

We must adjust the mathematical model of monitoring, as used above, to address this question, because that model is based on the premise that investors seek to maximize absolute rather than relative returns. In other words, the model assumes that an investor will monitor whenever a dollar invested in monitoring generates a return of more than a dollar, net of costs. By considering relative return, we have observed that this assumption is too simplistic. It may not be rational for an investor to undertake activities that net a positive return, if the return to non-monitoring shareholders is greater. An investor judged on a relative basis is disadvantaged by undertaking monitoring activities that yield greater net returns to its competitors.⁴⁶

⁴⁵ Thus Professor Coffee's concerns about exit, see *infra* note 56, carry more weight than he realized because monitoring requires investors to give up diversification in favor of stock-picking, to give up liquidity in favor of voice, and, as a result, to put themselves at a competitive disadvantage with their counterparts who index.

⁴⁶ The same is true with respect to the overall market rate of return. Professors Gilson and Kraakman make the argument that institutional investors will be best served by seeking system-wide improvements to the corporate governance structure that will increase market rates of return. Gilson & Kraakman, *supra* note 3. Such

In order to consider the effect of competition on the model, it is necessary to convert the returns generated to percentage terms because investment performance can only be compared by viewing returns on a percentage basis.⁴⁷ Such conversion involves quantifying the returns achieved by monitoring in terms of the percentage return generated over an arbitrary period of time.⁴⁸ If we designate the percentage return on an investment over some period of time as μ , we can calculate μ by dividing the absolute dollar amount of return by the amount of the investment. If the total amount of resources invested in investment i is reflected as $A(i)$, then $\mu(i) = r(i)/A(i)$.⁴⁹ The investor's investment return, U , on a total portfolio value of T , where $T = \Sigma A(i)$, is, in relative terms, $\Sigma r(i)/T$. Put differently, the overall return is the weighted average of the investor's returns on individual investments, $U = (\Sigma \mu(i)A(i))/\Sigma A(i)$.

Thus the effect of monitoring on overall investment returns is directly related to the degree to which the investor's portfolio is concentrated in the subject corporation. Increasing the return on an individual investment in the portfolio through monitoring will have a progressively greater impact on the investor's overall investment returns to the extent that an increasing proportion of the investor's portfolio is devoted to that investment. In other words, monitoring is more effective, in terms of increasing portfolio returns on a percentage basis, when the monitored company represents a large portion of the monitoring investor's portfolio.

Recall, however, that the return to the monitoring investor must also reflect the costs of monitoring. This cost is not shared by other shareholders. Therefore the improvement on a percentage yield basis of an investment's performance, based on monitoring activity, is always going to be less for the monitoring investor than for nonmonitoring shareholders. If monitoring increases performance by ten percent, the monitoring

improvements, however, will not improve any single investor's competitive position relative to the industry as a whole and are therefore unlikely objectives of investors subject to evaluation on relative terms.

⁴⁷ It is meaningless to try to evaluate an investment on the ground that it generates a return of \$10. The implicit question is the amount of return in relationship to the investment size. Thus a \$10 return on a \$10 investment is a return of 100%, a very good return, while a \$10 return on a \$100,000 investment is a return of .01%, a very poor rate.

⁴⁸ The relevant time period need not be specified for purposes of this analysis but could, for example, be the period of time over which an investor was evaluating the effect of its monitoring activity on performance. Obviously some time component is a necessary predicate for this evaluation—a 5% rate of return per month is significantly better than a rate of 5% per year.

⁴⁹ The reader will recall that $r(i)$ is the return on investment i , in absolute terms.

shareholder always captures some return less than ten percent, because its return, and only its return, is reduced by the cost of monitoring.

Monitoring, therefore, diminishes the institutional investor's returns relative to the market as a whole. Does this mean that a rational investor interested in relative returns will never monitor because that investor's returns will be improved by less than those of its competitors? The answer is no. The effect of monitoring on overall portfolio performance, as we saw above, is a function of two things: the increase in relative returns on that investment and the concentration of the investor's portfolio invested in the target company *relative to the concentration of its competitors*. We can reflect the investor's excess concentration in investment i , that is, the degree to which its portfolio concentration exceeds the concentration of its competitors, by $A(i)/T - M(i)/Z$ where $M(i)$ is the total amount of resources invested in investment i by competitor institutions and Z is the total investment of competitor institutions.⁵⁰ Thus if $\mu'(i)$ is the excess profit generated by monitoring investment i , the rational investor will monitor whenever $\mu'(i)(A(i)/T - M(i)/Z) - C(m) > 0$.

In order for this formula to be satisfied, the monitoring shareholder must concentrate its portfolio substantially. If an investor effects profitable monitoring in a company in which it owns, proportionately, a larger stake than its competitors, the effect on its performance, relative to the effect on the performance of competitors, will be larger. Thus, in that case, and only in that case, will the investor improve its relative position.

Portfolio theory tells us that concentration subjects an investor to a large amount of unsystematic or alpha risk—the risk that results from firm-specific variables.⁵¹ Because this risk can be eliminated through diversification,⁵² it is an uncompensated risk; that is, unlike beta risk, the

⁵⁰ $M(i)/Z$ reflects the overall percentage of competitor resources concentrated in investment i or target company i . We might similarly evaluate an investor's concentration relative to the market as a whole. A benchmark for market concentration would be the percentage of a value-weighted market index, such as the Standard & Poor's (S&P) 500, represented by company i .

⁵¹ The classic works on the relationship between risk and return and the ability to eliminate unsystematic risk through diversification are Franco Modigliani and Gerald A. Pogue, *An Introduction to Risk and Return: Concepts and Evidence* (pts. 1 & 2), 30 FIN. ANALYSTS J., Mar.-Apr. 1974, at 68 (pt. 1), May-June 1974, at 69 (pt. 2).

⁵² Indeed, most institutions hold broadly diversified portfolios for the explicit purpose of eliminating all unsystematic risk. Unsystematic risk, or unique risk, is that part of total risk that is unique to a company or industry; it can therefore be eliminated by diversification. See, e.g., RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 136-38 (4th ed. 1991) (explaining how diversification eliminates unsystematic risk); BURTON G. MALKIEL, A RANDOM WALK

market does not provide a superior return for investors who choose to bear alpha risk. Accordingly, concentration creates an additional cost for investors.⁵³ Because firm-specific risk is a function of the degree of concentration,⁵⁴ we can represent it as an additional cost in the mathematical model: $\alpha(A(i)/T)$. Our mathematical model now indicates that the rational investor will monitor if $\mu'(i)(A(i)/T - M(i)/Z) - C(m) - \alpha(A(i)/T) > 0$.

IV. RETHINKING THE PROMISE OF RELATIONSHIP INVESTING

A. Further Thoughts on the Likelihood of Activism

The foregoing model suggests that, for most rational institutional investors, the benefits of active monitoring do not outweigh the costs. A number of skeptics have suggested additional explanations why relationship investing is unlikely to reform corporate governance.⁵⁵ Although a detailed analysis of these concerns is beyond the scope of this Article, several scholars have criticized the traditional analysis of monitoring as understating the costs of institutional activism. These scholars argue that the costs of monitoring include both direct and indirect costs. The indirect costs include a loss of liquidity,⁵⁶ costs of legal rules designed to constrain

DOWN WALL STREET 223-27 (5th ed. 1990) (same); see also W.H. Wagner & S.C. Lau, *The Effect of Diversification on Risk*, 27 FIN. ANALYSTS J. Nov.-Dec. 1971, at 48.

⁵³ To the degree that concentration increases the size of the average investment position, it also decreases liquidity, which creates additional cost. See, e.g., Coffee, *supra* note 10, at 1288 (stating that investors face substantial price discounts in trying to sell large blocks of stock); Ira M. Millstein, *On the Making of Pension Funds as "Patient Capitalists"*, DIRECTORS & BOARDS, Winter 1990, at 11, 15 (explaining that large blocks of stock create liquidity problems for pension funds).

