

# The Rise and Fall (?) of the Berle-Means Corporation

Brian R. Cheffins\*

## Abstract

This paper forms part of the proceedings of the 10<sup>th</sup> Annual Berle Symposium (2018), which focused on Adolf Berle and the world he influenced. He and Gardiner Means documented in *The Modern Corporation and Private Property* (1932) what they said was a separation of ownership and control in major American business enterprises. Berle and Means became sufficiently closely associated with the separation of ownership and control pattern for the large American public firm to be christened subsequently “the Berle-Means corporation”. This paper focuses on the “rise” of the Berle-Means corporation, considering in so doing why ownership became divorced from control in most of America’s biggest companies. It also assesses whether developments concerning institutional investors and shareholder activism have precipitated the “fall” of the Berle-Means corporation, meaning U.S. corporate governance is no longer characterized by a separation of ownership and control.

Keywords: Berle-Means corporation, separation of ownership and control, institutional shareholders, shareholder activism, index trackers

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\* Faculty of Law, University of Cambridge. When drafting this paper, the author has drawn heavily on *THE PUBLIC COMPANY TRANSFORMED*, which is currently in press. The research has been supported by funding the Leverhulme Trust has generously provided.

## I. INTRODUCTION

Adolf Berle and Gardiner Means maintained in 1932 in *The Modern Corporation and Private Property* that “in the largest American corporations, a new condition has developed....(T)here are no dominant owners, and control is maintained in large measure apart from ownership.”<sup>1</sup> This claim that in large firms ownership had separated from control would have an enduring legacy. Economists James Hawley and Andrew Williams suggested in 2000 “(t)he phenomenon Berle and Means identified in 1932 – the divorce of ownership and control – would come to dominate most thinking about issues of corporate governance for the rest of the twentieth century.”<sup>2</sup> Indeed, in 1991, law professor Mark Roe coined the term “Berle-Means corporation” to refer to a large public firm with fragmented share ownership.<sup>3</sup> This shorthand (sometimes changed slightly to “Berle and Means corporation”) has been adopted with some regularity since.<sup>4</sup>

This paper examines the rise and the possible fall of the Berle-Means corporation. With respect to the rise, it might be thought nearly nine decades after the publication of *The Modern Corporation and Private Property* it would be well known why the separation of ownership and control which Berle and Means documented was occurring. Plausible causes

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<sup>1</sup> ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION & PRIVATE PROPERTY* 110-11 (1932).

<sup>2</sup> JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC* 42 (2000).

<sup>3</sup> Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 11 (1991).

<sup>4</sup> See, for example, Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POLICY 671, 674 (1995); Sofie Cools, *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, 30 DEL. J. CORP. L. 697, 698 (2005); Robert C. Bird & Stephen Kim Park, *Organic Corporate Governance*, 59 B.C. L. REV. 21, 29 (2018). See also *infra* notes 143-44 and related discussion.

have indeed been identified but debate continues.<sup>5</sup> This paper will not provide a definitive explanation for the separation of ownership and control in large American firms. Doing so may be impossible since multiple factors contributed to the rise of the Berle-Means corporation.

With respect to the rise of the Berle-Means corporation the paper moves the debate about causes forward in two ways. First, an analytical framework will be provided that clarifies the factors at work. Second, an important voice will be added to the discussion, namely Adolf Berle's. He speculated on various occasions on developments that likely contributed to the separation of ownership and control he and co-author Gardiner Means sought to document. His conjectures provide intriguing insights into why the Berle-Means corporation moved to the forefront of American corporate governance.

Given that Mark Roe conceived of the expression "Berle-Means corporation" in the early 1990s and given that the shorthand caught on thereafter it might be assumed that a separation of ownership and control remains well-ensconced in the American corporate governance firmament. In fact, doubts have been cast recently on the continued relevance of Berle and Means' description of the typical large public company. For instance, in 2013 corporate law scholars Ronald Gilson and Jeff Gordon argued "(t)he Berle-Means premise of dispersed share ownership is now wrong."<sup>6</sup> Thus, the Berle-Means corporation could be falling away as a symbol of American corporate governance arrangements, if it has not fallen already.

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<sup>5</sup> Cools, *supra* note 4, 698. See also Part IV *infra*.

<sup>6</sup> Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013).

This paper argues that it is premature to write off the Berle-Means corporation. The Berle-Means analysis of the public company, duly amended to reflect the growing prominence of institutional shareholders, remains relevant.<sup>7</sup> When Berle and Means wrote, aside from those stockholders that were vested with sufficient voting power to count on prevailing when resolutions were put forward, the shareholder base of public companies was comprised largely of individuals with tiny stakes who had neither the aptitude nor the inclination to intervene in corporate affairs. Today, with institutional investors holding the bulk of public company shares, this sort of wholesale diffusion of share ownership and an associated intrinsic bias in favor of passivity are now absent. The collective ownership stakes of leading institutional shareholders are now substantial enough to mean theoretically they can readily collaborate and put executives running large companies squarely on the back foot, a prospect foreign to the dispersed individual shareholders prevalent when Berle and Means wrote.

While the rise of institutional investors has changed governance dynamics in large American public companies, passivity remains the default position for today's shareholders. This pattern, moreover, is being reinforced by the rapidly growing popularity of funds the mandate of which is to buy and sell shares to match the performance of well-known stock market indices. The business model of these "index trackers", oriented around simplicity and cost-savings, creates a strong bias in favor of governance passivity likely to reinforce the sort of managerial autonomy with which Berle and Means would have been familiar. The term "Berle-Means corporation" thus remains appropriate short-hand for the paradigmatic American public company.

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<sup>7</sup> For a similar argument, made primarily in the British context but also referring to the American situation, see MARC MOORE & MARTIN PETRIN, *CORPORATE GOVERNANCE: LAW, REGULATION AND THEORY* 98-99 (2017).

The paper proceeds as follows. Section II charts the rise of the Berle-Means corporation, indicating in so doing that the separation of ownership and control with which Berle and Means became associated remained very much a work in progress when *The Modern Corporation and Private Property* was published in 1932. Section III discusses the explanation for ownership separating from control that was widely, if often implicitly, accepted through to the early 1990s, namely that a strong managerial orientation and diffuse share ownership inexorably followed from basic business logic. Section IV considers in an American context theoretical explanations for ownership and control patterns advanced since that point in time, organizing the analysis by reference to three core questions: 1) Why might those owning large blocks of shares want to exit or accept dilution of their stake? 2) Will there be demand for shares available for sale? 3) Will the new investors be inclined to exercise control themselves?

Section V switches the focus of the paper from the past to the present, drawing attention to arguments that institutional investors have collectively accumulated a sufficiently sizeable collective stake to displace the Berle-Means corporation. Section VI reverts to a historical approach, discussing past patterns of behavior of institutional shareholders to show that a public company can be characterized by a separation of ownership and control even if institutional investors own the bulk of the shares. Section VII draws upon the insights Section VI provides to argue that the Berle-Means corporation shorthand remains relevant today and likely will remain so for the foreseeable future. Section VIII concludes.

## II. THE RISE OF THE BERLE-MEANS CORPORATION

A description of a separation of ownership and control in America's largest companies was the best-known feature of Adolf Berle and Gardiner Means' renowned 1932 book *The Modern Corporation and Private Property*. Fully diffuse share ownership did not prevail, however, in a majority of large public firms at that point in time. The rise of the

Berle-Means corporation, marked by a dearth of dominant shareholders and by executives owning no more than a small fraction of the equity, would only be consolidated after World War II.

A. *Ownership and Control as of 1930*

*The Modern Corporation and Private Property* has long been recognized as a book of pivotal importance. Historian Robert Hessen wrote in 1983 as part of a symposium marking the 50<sup>th</sup> anniversary of publication “(f)ew American books have been as highly acclaimed...and fewer still enjoy as illustrious a reputation fifty years after they were published.”<sup>8</sup> Esteemed management theorist Peter Drucker suggested in 1991 Berle and Means’ monograph was “arguably the most influential book in U.S. business history.”<sup>9</sup> Sociologist Mark Mizruchi maintained in 2004 “the field now known as corporate governance dates back to Berle and Means’s classic work.”<sup>10</sup>

*The Modern Corporation and Private Property* addressed several themes, including documenting a growing concentration of economic power in large corporations and exploring the role judicially generated equitable constraints could and should play in limiting the exercise of managerial power.<sup>11</sup> However, the primary theme, occupying two-thirds of the book, was the separation of ownership and control in large business enterprises.<sup>12</sup> *The Modern Corporation and Private Property* would in turn become best known subsequently

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<sup>8</sup> Robert Hessen, *The Modern Corporation and Private Property: A Reappraisal*, 26 J. L. & ECON. 273, 273 (1983).

<sup>9</sup> Peter F. Drucker, *Reckoning with the Pension Fund Revolution*, HARV. BUS. REV., March/April 1991, 106, 114.

<sup>10</sup> Mark S. Mizruchi, *Berle and Means Revisited: The Governance and Power of Large U.S. Corporations*, 33 THEORY & SOCIETY 579, 579 (2004).

<sup>11</sup> BERLE & MEANS, *supra* note 1, 18-46, 196-206, 219-43; George J. Stigler and Claire Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J.L. & ECON. 237, 238-40 (1983).