⁵⁴ The function is exponential rather than linear. Accordingly, small amounts of diversification can greatly reduce an investor's alpha risk.

⁵⁵ Articles expressing skepticism about the likelihood or value of institutional monitoring include Coffee, *supra* note 10; Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994) [hereinafter Rock, *Controlling the Dark Side*]; Rock, *supra* note 2; Roe, *supra* note 14; Romano, *supra* note 13.

⁵⁶ In his classic piece on the subject, Professor Coffee explains that an investor's choice to exercise control reduces the liquidity of the investor's holdings. Coffee, *supra* note 10. Thus an investor is faced with a choice of whether to exercise greater voice through monitoring activities or to retain the maximum amount of liquidity possible. See, e.g., *id.* at 1287 ("[A]ny attempt by institutional investors in the United

institutional activism,⁵⁷ risk of management retaliation,⁵⁸ and public

States to exercise control over corporate managements will entail a probable sacrifice of this liquidity, which may be an unacceptable cost to them.”); *id.* at 1318–28 (discussing various structural constraints that force institutional investors to choose between “exit” and “voice”). Many institutional investors are unable, because of their structure, to accept diminished liquidity. For example, open end mutual funds must stand ready to liquidate holdings at any time in order to meet customer redemption requests. *Id.* at 1318. Even for investors who can accept less liquidity, the reduction represents an additional cost of monitoring. Indeed, Professor Coffee concludes that the costs of monitoring make it unlikely that investors will voluntarily increase their monitoring activities at the expense of liquidity and offers, as an alternative explanation for recent increases in shareholder activism, the suggestion that some institutions have already sacrificed liquidity by virtue of the size or nature of their shareholdings. *Id.* at 1288–89. For those investors, because exit is no longer an option, monitoring does not impose this additional cost.

⁵⁷ Legal rules can restrict institutional monitoring in two ways. First, legal rules of general application can limit the role of shareholders in corporate decisionmaking or the ability of shareholders to act collectively. An example of the former is the regulation of shareholder voting under the federal proxy rules. Although, as described above, the federal proxy regulations were recently amended to facilitate institutional activism, the rules continue to limit the ability of shareholders to affect corporate decisionmaking. For example, the SEC’s application of Rule 14a-8 has limited the ability of institutional investors to propose policy changes through the shareholder proposal process; the SEC has determined that many such proposals are not proper matters for shareholder action because they relate to the ordinary business operations of the corporation. *See Fisch, supra* note 38, at 1155–62 (discussing SEC’s application of the exclusion for proposals relating to ordinary business operations). Similarly the proxy rules require institutions that wish to propose candidates for board positions to conduct a separate proxy solicitation, thereby increasing the costs of challenging management control of the nomination process. *See id.* at 1162–65 (discussing restrictions imposed by federal proxy regulation on direct nomination of directors by shareholders); *see also* Bebchuk & Kahan, *supra* note 4, at 1073 (describing how state law rules on reimbursement of proxy contest expenses favor management over stockholder/challengers and obstruct socially beneficial challenges).

The reporting requirements under § 13(d) of the Securities Exchange Act have also been criticized as a constraint on institutional activism. The statute and the SEC rules thereunder apply to persons who purchase or decide to hold as a group more than five percent of a corporation’s shares and require such persons to disclose their identity and intentions. Because the regulations define as a group, for disclosure purposes, investors who decide to act jointly with respect to voting their securities or otherwise influencing the control of the corporation, the filing requirement applies to efforts by investors to engage in collective action. In addition to actual filing, the requirement has been viewed as a burden on shareholder activism because it provides notice to the corporation of potentially hostile group action by shareholders and

because of the possibility that the corporation will respond with litigation. A related analysis suggests that it is possible to apply "controlling person" liability under the federal securities laws to institutional investors who actively monitor. *See* Conard, *supra* note 35.

Second, legal rules can regulate the investment activity of particular types of institutional investors by requiring a certain degree of diversification which limits the ability of an investor to invest on a concentrated basis, requiring that the investor limit its activity to passive investments, or both. Federal banking laws, for example, prevent banks from acquiring large blocks of corporate stock and explicitly require passivity with respect to these investments. Banks are prohibited by law from owning stock directly, although bank holding companies are permitted to own up to five percent of the voting shares of a nonbank. *See, e.g.*, Banking Act of 1933 (Glass-Steagall), § 5(c), 12 U.S.C. § 335 (1988). For a more detailed discussion of legal limitations on equity ownership and participation by banks, see Aleta G. Estreicher, *Beyond Agency Costs: Managing the Corporation for the Long Term*, 45 RUTGERS L. REV. 513, 567-68 (1993); Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927 (1993) [hereinafter Roe, *Differences*].

The Investment Company Act of 1940 imposes similar limitations on concentration and activism on mutual funds. Commentators have explained that similar restrictions may be imposed on other types of institutional investors by insurance regulations, ERISA, state pension regulations or antitrust law. *See, e.g.*, Estreicher, *supra*, at 590-91 (describing legal limitations imposed by insurance regulations and Hart-Scott-Rodino Antitrust Improvements Act); Romano, *supra* note 13, at 800 (describing state law limits on percentage ownership by public pension funds of company's outstanding stock); *see also* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Helen Garten, *Institutional Investors and the New Financial Order*, 44 RUTGERS L. REV. 585, 613-20 (1992); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) [hereinafter Roe, *Political Theory*]. For example, in many states common stock holdings are completely ignored for the purpose of determining if an insurance company has sufficient capital to satisfy regulatory requirements. *See, e.g.*, N.Y. INS. LAW § 1402 (McKinney 1985); CAL. INS. CODE § 1170 (West 1993).

⁵⁸ *See* Lilli A. Gordon & John Pound, *Active Investing in the U.S. Equity Market: Past Performance and Future Prospects*, Report for the California Public Employees' Retirement System, 39-43 (Jan. 11, 1993) [hereinafter Gordon Group Study] (identifying risks of defeat and management retaliation associated with nonnegotiated or hostile activism). Certain types of institutions have traditionally seen themselves as affiliated with management and management's interests. Private pension funds serve as the primary example of this phenomenon; because pension fund managers owe their existence and selection to the management of public companies, they have a strong promanagement loyalty or bias that is difficult to overcome. *See, e.g.*, *Taking the Offensive*, INSTITUTIONAL INVESTOR, Dec. 1987, at 101 (noting that survey of corporate pension money managers revealed that only 6.8% claimed to have resisted advice from corporate pension officers regarding how to vote pension fund proxies).

approbation.⁵⁹

In addition, the structure of the institutional investor itself reflects a separation of ownership and control that creates agency costs within the institution.⁶⁰ In other words, institutional investors have, themselves, begun to succumb to a corporate mode of operating, in which those who exercise investment and voting authority are distinct from, and only

Banks and insurance companies operate within similar constraints, in part because they frequently look to corporate management for other business relationships, which active monitoring might jeopardize. The structural bias of these relationships suggests that, although these institutions may be able to engage in negotiated or management-friendly monitoring activities, they are unlikely to undertake activism of a more hostile or disciplinary nature. See, e.g., James A. Brickley et al., *Ownership Structure and Voting on Antitakeover Amendments*, 20 J. FIN. ECON. 267 (1988) (demonstrating that institutional investors that have additional business relationships with target companies are more likely to support management-sponsored proposals). Even those institutions that appear structurally resistant to management pressure are reluctant to challenge management. See Diana B. Henriques, *Fidelity's Secret Agent Man*, N.Y. TIMES, Jan. 27, 1991, § 3, at 1 (describing efforts by the Fidelity group of mutual funds to maintain reputation as friendly long-term investors); see also Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., Jan.-Feb. 1994, at 140 (suggesting that the threat of litigation by a portfolio company imposes a substantial and unpredictable cost on activism).