<sup>12</sup> Thomas K. McCraw, *Berle and Means*, 18 REV. AM. HIST. 578, 584 (1990).

for this feature.<sup>13</sup> George Dent, a corporate law academic, said in 1989 that since the book had been published, “corporate law’s central dilemma has been the separation of ownership and control in public corporations.”<sup>14</sup> Fellow corporate law professor William Bratton wrote in 2001 that the “*The Modern Corporation and Private Property* still speaks in an active voice. Since it first appeared in 1932, corporate law has been reckoning with its description of a problem of management responsibility stemming from a separation of ownership and control.”<sup>15</sup> Historians Kenneth Lipartito and Yumiko Morii maintained in a Berle symposium article published in 2010 the book “has attracted historians, economists, policy makers, and the popular press, all of whom accepted its thesis on the separation of ownership and management in the modern corporation.”<sup>16</sup>

One might infer from the notoriety of Berle and Means’ separation of ownership and control thesis that dominant shareholders were passé in large U.S. companies by 1932. Berle and Means indeed referred in *The Modern Corporation and Private Property* to “a revolution” that “has destroyed the unity that we commonly call property – has divided ownership into nominal ownership and the power formerly joined to it” and declared that “the dispersion of ownership has gone to tremendous lengths among the largest companies and has progressed to a considerable extent among the medium sized.”<sup>17</sup> In fact, the diffusion of share ownership with which the book is so closely associated still had some distance to go.

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<sup>13</sup> Mizruchi, *supra* note 10, 581; William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99, 148 (2008).

<sup>14</sup> George W. Dent, *Toward Unifying Ownership and Control in the Public Corporation*, [1989] WISC. L. REV. 881, 881.

<sup>15</sup> William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 737 (2001) (footnote omitted).

<sup>16</sup> Kenneth Lipartito & Yumiko Morii, *Rethinking the Separation of Ownership from Management in American History*, 33 SEATTLE U. L. REV. 1025, 1027 (2010).

<sup>17</sup> BERLE & MEANS, *supra* note 1, 7, 53.

Berle and Means relied on empirical analysis to document their claim that a separation of ownership and control characterized large U.S. companies. Drawing on industrial manuals, press reports and “street knowledge” they reported on control arrangements in the 42 railroads, 52 public utilities and 106 industrials which comprised America’s largest 200 non-financial corporations, ranked by assets.<sup>18</sup> Berle and Means categorized companies as being under 1) “private ownership” (an individual or compact group owning most or all of the shares) 2) “majority control” (ownership of a majority of stock by a single individual or small group) 3) “control through legal device” (use of corporate “pyramids”, non-voting shares and voting trusts to secure the legal power to vote a majority of the voting shares) 4) “minority control” (an individual or small group holding a sufficiently large minority stake to dominate the affairs of the company) 5) “management control” (no individual or small group having a minority interest large enough – defined as 20 percent -- to hold sway) 6) in receivership.

Berle and Means’ data did not match up fully with their “revolution” rhetoric. Only a minority (88) of their 200 companies qualified as management controlled and only 21 of these 88 were categorized as management-controlled on the basis of direct evidence of a lack of a shareholder with an ownership stake of 20 percent or more.<sup>19</sup> The other “management controlled” companies were ones where the locus of control was doubtful but was presumed to be held by management and where there was a dominant shareholder but that shareholder was a corporation that fell into the management control category.<sup>20</sup>

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<sup>18</sup> *Id.* at 19-27, 67-109. Their analysis expanded on findings Means published in a 1931 article: Gardiner C. Means, *The Separation of Ownership and Control in American Industry*, 46 Q.J. ECON. 68 (1931).

<sup>19</sup> BERLE & MEANS, *supra* note 1, 98-101, 106. Berle and Means actually classified 88½ companies as being under management control. The half was awarded due to a “special situation”, namely the utility Chicago Rys. Co. being in receivership (at 101).

<sup>20</sup> *Id.* at 90-97.



While Berle and Means spoke of a “new condition” in large business enterprises they did acknowledge that a divorce between ownership and control was not yet a fully established fact.<sup>21</sup> They said of the dispersion of the ownership of shares that while “(a) rapidly increasing proportion of wealth appears to be taking this form,” “the separation of ownership and control has not yet become complete.”<sup>22</sup> A 1940 study by the Temporary National Economic Committee (TNEC), which had been established jointly by Congress and President Franklin Roosevelt to investigate the concentration of economic power in the U.S., underscored that dominant shareholders remained prominent in large companies during the 1930s.<sup>23</sup> The TNEC sought to identify as of 1939 who controlled America’s 200 largest non-financial corporations. Statutory powers authorizing data gathering were relied upon to ascertain the percentage of shares owned by the 20 largest stockholders in each firm and the TNEC’s efforts were praised for both accuracy and reliability.<sup>24</sup>

The TNEC report distinguished between those companies under ownership control, either by a family or another corporation, and those with no center of ownership control, the category akin to Berle and Means’ management-controlled grouping. The TNEC assumed ownership control existed where there was a sizeable concentration of equity in the hands of an identifiable dominant group or the largest shareholders had managerial representation and remaining shareholdings were highly dispersed. Among the top 200 non-financial

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<sup>21</sup> Michael Patrick Allen, *Management Control in the Large Corporation: Comment on Zeitlin*, 81 AM. J. SOC. 885, 885 (1976).

<sup>22</sup> BERLE & MEANS, *supra* note 1, 64, 302.

<sup>23</sup> RAYMOND GOLDSMITH *et al.*, THE DISTRIBUTION OF OWNERSHIP IN THE 200 LARGEST NON-FINANCIAL CORPORATIONS, TNEC INVESTIGATION OF CONCENTRATION OF ECONOMIC POWER, MONOGRAPH NO. 29 (1940).

<sup>24</sup> Don Villarejo, *Stock Ownership and the Control of Corporations*, NEW UNIV. THOUGHT, Autumn 1961, 33, 50-51, 56; PHILIP H. BURCH, THE MANAGERIAL REVOLUTION REASSESSED: FAMILY CONTROL IN AMERICA’S LARGE CORPORATIONS 128 (1972); Dennis Leech, *Ownership Concentration and Control in Large U.S. Corporations in the 1930s: An Analysis of the TNEC Sample*, 35 J. INDUST. ECON. 333, 333 (1987).

corporations, the TNEC found that only in 61 was there no center of control. Of the remaining 139 companies, the TNEC classified 77 as being under family control, 56 as being controlled by other corporations and six as being under joint control of family and corporate interest groups. The TNEC concluded control through ownership (albeit usually minority control) was the typical situation in large business enterprises.<sup>25</sup>

*B. Consolidation of the Separation of Ownership and Control*

While Berle and Means' 1932 declaration that ownership and control were apart "in large measure" likely was an overstatement at that point in time matters were evolving in the direction they had suggested. The *New York Times* said in 1943 that "wealthy individuals (and) estates are disposing of important stockholdings piecemeal....(T)his liquidation is being absorbed by an army of relatively small investors....The current period will go down in financial history as one in which important changes were made in the ownership of corporations."<sup>26</sup> The same newspaper said in 1955 of public companies and their executives:

"A generation or so ago, most corporations were held by small groups of investors. Often as not, members of the founding family held the majority of shares. Then came in succession the Great Depression, high taxes on incomes and estates and the need for new capital in a rapidly growing economy. Result: today, the stock of many companies is widely distributed among thousands or even hundreds of thousands of shareholders.

Management, in effect, has become a high-priced employe(e)."<sup>27</sup>

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<sup>25</sup> ROBERT A. GORDON, *BUSINESS LEADERSHIP IN THE LARGE CORPORATION* 42 (1945).

<sup>26</sup> Edward J. Condlon, *Scattering of Big Security Blocks Speeded by Taxes, Post-War Views*, N.Y. TIMES, Oct. 24, 1943, S7.

<sup>27</sup> Richard Rutter, *Proxy Wards Shed No Gore, Much Ink*, N.Y. TIMES, May 24, 1955, 44.

A 1955 study of the background of chief executives and board chairmen of large companies covering 1900, 1925 and 1950 confirmed “the general trend is toward increasing management control” unaffiliated with substantial share ownership, evidenced by the fact that as of 1950 at least three-quarters of the chief executives and chairmen owned less than one percent of their company’s voting stock.<sup>28</sup>

Berle would in time agree that the emergent historical process he and Means had identified was subsequently consolidated in a way that made a separation of ownership and control the norm in large public companies. In 1959 he said “(a) ‘big corporation’ of the year 1925 was still primarily a personal expression. In 1955, the same corporation...is quite obviously an institution.”<sup>29</sup> He noted the same year that while as of 1929 large enterprises were usually under the “working control” of shareholders, “management control...meaning...that no large concentrated stockholding exists that maintains a close working relationship with management” had become “the norm” with “the bulk of American industry now.”<sup>30</sup> In a 1962 *New York Times* article Berle said of public company shares “distribution continues to split up big holdings. Most big corporations are not – indeed cannot be – controlled by any shareholder.”<sup>31</sup> He observed similarly in the *Columbia Law Review* the same year “(n)o one...now denies the essential separation of ownership of the large corporation from its control. Thirty years have markedly accentuated this separation.”<sup>32</sup>

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<sup>28</sup> MABEL NEWCOMER, *THE BIG BUSINESS EXECUTIVE: THE FACTORS THAT MADE HIM* 5-6 (1955).

<sup>29</sup> Adolf A. Berle, *Foreword*, *THE CORPORATION IN MODERN SOCIETY* ix, xiv (Edward S. Mason ed., 1959).

<sup>30</sup> ADOLF A. BERLE, *POWER WITHOUT PROPERTY: A NEW DEVELOPMENT IN AMERICAN POLITICAL ECONOMY* 73-74 (1959).

<sup>31</sup> A.A. Berle, *Bigness: Curse or Opportunity?*, N.Y. TIMES, Feb. 18, 1962, Sunday Magazine, 10.

<sup>32</sup> Adolf A. Berle, *Modern Functions of the Corporate System*, 62 COLUM. L. REV. 433, 437 (1962).