⁵⁹ The best example of public resistance to institutional activism is the response to the takeover environment of the 1980s, in which institutional investors were portrayed as destructive, greedy, and concerned exclusively with short-term gains, and a variety of legal reforms were proposed to prevent Wall Street from destroying the U.S. corporation through activism. See, e.g., Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 205-13 (1991) (proposing to eliminate hostile tender offers and limit director elections to once every five years to address problems caused by increasing institutional activism and short-termism). Moreover, the very institutions typically viewed as likely activists because of their freedom from management loyalties may be constrained by the adverse reaction of their "other constituencies" to activism. For example, Professor Barnard relates the conflict and political fallout created when the State of Wisconsin Investment Board submitted a management-critical shareholder proposal to General Motors at a time when General Motors was considering expanding operations and providing additional jobs in Wisconsin. Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. REV. 1135, 1141 n.39 (1991). For an extensive discussion of the political constraints on activism by public pension funds, see Romano, *supra* note 13.

⁶⁰ See *Institutional Investors and Corporate America: Conflicts and Resolutions: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 101st Cong., 1st Sess. 2-3 (Oct. 3, 1989) (prepared by Carolyn Kay Brancato at the request of the Senate Subcommittee on Securities).

marginally accountable to, the beneficiaries.⁶¹ Indeed, it is likely that agency costs are greater for institutional investors than for corporations because many of the structures designed to provide accountability at the corporate level—such as the possibility of beneficiary exit, the discipline of proxy contests and takeover battles, and the checks provided by shareholder voting power—are absent in most institutional structures.⁶²

Thus, in the view of the skeptics, activist monitoring by institutional investors is even less likely to occur. This conclusion is supported by examining the recent evidence of institutional activism. Although both the popular and academic press have lauded the rise in active participation by institutional shareholders and proclaimed the “big impact” of relationship investing on the “running of American business,”⁶³ reports of shareholder monitoring may be overstated.⁶⁴

First, institutions are, for the most part, taking only the small step of deciding to read proxy statements and to exercise the right to vote.⁶⁵

⁶¹ Professor Coffee cites public pension funds as an example of institutional investors that are particularly unaccountable to their beneficiaries because of their size, organizational structure, and the dispersion of their beneficiaries. *See* Coffee, *supra* note 10, at 1335–36; *see also* Rock, *supra* note 2, at 452 (explaining that increasing concentration of shareholding raises problems of increased agency costs within the institutional investor).

⁶² *See* Coffee, *supra* note 10, at 1283 n.21 (describing various reasons why agency costs will be higher at the institutional investor level than within the corporate management structure).

The creation of shareholder advisory committees, a monitoring tool that has received recent attention, creates yet another layer of agency costs by placing an additional set of agents between the institutional investors and the boards of portfolio companies. *See* Barnard, *supra* note 59, at 1166–67.

⁶³ Dickson, *supra* note 6.

⁶⁴ For example, there has been widespread reporting of institutional activism at A&P and Paramount. A&P is 53% owned by a German retailing group, however, making protests by institutional investors somewhat futile. Moreover, in spite of some furor about Paramount’s executive pay policy, led by Wisconsin’s public pension fund, the Paramount directors were re-elected with more than 98% of the vote cast. *Id.*

⁶⁵ Further attention to and exercise of voting rights is clearly one area in which institutional investors have become more active, both in the United States and abroad. *See, e.g.*, James Kim, *Campbell Puts Heat on Other Companies*, USA TODAY, July 16, 1993, at B1 (describing decision by Campbell Soup Company and a small group of other private corporate pension funds to exercise their proxy voting power critically with respect to issues of corporate governance); John Plender, *Survey of Pension Fund Investment*, FIN. TIMES, May 6, 1993, at VII (describing evolution from system in which four out of five pension fund managers did not exercise their voting rights as a

Although more frequent and critical⁶⁶ voting by institutional investors may affect management decisions indirectly, its primary effect is likely to be limited to rejecting antitakeover provisions and supporting precatory shareholder proposals that advocate more responsible exercise of management power.⁶⁷ These activities do not naturally lead toward the model of relationship investing in which management and institutions work hand in hand to forge corporate policy. Nor do they promise increased disciplining of management beyond the highly publicized takeover arena. Voting, even in opposition to management's recommendations, is unlikely to effect substantial changes in management behavior.⁶⁸

Second, few institutional investors appear to be going further.⁶⁹ To the extent that monitoring involves the use of more activist efforts to influence corporate policy, institutions do not appear convinced that the game is worth the candle.⁷⁰ Pension funds are reportedly leery of the risks

matter of course to system in which the Cadbury report recommends positive use of voting rights by institutional investors); Leslie Wayne, *Seeking Investment with Principle*, N.Y. TIMES, Aug. 10, 1993, at D1 (describing "Avon letter" issued by Department of Labor in 1988, which described corporate proxies as a pension plan asset that plan managers were required to take seriously).

⁶⁶ There are extensive press reports of efforts by institutional shareholder organizations to disseminate information designed to motivate active shareholdership. See, e.g., Martin Dickson, *'Poor performers' List Gives Ammunition to Institutions*, FIN. TIMES, Oct. 8, 1993, at 25 (describing list prepared by Council of Institutional Investors identifying the poorest performing companies in America). Beyond generating publicity, however, it is not clear that institutions are making much use of this information.

⁶⁷ See, e.g., *American Corporate Governance; Shareholders Call the Plays*, ECONOMIST, Apr. 24, 1993, at 83 (describing increase in efforts by institutions to reform corporate governance through proxy voting and informal negotiations and listing targeted changes as including removal of staggered boards, golden handcuffs and poison pills); Dean Foust, *Who's in Charge Here?*, BUS. WK., Mar. 19, 1990, at 38-39 (describing institutional activism with respect to shareholder proposals on poison pills, golden parachutes and staggered boards).

⁶⁸ This situation is aggravated by the legal and institutional limitations on the effectiveness of shareholder voting. Even under a campaign in which institutions overwhelmingly vote in opposition to management's slate of directors, for example, in the absence of a competing slate, the directors will nonetheless be elected. Cf. Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993).

⁶⁹ See Gordon Group Study, *supra* note 58, at 44 ("One difficulty in measuring the value effects of [relationship investing] is that remarkably little of it has in fact occurred to date in the U.S. market.")

⁷⁰ See, e.g., *Meaningful Relationships*, ECONOMIST, June 26, 1993, at 82

associated with relationship investing,⁷¹ and institutions that engage in stock-picking investment strategies also appear skeptical.⁷²

Indeed, it is possible to explain the rapid growth in institutional activism as simply a second order institutional response to the takeover era. Institutional activism was first observed in the context of corporate control transactions, in which institutions were criticized for their short-term orientation.⁷³ Takeovers were defended, however, as the means by which the stock market monitored corporate management: inefficient management caused declining stock prices that would create a takeover opportunity.⁷⁴

The combination of state antitakeover statutes and court-sanctioned antitakeover devices substantially contributed to the decline of takeovers in the late 1980s. The rise in institutional participation in corporate governance directly coincides with this decline.⁷⁵ The correlation is clear. To the extent that takeovers provided a check on management inefficiency, the advent of these defensive measures should have operated to depress stock prices artificially.⁷⁶ Accordingly, it would be rational for institutions

(questioning whether relationship investing may be too risky for institutional investors).

⁷¹ A study of the value of shareholder activism conducted by the Gordon Group on behalf of CalPERS concluded that although active investments had the potential to generate superior returns, they presented a variety of risks for an investor like CalPERS, many of which risks could not readily be quantified. Gordon Group Study, *supra* note 58.

⁷² *American Corporate Governance; Shareholders Call the Plays*, *supra* note 67, at 83.

⁷³ See, e.g., *The Impact of Institutional Investors on Corporate Governance, Takeovers and the Capital Markets: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 101st Cong., 1st Sess. 228 (Oct. 3, 1989) (statement of Sen. Terry Sanford) (stating that concentration of stock in the hands of institutional investors with short-term focus was "a major cause of the rampant wave of hostile, highly leveraged transactions that we have seen sweep across the country in the past 10 years"); Lipton & Rosenblum, *supra* note 59, at 205-13.

⁷⁴ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1187-88 (1981); Ronald Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 841 (1981); Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

⁷⁵ See Barnard, *supra* note 59, at 1152-53 (describing development of institutional activism in late 1980s).

⁷⁶ The empirical evidence is mixed but suggests that many antitakeover statutes and other devices are associated with reductions in stock price and/or corporate value. See, e.g., W. Thomas Connor, Note, *Sword or Shield: The Impact of Third-Generation State Takeover Statutes on Shareholder Wealth*, 57 GEO. WASH. L. REV.

to focus their efforts on removing impediments to socially beneficial takeovers,⁷⁷ both because removal would increase stock prices and because restoring the market's monitoring function would obviate the need for more extensive direct monitoring efforts by investors.⁷⁸ Thus, activism in the area of takeovers may be a special case⁷⁹ and may even be consistent with diminished rather than increased institutional interest in activism.⁸⁰

958, 984 (1989) (finding "substantial evidence that [these] third-generation control share acquisition acts . . . have adversely affected shareholder wealth"); Gregg Jarrell & Annette Poulsen, *Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980*, 19 J. FIN. ECON. 127 (1987) (correlating abnormal negative returns with supermajority amendments and relating more harmful amendments to corporations with a lower percentage of institutional ownership); S. Linn & J. McConnell, *An Empirical Investigation of "Antitakeover" Amendments on Common Stock Prices*, 11 J. FIN. ECON. 361, 389-91 (1983) (finding inconclusive effect on stock price); see also Kenneth B. Davis, Jr., *Epilogue: The Role of the Hostile Takeover and the Role of the States*, 1988 WIS. L. REV. 491, 493-500 (summarizing a variety of empirical studies). For summaries of the debate, see also ROMANO, *supra* note 19, at 60-72; Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 911-12 (1992).

⁷⁷ See Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective*, 1992 COLUM. BUS. L. REV. 223, 233-34 (describing topics addressed by most recent institutional shareholder initiatives as including "rescissions of poison pills, implementation of confidential voting procedures, reduction in golden parachutes, installation of anti-greenmail provisions, review of executive compensation, opting out of state takeover statutes, repealing classified boards of directors. . .") (footnote omitted); Rosenbaum & Korens, *supra* note 23 (describing most common institutional investor sponsored shareholder proposals and related efforts addressing greenmail, antitakeover statutes, poison pills, and confidential voting); see also Jeffrey N. Gordon, *Corporations, Markets and Courts*, 91 COLUM. L. REV. 1931, 1971 n.148 (1991) (describing how, in response to intense lobbying by institutional investors, Pennsylvania modified "draconian" antitakeover statute and majority of large publicly traded companies opted out of one or more statutory provisions); see also *supra* note 67.

⁷⁸ But see Rock, *supra* note 2, at 487 n.164 (citing E. FLAX, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE QUESTIONS IN THE 1985 PROXY SEASON 1 (1985)) (finding limited success by institutions in defeating antitakeover proposals; in study of more than 450 antitakeover charter amendment proposals, only 19 were defeated).

⁷⁹ The United Shareholders Association has focused its agenda regarding shareholder activism directly on removing antitakeover provisions that impede market discipline of corporate governance. Robert Weisman, *Shareholders' Group Takes Aim at Anti-Takeover Provisions*, HARTFORD COURANT, Oct. 7, 1991, at 3.

⁸⁰ See, e.g., Lilli A. Gordon & John Pound, *Information, Ownership Structure, and Shareholder Voting: Evidence from Shareholder-Sponsored Corporate Governance*

Moreover, even the forerunners in the area of institutional activism appear to be reducing their efforts. CalPERS, probably the most visibly active institutional investor, dramatically reduced the number of shareholder initiatives it sponsored during the last proxy season. Recently it announced a decision not to invest in the LENS fund, a fund organized by Robert Monks for the purpose of employing active investing techniques.⁸¹ This decision came as a major setback to Monks, who had called CalPERS the "best prospect [he] had in a world where new ideas are difficult to sell."⁸² According to another recent report, John Biggs, chairman of TIAA-CREF, one of the country's largest institutional investors, which had participated in a number of efforts to pressure managers to reorganize their businesses, has stated that he is not interested in seeking further "high-profile examples of muscle flexing."⁸³

The promotion of activism has led to the development of a small group of specialist funds, however, which seek superior returns through self-conscious activism.⁸⁴ The investment plans of these funds include concentrating investment in a limited number of companies and using

Proposals, 48 J. FIN. 697 (1993) (finding empirical evidence of higher institutional support for shareholder proposals to rescind poison pills and relax supermajority requirements and characterizing such support as a response to state law and management action to reduce shareholder rights in the takeover context over the past decade).

⁸¹ See *Meaningful Relationships*, *supra* note 70 (describing decision by CalPERS not to invest in LENS fund). For a more detailed description of the LENS fund and similar funds, see *infra* note 84.

⁸² Susan Pulliam, *Calpers Won't Invest in Activist's Fund*, WALL ST. J., June 22, 1993, at C1. According to a press report in June, Richard Monks pitched the LENS fund to more than 60 pension funds, but all rejected the opportunity to participate in relationship investing. Leslie Wayne, *Money Manager's 'Reality Check'*, N.Y. TIMES, June 22, 1993, at D1. The article suggests that competing relationship investing funds are having similar fundraising problems. *Id.*

⁸³ Michael Quint, *Teachers' Pension Fund Asks for Diverse Boards*, N.Y. TIMES, Oct. 6, 1993, at D6.

⁸⁴ The funds include the LENS fund, managed by Robert Monks; Corporate Partners, an investment fund managed by Lazard Freres; Allied Investment Partners, sponsored by Dillon Read; and the 1818 Fund, sponsored by Brown Brothers Harriman. See, e.g., Wayne, *supra* note 82 (describing size, sponsorship, and investment objectives of the four funds). The funds offer the opportunity for larger institutions to invest in activism indirectly by committing resources as passive investors in the funds. See, e.g., Allen R. Myerson, *Pension Funds Join in Turnaround Venture*, N.Y. TIMES, Nov. 2, 1993, at D1. Of course, engaging in relationship investing by proxy through the use, by institutions, of an investment in a specialist fund, creates an additional layer of agency relationships.

activism to generate improved returns in those companies.⁸⁵ Because the funds are concentrated, they meet the criteria of the model for which monitoring is a rational decision. For these funds, monitoring has a much greater effect on overall returns than it does for diversified investors.⁸⁶ Thus the funds are able to distinguish themselves from competitors. The distinction can operate, however, in either direction. If the monitoring improves firm performance, the fund will do exceptionally well. If the monitoring is unsuccessful, or if one of the targets experiences unrelated problems, the fund's concentration in that company is likely to result in a greatly inferior return.

Do these funds represent the future for institutional investors? And should legal reforms along the lines of the amendments to the federal proxy rules be extended, both to facilitate activism and to encourage institutional investors to employ specialist funds as investment vehicles? In order to answer those questions, it is necessary to consider further the value of institutional monitoring.⁸⁷

B. *The Value of Activism*

A second type of criticism questions whether relationship investing is capable of improving corporate performance. That is, will activism add value to corporations? The empirical evidence on this subject is limited.⁸⁸

⁸⁵ See Gordon Group Study, *supra* note 58 (describing investment objectives of four specialist funds); Wayne, *supra* note 82, at 1 (same); Dobrzynski, *supra* note 5 (describing three specialist funds and their stated objectives).