Berle's assessment reflected the general consensus. *Forbes* indicated in 1957 "today's manager works for no single imperious owner. Instead he serves thousands, even hundreds of thousands of stockholder owners."<sup>33</sup> Harvard economist Edward Mason observed in 1959 "(a)lmost everyone now agrees that in the large corporation, the owner is, in general a passive recipient; that typically control is in the hands of management; and that management normally selects its own replacements."<sup>34</sup> Princeton sociologist Wilbert Moore wrote in 1962 that "the Berle-Means doctrine" had "achieved wide acceptance" and that managers had "acquired a large degree of independence from stockholders."<sup>35</sup>

While by the beginning of the 1960s it was widely accepted that in large public companies diffuse share ownership was the norm and dominant shareholders were anomalous, empirical data on point was "all too often scanty or badly out of date."<sup>36</sup> The TNEC's 1939 study remained the best source.<sup>37</sup> Matters changed in the 1960s and 1970s, with a number of studies of ownership and control being conducted. Economist Robert Lerner, for instance, sought to replicate Berle and Means' methodology using data from 1963. He reported that 75 percent of the 500 largest companies in the U.S. were under management control and said his results showed the "managerial revolution" was "close to

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<sup>33</sup> *Not to Pioneer, But to Mesh...*, FORTUNE, Nov. 15, 1957, 27.

<sup>34</sup> Edward S. Mason, *Introduction* in THE CORPORATION, *supra* note 29, 1, 4 (Edward S. Mason ed., 1959).

<sup>35</sup> WILBERT E. MOORE, THE CONDUCT OF THE CORPORATION 6-7 (1962).

<sup>36</sup> Villarejo, *supra* note 24, 49.

<sup>37</sup> *Id.* at 51. See also ROBERT J. LARNER, MANAGEMENT CONTROL AND THE LARGE CORPORATION 7 (1970).

complete.”<sup>38</sup> *Business Week* agreed, saying Larner’s data established that “(m)anagement...holds sway in all but a minor share of America's corporate giants.”<sup>39</sup>

Additional research confirmed for the most part Larner’s finding that dispersed ownership was the norm in large American business enterprises in the 1960s and 1970s.<sup>40</sup> There were studies indicating that only a minority of large companies had fully diffuse share ownership but most of these used a low threshold of share ownership of 5 percent or more to find “control”.<sup>41</sup> Noted political theorist Robert Dahl said in 1970 that “(e)very literate person now rightly takes for granted what Berle and Means established four decades ago in their famous study.”<sup>42</sup> There was by that point in time a solid empirical foundation for the received wisdom.

### III. THE BERLE-MEANS CORPORATION AS A PRODUCT OF BUSINESS LOGIC

Having documented the rise of the Berle-Means corporation in the United States, we will consider now why a separation of ownership and control became the norm in large public companies. Accounting for patterns of ownership and control in the corporate context is not a straightforward exercise, with multiple factors plausibly contributing to prevailing arrangements. Economists Randall Morck and Lloyd Steier have said of theories advanced to explain cross-country variations, “(i)t would be wonderful for economists if we could

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<sup>38</sup> LARNER, *supra* note 37, 17; Robert J. Larner, *Ownership and Control in the 200 Largest Nonfinancial Corporations, 1929 and 1963*, 56 AMER. ECON. REV. 777, 787 (1966).

<sup>39</sup> *Managers Tighten Their Grip*, BUS. WK., Nov. 5, 1966, 63

<sup>40</sup> For a summary, see Brian Cheffins & Steve Bank, *Is Berle and Means Really a Myth?*, 83 BUS. HIST. REV. 443, 468-69 (2009) (see Appendix 2).

<sup>41</sup> *Id.* at 458, 470-71 (Appendix 3).

<sup>42</sup> ROBERT A. DAHL, *AFTER THE REVOLUTION* 104 (1970).

conclude that one is correct and discard the others, but economics is rarely so simple.”<sup>43</sup> The United States is no different in this regard. Finance professor Marco Becht and economic historian Bradford DeLong conceded in a 2005 paper seeking to account for the dearth of controlling shareholders in U.S. public companies “the story we have to tell turns out not to be a neat one.”<sup>44</sup>

While providing a definitive explanation why a divorce of ownership and control took place in the U.S. probably is not feasible, plausible conjectures regarding contributing factors can be offered. A helpful way to start is to consider the extent to which basic business logic accounts for what occurred. Until the early 1990s, it was universally, if largely implicitly, accepted that no further explanation was required for the separation of ownership and control in large firms. Doubts would arise at that point that would provide a platform for the development of theories regarding ownership and control canvassed in Part IV.

#### A. The Business Logic Underlying the Separation of Ownership and Control

While it is now widely acknowledged that explaining ownership patterns in large corporations is not a straightforward exercise, doubts about why the Berle-Means corporation moved to the forefront of America’s corporate economy were slow to emerge. Once a consensus developed that there in fact was a separation of ownership and control in large American corporations, to the extent that there was debate about the phenomenon it focused on whether the stockholder passivity associated with diffuse share ownership begat counterproductively unconstrained executive power that necessitated a substantial regulatory

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<sup>43</sup> Randall K. Morck & Lloyd Steier, *The Global History of Corporate Governance: An Introduction*, in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 1, 29 (Randall K. Morck, ed., 2005).

<sup>44</sup> Marco Becht & Bradford DeLong, *Why Has There Been so Little Blockholding in America?*, in HISTORY OF CORPORATE GOVERNANCE, *supra* note 43, 613, 651.

response.<sup>45</sup> Underpinning the discourse was a widespread belief that, as a matter of business logic, most large corporations would feature diffuse share ownership and managerial control.