⁸⁶ A specialist fund typically invests in five to ten portfolio companies. By contrast, most institutional investors own hundreds of portfolio companies. See, e.g., Dickson, *supra* note 66 (describing TIAA-CREF as owning stock in 1500 companies). TIAA-CREF's efforts to monitor a single portfolio company, unlike those of a specialist fund, are therefore likely to have an insubstantial impact on its overall returns.

⁸⁷ For example, Professors Gilson and Kraakman suggest an expansion of the approach of the specialist funds through the use of MSICs. They define an MSIC as a "publicly-traded financial intermediary . . . that pursues a core strategy of making large and active equity investments in a small portfolio of public companies." Gilson & Kraakman, *supra* note 36, at 985, 992. Although Gilson and Kraakman advocate the use of MSICs as an incremental means of achieving the superior monitoring associated with relationship investing, they acknowledge that the primary concern with adopting legal reforms to encourage MSICs is the possibility that MSICs would appropriate value for themselves and would fail to add real value to their portfolio companies. *Id.* at 1004.

⁸⁸ In part, this reflects the difficulty of measuring the effect of monitoring on

In 1993, the Gordon Group conducted an extensive study of the monitoring activities and returns of four activist funds in an effort to determine whether active investing could provide significantly above-market rates of return.⁸⁹ The evidence from the study was largely inconclusive.⁹⁰

The study did conclude that there was strong evidence that active investment strategies were “capable of leading to significant value increases,”⁹¹ but it distinguished between negotiated, “friendly,” transactions and nonnegotiated activism such as proxy initiatives. It found that the strongest evidence of the value of relationship investing was presented by nonnegotiated voting initiatives by institutional investors, and that evidence was “more qualified” on the value effects of friendly relationship investments.⁹²

Three of the four funds studied, however, limit their investments to friendly negotiated transactions and will not take a position hostile to existing management. The Gordon Group study identified “mixed value effects” from friendly relationship investments and hypothesized that the profitability of these investments may depend in large part on the identity of the investor.⁹³

There are obvious reasons for institutions to prefer negotiated transactions; limiting participation to negotiated settings eliminates a number of the downside risks associated with shareholder activism.⁹⁴ In particular, friendly transactions are unlikely to generate the political repercussions associated with hostile monitoring activities. Thus, friendly transactions are more palatable both in the context of a particular company

corporate performance. Many shareholder initiatives, such as increasing the percentage of outside directors on corporate boards or linking executive compensation to corporate returns may be beneficial even if they cannot be directly linked to changes in stock price. Pozen, *supra* note 58. Moreover, even when institutional activism is followed by increased stock price, it is difficult to conclude that the activism caused the increase. Pozen suggests, for example, that the claimed success of the LENS fund in pressuring Sears to change its policies did not cause Sears' returns to differ significantly from the S&P 500 except on the day following the announcement of a change in policy. *Id.*

⁸⁹ Gordon Group Study, *supra* note 58.

⁹⁰ An empirical analysis of the benefits of monitoring for public pension funds found that “[l]ittle [could] be concluded concerning the effect of corporate governance activism on fund performance.” Romano, *supra* note 13, at 830.

⁹¹ Gordon Group Study, *supra* note 58, at 44.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *See id.* at 39–43 (describing reduced risk associated with negotiated investments).

and within the context of the legal and structural regime.⁹⁵ Unfortunately, the evidence does not suggest that friendly transactions actually increase firm value. The very fact that a friendly transaction is negotiated between the investor and the target company presents the potential for abuse of the relationship to generate private gains for the investor rather than gains to common shareholders.⁹⁶

Professor Bernard Black conducted the other major examination of the empirical evidence on the value of institutional monitoring. In a recent article, Professor Black analyzed a variety of studies on the relationship between active investment strategies such as block acquisitions, control transactions, and proxy initiatives and shareholder returns.⁹⁷ He concluded that evidence of the value of institutional monitoring was quite limited, although there was "some direct evidence that large outside shareholders do valuable monitoring, or at least that their presence correlates with improved performance."⁹⁸

Importantly, Professor Black identified a number of methodological problems with existing studies of the value of institutional monitoring that also apply to the Gordon Group study. These problems include small sample size, failure to control for the signaling effect of institutional investor purchases and for the effect of outside factors on stock price, and inability to design studies that examine the effect of investor oversight as opposed simply to investor presence.⁹⁹ This last point is particularly problematic: it means that the studies do not provide evidence as to whether an investor's participation in decisionmaking, the key element of relationship investing, is responsible for improving corporate performance.

Indeed, a serious question about the value of relationship investing

⁹⁵ Corporations have successfully created major backlashes against investors who seek to exercise too much control in an unfriendly manner. The activities of financial conglomerates like the old House of Morgan, for example, led to a variety of legal restrictions on the ability of banks to exercise control over portfolio companies. Most recently, the involvement of institutional investors in encouraging corporate takeovers led to criticism that investors were destroying U.S. business in favor of short-term profits and generated a variety of state antitakeover statutes.

⁹⁶ See discussion of private gains *infra* part IV.C.

⁹⁷ Black, *supra* note 76, at 917-27.

⁹⁸ *Id.* at 897.

⁹⁹ *Id.* at 917-27. The success of the Brown Brothers Harriman 1818 Fund provides some anecdotal evidence that the presence of a large investor may contribute to increased returns even when the investor does not engage in monitoring. The Fund takes large but noncontrolling stakes in companies that it perceives as undervalued but well-managed and thus not in need of active monitoring. Returns from the first of two such funds have averaged more than 25% annually. Wayne, *supra* note 82, at D22.

concerns the competence of institutional investors as corporate decisionmakers. Apart from the question of whether institutions have the ability to influence, it is not clear that they have the necessary expertise to improve performance. Particularly with respect to more intrusive participation, such as setting corporate policy, defining limitations on capital expenditures, and selecting directors and management, there is little reason to believe that the individuals who exercise voting power on behalf of institutional investors will be able to do better than existing management. In this respect, comparing activism by institutional investors to the guidance provided by individuals such as Warren Buffett is misleading.¹⁰⁰

Most fund managers have little experience in operating industrial corporations. Moreover, it is frequently difficult to distinguish poor corporate performance due to management defects from problems beyond the control of the corporation such as industry-wide declines or technological changes. Many of the "underperforming" companies that have been targeted for institutional activism have been experiencing major business problems for a number of years and have been unable to turn their performance around in spite of aggressive strategic changes.¹⁰¹ Under these circumstances, it is hard to understand how a group of civil servants, bankers, and investment advisors will make the corporation perform better.¹⁰²

A recent example is the troubled performance of Eastman Kodak Company. Kodak has been one of the investments targeted by the LENS fund¹⁰³ and other institutional activists and has been unable to improve its performance in spite of persistent pressure by outside investors. Kodak's attempts to respond have included numerous restructurings as well as personnel changes designed to invigorate the company with new leadership.¹⁰⁴ To date, these efforts have not satisfied critics who claim

¹⁰⁰ See Dobrzynski, *supra* note 5 (citing Buffett's counseling and board positions on many of his portfolio companies as evidence of the existence and profitability of relationship investing).

¹⁰¹ See, e.g., Rohatyn *supra* note 5 (questioning ability of institutional investors to anticipate corporate performance problems and identify appropriate solutions).

¹⁰² See William Taylor, *Can Big Owners Make a Big Difference?*, HARV. BUS. REV., Sept.-Oct. 1990, at 70, 81 (questioning whether institutional investors have the expertise to propose business solutions for troubled companies).

¹⁰³ Wayne, *supra* note 82, at D22.