The consensus regarding the business logic explanation for the divorce of ownership and control in large firms was typically implicit.<sup>46</sup> For instance, a review of a 1968 reissue of *The Modern Corporation and Private Property* noted when describing the managerially controlled firms dominating the American economy that even “(m)odern critics of the large corporation usually take for granted its inevitability.”<sup>47</sup> Law professor Nicholas Wolfson, very much a fan rather than a critic of big business, nevertheless made explicit the reasoning involved in 1984, saying “(t)he separation of ownership and control is the inevitable product of the need to maximize managerial efficiency in corporate firms.”<sup>48</sup> Such reasoning harkened back to *The Modern Corporation and Private Property*, where Berle and Means said “(d)ispersion in the ownership of separate enterprises appears to be inherent in the corporate system. It has already proceeded far, it is rapidly increasing, and appears to be an inevitable development.”<sup>49</sup>

Financial imperatives were part of the logic assumed to underpin the managerially-dominated corporation’s move to the forefront. Companies needing to raise large amounts of capital seemingly could proceed most readily if their equity was carved up into small units

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<sup>45</sup> Gregory A. Mark, *Realms of Choice: Finance Capitalism and Corporate Governance*, 95 COLUM. L. REV. 969, 973, 975-76 (1995); Brian R. Cheffins, *The Trajectory of (Corporate Law) Scholarship*, 63 CAMBRIDGE L.J. 456, 480-83 (2004).

<sup>46</sup> PAUL A. BARAN & PAUL M. SWEEZY, *MONOPOLY CAPITAL: AN ESSAY ON THE AMERICAN ECONOMIC AND SOCIAL ORDER* 21 (1966) (indicating that it was “taken for granted as an accomplished fact” that control of large corporations would end up in management’s hands).

<sup>47</sup> Robert Lekachman, *The Corporation Gap*, N.Y. TIMES, Sept. 15, 1968, Book Review, 8.

<sup>48</sup> NICHOLAS WOLFSON, *THE MODERN CORPORATION: FREE MARKETS VERSUS REGULATION* 39 (1984).

<sup>49</sup> BERLE & MEANS, *supra* note 1, 47.

that could be distributed publicly to thousands of investors.<sup>50</sup> Dispersed share ownership would then typically follow in turn. This logic seemingly appealed to Berle and Means, who said “(i)n a truly large corporation, the investment necessary for majority ownership is so considerable as to make control extremely expensive.”<sup>51</sup> Berle struck a similar chord in 1954, indicating a separation of ownership and control “was inevitable, granting that modern organizations of production and distribution must be so large as to be incapable of being owned by any individual or small group of individuals.”<sup>52</sup>

Practical challenges associated with running large business enterprises also featured in the basic business logic assumed to underpin the divorce between ownership and control. As firms grew bigger, their operations were likely to become more complex and physically decentralized. Continued success under such circumstances, the thinking went, was contingent upon developing robust managerial capabilities buttressed by the hiring of career-oriented, professionally trained executives.<sup>53</sup> Moreover, so long as companies refrained from treating substantial stock ownership as a necessary qualification for a top executive post, the talent pool from which senior management could be drawn would be greatly expanded. A split between ownership and control logically ensued. For instance, business historian Thomas Cochran accounted in 1957 for the two being divorced in large firms on the basis “that large-scale mass production and transportation hastened the shift toward managerial...control” with “the new big companies plac(ing) executive control in the hands of careerists, selected for

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<sup>50</sup> MARGARET BLAIR, *OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY* 96 (1993); ROBIN MARRIS, *MANAGERIAL CAPITALISM IN RETROSPECT* 6-7 (1998).

<sup>51</sup> BERLE & MEANS, *supra* note 1, 68.

<sup>52</sup> ADOLF A. BERLE, *THE 20<sup>TH</sup> CENTURY CAPITALIST REVOLUTION* 30 (1954).

<sup>53</sup> GORDON, *supra* note 25, 160; OSWALD KNAUTH, *MANAGERIAL ENTERPRISE: ITS GROWTH AND METHODS OF OPERATION* 43 (1948); FRANKLIN G. MOORE, *MANAGEMENT: ORGANIZATION AND PRACTICE* 19 (1964).



their managerial ability. The professional executive needed to own no stock in the enterprise, and if he did buy some it was usually not enough to give him any great stake in the company profits.”<sup>54</sup>

Alfred Chandler, a distinguished business historian best known for his work on how and why firms which pioneered the implementation of sophisticated managerial hierarchies in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries achieved commercial pre-eminence,<sup>55</sup> was probably the leading exponent of the close association between the bolstering of managerial capabilities and the growth and success of business enterprises. His “account of the managerial revolution, including the careful and methodical reasoning and mountainous store of evidence that seemed to support it, proved so compelling that few historians of business and technology took issue with it.”<sup>56</sup> According to Chandler, a new transportation and communication infrastructure oriented around railways, telegraph networks and subsequently telephone service that was taking shape as the 19<sup>th</sup> century drew to a close meant for the first time successful firms were focusing on genuinely national markets for goods and services.<sup>57</sup> At the same time, technological innovations such as mass generation of electric power were fostering previously unimaginable economies of scale and thereby encouraging the

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<sup>54</sup> THOMAS C. COCHRAN, *THE AMERICAN BUSINESS SYSTEM: A HISTORICAL PERSPECTIVE* 11 (1957).

<sup>55</sup> ALFRED D. CHANDLER, *STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF INDUSTRIAL ENTERPRISE* (1962); ALFRED D. CHANDLER, *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977); ALFRED D. CHANDLER, *SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM* (1990). On Chandler’s legacy, see *Alfred Chandler*, ECONOMIST.COM, available at <http://www.economist.com/node/13474552> (accessed March 12, 2018); Douglas Martin, *Alfred D. Chandler Jr., a Business Historian, Dies at 88*, N.Y. TIMES, May 12, 2007, B7.

<sup>56</sup> George David Smith & Davis Dyer, *The Rise and Transformation of the American Corporation* in *THE AMERICAN CORPORATION TODAY* 28, 34 (Carl Kaysen, ed., 1996).

<sup>57</sup> CHANDLER, *VISIBLE*, *supra* note 55, 8.

centralization of production in large plants.<sup>58</sup> These changes set the scene for the emergence of what Chandler called “the modern business enterprise,” with well-developed managerial hierarchies being the defining characteristic.<sup>59</sup> Companies that invested heavily in building managerial capabilities, Chandler argued, tended to prosper – and dominate -- because they would be co-ordinating production, distribution and marketing more effectively than would be possible with heavy reliance on arm’s-length transactions between independent businesses.<sup>60</sup> Hence, corporate success was associated with the growth of what Chandler termed in the late 1970s “the visible hand” of management at the expense of the “invisible hand” market forces constituted.<sup>61</sup>

Chandler maintained that the managerially-focused “visible hand” contributed to industrial and commercial success because large plants set up to exploit economies of scale had to feature effective capacity utilization, which in turn demanded “the constant attention of a managerial team or hierarchy.”<sup>62</sup> The national scale on which leading corporations had begun to operate also favored investment in managerial capabilities. Expansion into new regions combined with the rolling out of wider ranges of products created risks that those overseeing increasingly sprawling enterprises would be overwhelmed by the volume and complexity of assigned tasks and that policy and planning would be handled inefficiently by negotiations between far-flung corporate fiefdoms.<sup>63</sup> The most effective response seemed to

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<sup>58</sup> *Id.* at 207; CHANDLER, *SCALE*, *supra* note 55, 62.

<sup>59</sup> CHANDLER, *VISIBLE*, *supra* note 55, 7.

<sup>60</sup> *Id.* at 6-7.

<sup>61</sup> *Id.* at 1.

<sup>62</sup> ALFRED D. CHANDLER & RICHARD S. TEDLOW, *THE COMING OF MANAGERIAL CAPITALISM: A CASEBOOK ON THE HISTORY OF AMERICAN ECONOMIC INSTITUTIONS* 405 (1985). See also CHANDLER, *VISIBLE*, *supra* note 55, 7.

<sup>63</sup> Oliver Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537, 1555-56 (1981).

be a robust managerial hierarchy where divisional managers were assigned responsibility for running key business units day-to-day and senior head office executives dictated the general direction of the company supported by sophisticated financial control systems and cost management techniques.<sup>64</sup>

Berle became aware of and acknowledged the connection between Chandler's research and his own work on the separation of ownership and control. In a 1967 book entitled *Power* he cited research by Chandler from the early 1960s when describing how "corporation bureaucracy" emerged in the opening decades of the 20<sup>th</sup> century because "enterprises became too big for personal dictatorship."<sup>65</sup> Chandler in turn cited in his 1977 book *The Visible Hand* Larner's 1960s empirical research on ownership and control when saying "by the 1950s the managerial firm had become the standard form of modern business enterprise in major sectors of the American economy," meaning "managerial capitalism had gained ascendancy over family and financial capitalism."<sup>66</sup>

Chandler only occasionally referred to Berle and Means in his work on the emergence of managerial capitalism.<sup>67</sup> Nevertheless, he did acknowledge that Berle and Means launched debate about the implications of a separation of ownership from management.<sup>68</sup> More generally Chandler's research on the business logic underpinning the growth of managerial hierarchies dovetailed neatly with their characterization of the modern corporation as one

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<sup>64</sup> CHANDLER, *VISIBLE*, *supra* note 55, 463; Alfred D. Chandler, *The Competitive Performance of U.S. Industrial Enterprises since the Second World War*, 63 *BUS. HIST. REV.* 1, 11 (1994).

<sup>65</sup> ADOLF A. BERLE, *POWER* 191 (1967), citing CHANDLER, *STRATEGY*, *supra* note 55.

<sup>66</sup> CHANDLER, *VISIBLE*, *supra* note 55, 491, 493.

<sup>67</sup> Lipartito & Morii, *supra* note 16, 1036.