¹⁰⁴ For a chronicle of developments at Kodak over the last year, see Mark Maremont & Elizabeth Lesly, *Getting the Picture*, BUS. WK., Feb. 1, 1993, at 24; Eric D. Randall, *Whitmore: 'We will deliver'*, USA TODAY, May 13, 1993, at B2; *Change's Pace Costs Kodak CEO*, CHI. TRIB., Aug. 7, 1993, at 1 (describing

that the company has failed to adapt to the changing world.¹⁰⁵

Similarly, recent news reports have described the problems of stagnant revenues and earnings at Borden, Inc.¹⁰⁶ Although a variety of institutions have contacted Borden's management and offered advice on how to improve corporate performance, there is little consensus, even among the investors, about what steps to take.¹⁰⁷ Although investor activism may pressure a corporation into taking steps that management had identified as necessary but resisted for personal or political reasons, cases like Kodak and Borden illustrate that it is less likely that investors will be able to identify the means to improve poor performance.

C. *Private Gains*

The possible divergence of an institutional investor's interests from those of other shareholders creates a second reason for concern about the ability of institutions to act as effective monitors.¹⁰⁸ A decision that maximizes value from the perspective of the institution might not be optimal from the perspective of other investors.¹⁰⁹ The fact that a corporate

institutional investor complaints leading to radical restructuring efforts and selection of Christopher Steffen as chief financial officer, departure of Steffen eleven weeks later, and subsequent ousting of CEO Kay Whitmore amid charges that he failed to respond quickly enough to investors' concerns). Interestingly, the reports of institutional activism, which seemingly led nowhere in terms of corporate performance, nonetheless generated an increase in Kodak's stock price from around \$43/share in January 1993 to a 52-week high of \$58/share in August.

¹⁰⁵ *Change's Pace Costs Kodak CEO*, *supra* note 104, at 1 (quoting Brenda Landry, an investment analyst at Morgan Stanley); *see also* Hubert B. Herring, *At Kodak, No Quick Fixes*, N.Y. TIMES, Dec. 19, 1993, at F2 (describing plunge in Kodak stock price in December 1993 in response to statements by new chairman George Fisher explaining difficulty of solving Kodak's earnings problems).

¹⁰⁶ *See, e.g.*, Alison L. Cowan, *Advice Alone Can't Cure Borden*, N.Y. TIMES, Dec. 12, 1993, at F13.

¹⁰⁷ *See id.* (describing advice ranging from recruiting more food industry veterans onto the board of directors to hiring executives with turnaround expertise, and from recommending spin-offs of unprofitable divisions of the company to suggesting a sale of the entire company to a competitor such as Nestle).

¹⁰⁸ *See, e.g.*, Coffee, *supra* note 10, at 1328-36 (describing various ways in which investment objectives of institutional investors may rationally diverge from those of other shareholders or from the best interests of the corporation).

¹⁰⁹ For example, a state employees' pension fund may be pressured to invest in and be supportive of local business. This pressure may translate into limiting the investor's ability to support efficiency-driven corporate decisions if they would have

decision may not affect all shareholders equally means that both the investor's evaluation of corporate performance and its determination of changes in corporate decisionmaking may be based on its private interests that are distinct from interests common to the entire shareholder class.¹¹⁰

A lack of complete alignment between the interests of the institutional investor and other shareholders may generate a variety of effects, the complete analysis of which is beyond the scope of this Article. The potential divergence of interest is significant, however, for the problem posed here, because it provides an alternative explanation both for increasing shareholder activism and for the ability of some relationship investors to achieve superior returns: the monitoring investor may be using relationship investing to generate private gains for itself rather than improved profits for the target corporation.

The monitoring model described above and the advocates of relationship investing share a common assumption: that a monitoring investor will use its influence to increase, in a general way, the value of the target company. Hence returns from monitoring will be shared by all shareholders in proportion to their ownership interest.¹¹¹ Such returns might be described as public gains from monitoring. Alternatively, however, the influence can be used to produce returns that accrue to the monitoring shareholder in some proportion greater than the shareholder's ownership interest. We might term any such excess returns as private gains.¹¹²

an adverse impact on in-state interests, such as jobs. From the investor's perspective, it is not making an irrational choice; it is simply recognizing an interest not common to other shareholders as part of the calculus.

¹¹⁰ For an example of a rational divergence between the interests of an indexed institutional investor and those of other shareholders with respect to the desirability of takeovers, see Wingerson & Dorn, *supra* note 77. Wingerson and Dorn observe that an indexed investor is essentially invested in all companies and therefore benefits from reducing the cost of intercompany transactions such as takeovers, even if the transactions are not beneficial from the perspective of a particular company. In addition, indexed investors tend to benefit from reduced competition within an industry, and takeovers are a legal means of reducing competition. *Id.* at 247-48.

¹¹¹ It is possible to create a more complicated version of the model in which side payments are permitted to enable shareholders to overcome collective action problems. Such a model would retain the assumption that monitoring will result in a net gain to all shareholders but would relax the assumption of pro rata distribution of that gain.

¹¹² To the extent that an investor is able to generate returns that accrue exclusively to it, the entire gain is a private gain. If, however, the investor merely receives a greater proportion of the gain than other shareholders, only the excess

Private gains can result from any situation in which the monitoring investor can obtain a benefit not generally available to other investors. For example, an investor can use its influence over an issuer to achieve private gains in connection with control transactions such as corporate takeovers,¹¹³ from personalized securities transactions such as the sale to an investor of “sweetheart preferred stock,” and by obtaining preferential treatment in business transactions between itself and the issuer.¹¹⁴

In the mathematical model, private gains operate in the exact reverse manner of monitoring costs: they accrue exclusively to the benefit of the monitoring shareholder. Thus, we can reflect private gains in the mathematical model simply by adding them as a positive return on the investment. If an investor’s private gains from monitoring investment i are designated as $P(i)$, the gains available from monitoring will be $\mu'(i)(A(i)/T - M(i)/Z) - C(m) - \alpha(A(i)/T) + P(i)$, and the investor will monitor as long as those gains are greater than zero.¹¹⁵ Moreover, private gains are frequently less speculative than gains through monitoring.¹¹⁶ Thus a rational investor is likely to be at least as willing to receive private gains as public gains as a result of relationship investing.

Friendly relationships between large investors and management can, and often do, result in the creation of private gains.¹¹⁷ For example, a

return constitutes a private gain.

¹¹³ It is generally assumed that control transactions provide both public and private gains. The control premium is a public gain, which is distributed to all shareholders. A private gain is also necessary, however, to justify the costs of the acquisition to the purchasing shareholder. Depending on one’s view of the economics of the corporate takeover, the private gain may be properly attributable to economies of scale, intracorporate business transactions, or the ability to select more efficient replacement management—as suggested by those in favor of the hostile tender offer. Alternatively, the gain may result from the acquirer’s ability to exploit or loot target company assets—the explanation of those who would regulate tender offers.

¹¹⁴ See also Peter V. Letsou, *Shareholder Voice and the Market for Corporate Control*, 70 WASH. U. L.Q. 755, 780 (1992) (describing the ability of a shareholder to use the corporate proxy machinery to obtain publicity regarding issues of particular concern to that shareholder as another example of private gains).

¹¹⁵ Because private gains are not shared with other shareholders, they do not affect the market rate of return, and, on a relative basis, they still provide an absolute benefit to the monitoring shareholder. Accordingly, for any given level of monitoring expenditures, private returns can be viewed as a constant, like monitoring costs.

¹¹⁶ See Rock, *Controlling the Dark Side*, *supra* note 55, at 1003.

¹¹⁷ An active investor can achieve private gains even if it has an unfriendly relationship with management, but the opportunities to generate such gains are more limited.

friendly investor may make its investment in a target company through the purchase of a different type of security or different class of stock than that owned by public shareholders.¹¹⁸ This relationship offers the opportunity for the investor to receive a return that differs from that available to common shareholders.¹¹⁹

The risk is that a friendly investor can receive private gains even if its monitoring does not add value to the target corporation and even if other shareholders do not benefit. In the extreme case, the investor may use its influence to appropriate corporate value for itself without improving corporate performance at all.¹²⁰ Professor Rock, who has done the most

¹¹⁸ Frequently the investor will purchase what is known as "sweetheart" preferred stock. The investor may receive private gains because the stock is sold at a lower price than it would fetch on the open market, or because the stock has special attributes such as conversion rights, lower risk or higher dividend payments. This type of securities transaction may result from management's desire to secure an infusion of "friendly capital" for the purposes of protecting the autonomy of existing management. In such a case, the investor is receiving sweetheart preferred stock as a form of protection money.

On the other hand, some commentators defend the practice of placing a large block of corporate securities in friendly hands by arguing that, among other things, this type of transaction insulates management from so-called distorted discipline, which might include overly aggressive threats of takeovers that prevent management from acting in the long-term interests of shareholders. *See, e.g.,* Ian Ayres & Peter Cramton, *An Agency Perspective on Relational Investing* (prelim. draft 1993) (on file with author). If this explanation is correct, the placement will ultimately increase returns to all shareholders by allowing management to run the corporation more effectively. A study conducted by Wruck examines the effect of announcements of private block sales by corporations of new equity, both common and preferred, on common stock price. Wruck concludes that the announcements have a net positive effect on common stock prices of approximately 4.5% and attributes the price increases to the market's belief that the presence of a concentrated monitor will increase long-term performance and value. Wruck, *Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings*, 23 J. FIN. ECON. 3 (1989).

¹¹⁹ In *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971), the court suggested that it would be a breach of fiduciary duty for a controlling shareholder to use its influence to pay dividends only to itself, even by use of a distinct class of stock. Most institutional stakes are too small, however, to subject investors to the fiduciary duties imposed on controlling shareholders.

¹²⁰ A pure economic analysis might evaluate the institution's influence in terms of net social gains by weighing the gain by the institution against the loss suffered by other investors. Most people would reject such an approach and require that institutional monitoring produce results that were at least pareto superior. In other words, a minimum criterion for effective institutional monitoring is that it increase returns to some investors without decreasing the return to anyone. A more demanding

extensive work on the subject of private gains to date, describes this scenario as “‘corrupt’ relational investing.”¹²¹

For example, Professor Rock describes the purchase by Corporate Partners¹²² of a special class of Polaroid preferred stock in exchange for protecting Polaroid against a tender offer by Diamond Shamrock.¹²³ Over a two-and-a-half year period, Corporate Partners earned an annual return of nearly twenty percent on its investment.¹²⁴ Polaroid common stock declined in value during the same time period.¹²⁵ The case illustrates the possibility that Corporate Partners’ success in generating superior returns for its fund may reflect its willingness to assist management rather than its ability to improve corporate performance.

Institutions may also use their influence to improve their business relationships with the target company.¹²⁶ For example, although the relationship between the House of Morgan and the corporations in which it invested is often cited as an example of the effectiveness of relationship investing,¹²⁷ the Morgan Bank enjoyed a variety of business relationships

standard would require that monitoring provide at least some public gains and not benefit the institutional investor exclusively.

¹²¹ Rock, *Controlling the Dark Side*, *supra* note 55, at 989.

¹²² Corporate Partners bills itself as “organized to make friendly investments, usually by taking large minority equity positions of approximately 10% to 30% in publicly held companies which could benefit from the presence of a large supportive shareholder. . . .” It has also described itself as “able to provide insulation from market operators and hostile acquirers. . . .” *Shamrock Holdings v. Polaroid Corp.*, 709 F. Supp. 1311, 1326 (D. Del. 1989) (quoting Corporate Partners’ descriptive brochure).

¹²³ Rock, *Controlling the Dark Side*, *supra* note 55, at 990-93.

¹²⁴ *Id.* at 993. The return resulted from a combination of profits from the resale of the stock to Polaroid and \$30 million in dividends payable on the preferred stock.

¹²⁵ *Id.*

¹²⁶ Improved business relationships are a possible explanation for the synergistic monitoring achieved by the Japanese keiretsu. Members of the keiretsu have a web of business relationships, including those of debtor-creditor and customer-supplier. *See, e.g.*, Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 *YALE L.J.* 871, 882-83 (1993); Roe, *Differences*, *supra* note 57, at 1985-86. The keiretsu allows the large block holders to improve their business operations through active monitoring and also serves to reduce risk and opportunistic behavior associated with the investor’s business dealings with the target company. Such improvements all constitute private gains.

¹²⁷ *E.g.*, David P. Hale, *Learning from Germany and Japan*, *WALL ST. J.*, Feb. 4, 1991, at A10 (arguing that American banks such as Morgan were effective corporate monitors until the early 1900s); *cf.* Garten, *supra* note 57, at 590 n.15 (describing as “surprising” the number of scholars who cite the House of Morgan as

with issuers through which it received gains not available to other equityholders and gains that may not have reflected value added by Morgan.¹²⁸

Professor Rock argues that Lazard Freres, the manager of the Corporate Partners fund, has been able to take similar advantage of Corporate Partners' investments to achieve increased investment banking business (and fees).¹²⁹ For example, Rock describes the fact that Lazard Freres earned over fourteen million dollars in investment banking fees from its involvement with Transco Energy Company during the time period 1989 through 1992. During that same time period, Corporate Partners owned \$125 million of a special issue of convertible preferred stock, representing nine percent of the voting power of Transco.¹³⁰

E. I. du Pont de Nemours & Company (Du Pont)'s relationship with General Motors in the early 1900s provides Rock with another illustration of an investor's ability to use its power to generate improved business.¹³¹ In 1917, Du Pont purchased approximately twenty-three percent of the stock of General Motors.¹³² During the subsequent forty years, Du Pont exercised a substantial amount of influence over General Motors' policies, exemplifying the type of long-term investor/issuer relationship currently in vogue.¹³³ In the course of this relationship, General Motors purchased an increasing percentage of its paints, finishes, and coated fabrics from Du Pont.

Eventually, the United States brought a successful antitrust suit against Du Pont, claiming that Du Pont's acquisition of General Motors stock had resulted in Du Pont obtaining an illegal preference over its competitors in product sales to General Motors. Although it is not clear that Du Pont had

the model of an effective institutional investor).

¹²⁸ See Garten, *supra* note 57, at 590 (describing power of institutional investors like the old House of Morgan as arising "from multiple financial and professional relationships with a firm The institution's role as lender, underwriter, and financial advisor made it a true partner of management.").

¹²⁹ Rock, *Controlling the Dark Side*, *supra* note 55, at 998-99.

¹³⁰ Corporate Partners purchased the stock in early 1989.

¹³¹ Indeed, Professor Louis Lowenstein cites the relationship between Du Pont and GM in the 1920s as a model for contemporary relationship investing. LOUIS LOWENSTEIN, *SENSE AND NONSENSE IN CORPORATE FINANCE* 211-17 (1991).

¹³² The history and nature of the acquisition are described in *United States v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 600-02 (1957).

¹³³ See, e.g., Louis Lowenstein, *More Like Whom?*, Opening Remarks, Conference on Relational Investing, at 12 (Appendix) (New York, May 6, 1993) (on file with author) (describing the Du Pont/General Motors relationship as an illustration of relational investing).

received preferential treatment as a result of its actual or perceived influence over General Motors' purchasing decisions,¹³⁴ the Supreme Court's majority opinion observed that "[t]he inference is overwhelming that Du Pont's commanding position [as supplier to General Motors] was promoted by its stock interest and *was not gained solely on competitive merit.*"¹³⁵

The ability to create private gains at the expense of other shareholders is not limited to private institutional investors. Efforts by public pension funds to influence corporate policies to address political rather than economic concerns can also be viewed as a type of private gain. A pension fund may, for example, be able to extract concessions from portfolio companies to benefit local constituencies, such as in-state employment commitments.¹³⁶ Although it is not clear that activism focused on creation of jobs or preservation of in-state business will result in poorer economic performance by target companies,¹³⁷ this type of strategy has the potential to place the goals of the fund in conflict with those of other shareholders.

The creation of private gains means that the decision to monitor may be completely unrelated to the creation of value for common shareholders. In other words, rational monitoring decisions, according to the model, will sometimes result in shareholder activism that does not generally improve corporate performance. If private gains are not available, shareholders will sometimes continue to forgo activism that would benefit the target company. The availability of private gains creates an incentive for an institutional investor to use its influence to appropriate existing corporate value rather than to improve corporate performance.¹³⁸

¹³⁴ The dissenting opinion takes issue with the majority on precisely this point. *See Du Pont*, 353 U.S. at 627-46 (Burton, J., dissenting) (analyzing purchasing decisions by General Motors and concluding that decisions were made on the basis of competitive merit and did not result from Du Pont's participation or influence in General Motors' affairs).

¹³⁵ *Id.* at 605 (emphasis added).

¹³⁶ For example, a recent article described the views of Olena Berg, the new Assistant Secretary of Labor for Pension and Welfare Benefits, as encouraging pension funds to focus on investments targeted to increase jobs. Wayne, *supra* note 65, at D1. *See also* Vanecko, *supra* note 3, at 413 (noting that pension funds may respond to citizens' political concerns in making investment decisions regardless of whether the political investing is in the best interests of fund beneficiaries).

¹³⁷ *See* Wayne, *supra* note 65, at D14 (describing mixed track record of "economically targeted investments" by pension funds).

¹³⁸ *See* Letsou, *supra* note 114, at 780-90 (describing various ways an institutional investor can use its influence to extract private gains rather than to benefit the corporation).

Professor Rock describes the ability of an institution to maximize its self-interest at the expense of corporate value as the "dark side" of relationship investing.¹³⁹ Courts and commentators have traditionally viewed the generation of private gains as a corruption of the investor's relationship with its portfolio company.¹⁴⁰ This conclusion is, however, too facile. The use of investor influence to create private gains should not be viewed as per se proof that the influence is being used inappropriately. The better inquiry is whether the relationship results in a net gain to other stockholders.

In other words, a relationship that generates greater profits for all shareholders and an additional quantity of exclusively private gains provides both a net benefit to the corporation and a pareto superior outcome.¹⁴¹ This type of activism should be encouraged even if the monitoring investor receives more than a pro rata share of that benefit.¹⁴² The private gains may be viewed as compensation for the particular costs and risks borne by the monitoring investor. Within the context of the overall relationship, private gains offer a potential solution to the disincentive created by free riding.

The problem is that the empirical evidence, to date, offers no way to distinguish between good instances of relationship investing and "corrupt" relationships.¹⁴³ In other words, the evidence does not establish whether monitoring creates value. Moreover, liberalization of judicial views toward

¹³⁹ Rock, *Controlling the Dark Side*, *supra* note 55.

¹⁴⁰ See, e.g., *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955) (requiring controlling shareholder to share his sale premium on a pro rata basis with the minority shareholders); *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969) (finding breach of fiduciary duty where group of controlling shareholders used their influence to obtain benefits not available to minority shareholders); cf. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) (appropriate test for determining whether controlling shareholder has abused its position is whether controlling shareholder receives value from the company to the exclusion of the minority shareholders).

¹⁴¹ The requirement of pareto superiority is that no investor's position is made worse as a result of the institutional participation.

¹⁴² For an application of similar analysis to the sale of control by large block investors, see Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. CHI. L. REV. 1465 (1992).

¹⁴³ See, e.g., Rock, *Controlling the Dark Side*, *supra* note 55, at 995 (recent empirical work suggests that the relatively superior returns identified in relationship investing are likely the result of the creation of private gains).

private gains poses a danger of its own: the danger that a monitoring shareholder will retain all of the gains created by monitoring or go even further and actually reduce returns to common shareholders.¹⁴⁴

In many ways, the problem of assessing the value of institutional activism is similar to the question posed in the early 1980s about whether insider trading should be deregulated. Advocates of deregulation argued that the private gains available to corporate officials through insider trading were more than offset by gains to the corporation, including the ability to attract competent management for lesser salaries and improved corporate performance.¹⁴⁵ Thus, according to these commentators, deregulation would allow corporate insiders to generate private gains, the allocation of which could be determined by contract between the insiders and the corporation.¹⁴⁶ The private gains would give insiders the incentive to create corporate value, and the incentive structure would cost the corporation less than achieving the same objectives through direct compensation.¹⁴⁷

Critics of deregulation raised a variety of concerns about the deleterious effect of insider trading. In particular, they responded to the foregoing argument by suggesting that there was no reason to suppose insiders would perform more diligently, thereby increasing corporate value, if they were given the right to trade on inside information.¹⁴⁸ It was

¹⁴⁴ Indeed, the Gordon Group Study recommends that CalPERS exercise caution that high returns to the activist fund not come at the expense of its common stockholdings. Gordon Group Study, *supra* note 58, at 46. Presumably this concern identifies the possibility that private gains may be generated not simply as an alternative to public gains, but as an adjunct to public losses.

¹⁴⁵ See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 HOFSTRA L. REV. 127 (1984); Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801 (1980).

¹⁴⁶ See also Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 224-26 (1991) (describing argument that the use of inside information should be allocated, as other property rights, by private contract).

¹⁴⁷ See also Carlton & Fischel, *supra* note 145, at 870-71 (using insider trading to compensate executives may lead to desirable management behavior); Ronald A. Dye, *Insider Trading and Incentives*, 57 J. BUS. 295 (1984) (describing econometric analysis of insider trading as compensation).

¹⁴⁸ See, e.g., Iman Anabtawi, Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377, 386 (1989) (arguing that inability of shareholders to monitor may result in managers failing to maximize shareholder wealth); see also Fisch, *supra* note

also not clear that insiders would agree to accept reduced salaries in exchange for the ability to trade on inside information. Thus, if the private gains of insider trading were viewed within the context of the relationship between the corporate official and the corporation, existing empirical evidence could not determine whether allowing private gains would benefit the corporation.¹⁴⁹

Although this Article suggests caution, for the same reasons, in viewing increased institutional activism as the remedy for poor performance by United States corporations, the questions posed by relationship investing can be answered. The next step in studying the value of institutional investing requires recognition of the fact that institutional presence, by itself, is not evidence of monitoring. Moreover, even if stock price, in the short run, responds to the announcement of a block position, the block investor need not be improving corporate performance. There is a considerable difference between institutional presence and institutional voice.

V. CONCLUSION

Institutions are the new darlings of the corporate governance movement. Many commentators are convinced that institutions present a vehicle for improving United States corporate decisionmaking and efficiency. Yet the value of the institutional investor depends on its decision to participate actively in corporate monitoring. This Article has suggested that, in the absence of an opportunity for institutions to achieve some private gains, the risks of active investing for most institutional investors outweigh the benefits. Accordingly, it may be appropriate to take a more liberal view of private gains, by considering them within the context of the monitoring relationship. Before the legal constraints on an

146, at 219 n.181 (describing additional problems with using insider trading as management compensation, including the risk of moral hazard).

¹⁴⁹ See Frank H. Easterbrook, *Insider Trading as an Agency Problem*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 81, 90-97 (J. Pratt & R. Zeckhauser eds., 1985); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information*, 1981 SUP. CT. REV. 309, 332 (1981); Frank H. Easterbrook & Daniel R. Fischel, *Trading on Inside Information*, 36 THE LAW SCHOOL RECORD 10, 14 (1990) (private contract theory may not achieve optimal allocation of the property rights in information due to a variety of factors, including the difficulty in enforcing contracts that restrict insider trading because of the practical problems of detecting improper trades; accordingly, deregulation of insider trading may not be beneficial for corporations).

investor's ability to generate private gains are relaxed to facilitate relationship investing, however, it should be established that institutional monitoring will actually add value to United States corporations. For relationship investing to be socially beneficial, it must generate gains to public shareholders, as well as private gains. Its ability to create such public value remains, as yet, uncertain.