<sup>68</sup> CHANDLER, *SCALE*, *supra* note 55, 631. For other cites see Chandler, *supra* note 64, 14; Alfred D. Chandler, *The Role of Business in the United States: A Historical Survey*, *DAEDALUS*, Winter 1969, 23, 34.

where executives owning only a small proportion of the shares were in charge.<sup>69</sup> Economist Richard Langlois said in 2013 “(w)e learned early on from Berle and Means (1932) that, by the early twentieth century, the owner-managed firm had given way in the United States to a corporate form in which ownership was diffuse and inactive and in which control had effectively passed to managers. Then we learned from Chandler (1977) that this managerial revolution was both inevitable and desirable.”<sup>70</sup>

Ultimately, facets of Chandler’s research became combined with Berle and Means’ separation of ownership and control thesis to generate “a dominant theoretical narrative” that in the late 20<sup>th</sup> century underpinned “our understanding of the evolution of corporate structure in the modern era.”<sup>71</sup> Mark Roe described in 1994 a “dominant paradigm explaining the emergence and success of the large corporation in the United States” that saw “economies of scale and technology as producing a fragmentation of shareholding and a shift in power from shareholders to senior managers with specialized skills.”<sup>72</sup> The *Economist* said similarly

“For many years, it has been argued that the present shape of the American corporation, in which a vast and dispersed group of shareholders exercises little or no control over the firm’s managers, is in some way preordained. Organising firms like this, runs the argument, is simply the most efficient way of adapting to the demands of modern capitalism.”<sup>73</sup>

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<sup>69</sup> Lipartito & Morii, *supra* note 16, 1036.

<sup>70</sup> Richard N. Langlois, *Business Groups and the Natural State*, 88 J. ECON. BEH. & ORG. 14, 14 (2013).

<sup>71</sup> *Id.*

<sup>72</sup> MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* xiii (1994). Roe did not reference Chandler’s work explicitly in support of this proposition but did cite Chandler on a number of occasions when he elaborated on the point – see at 3-5.

<sup>73</sup> *Owners Versus Managers*, *ECONOMIST*, Oct. 8, 1994, 20.

The received wisdom, in sum, was that basic business logic dictated that professional executives owning only a small percentage of widely held shares would control the typical modern large corporation.

## B. Doubts Arise

Inconveniently for those in the post-World War II era who believed business logic preordained that a successful large company would be widely held and run by career-oriented executives lacking a substantial equity stake, from a global perspective the norm for major business enterprises was (and is) to have dominant shareholders.<sup>74</sup> The standard global pattern, however, appeared to be beside the point. Managerially-oriented American companies were the powerhouses of the global corporate economy during the middle decades of the 20<sup>th</sup> century, with 44 of the largest 50 global companies being from the United States as of 1959.<sup>75</sup> *Time* said in 1960 “the U.S. corporation has, by and large, used its awesome efficiency well (and) has become a model for the world.”<sup>76</sup> Economist and journalist Leonard Silk drew attention in 1969 to “Europe’s recognition of and concern over the remarkable drive of American business management.”<sup>77</sup> Given corporate America’s success, countries with corporate economies with different institutional characteristics could be safely

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<sup>74</sup> Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer & Robert Vishny, *Corporate Ownership Around the World*, 54 J. FIN. 471, 472, 491-95 (1999); Gur Aminadav & Elias Papaioannou, *Corporate Control Around the World*, NBER Working Paper 23010 19 (2016) (reporting that with publicly traded companies from 85 countries as of 2012, the ownership stake of the largest shareholder averaged 31.5 percent); María Gutiérrez & Maribel Sáez Lacave, *Strong Shareholders, Weak Outside Investors*, 18 J. CORP. L. STUD. 1, 4 (2018) (table based on 2016 data from the Osiris database of Bureau Van Dijk indicating that among 16 continental European countries in only three did a majority of large publicly traded firms lack a shareholder owning 25 percent or more of the shares.)

<sup>75</sup> Carl Kaysen, *Introduction and Overview* in AMERICAN CORPORATION, *supra* note 56, 3, 25.

<sup>76</sup> *Judging the Giant*, TIME, Feb. 22, 1960, 91.

<sup>77</sup> Leonard S. Silk, *Business Power, Today and Tomorrow*, 98 DAEDALUS 174, 186 (1969).

ignored. Mark Roe and fellow law professor Ronald Gilson elaborated on why in a 1993 law review article:

“The ‘traditional’ model of American corporate governance presented the Berle-Means corporation -- characterized by a separation of ownership and management resulting from the need of growing enterprises for capital and the specialization of management -- as the pinnacle in the evolution of organizational forms. Given this model's dominance, the study of comparative corporate governance was peripheral; governance systems differing from the American paradigm were dismissed as mere intermediate steps on the path to perfection, or as evolutionary dead-ends, the neanderthals of corporate governance. Neither laggards nor dead-ends made compelling objects of study.”<sup>78</sup>

While the success American companies were enjoying meant it was understandable following World War II there was an undisturbed consensus that business logic preordained a separation of ownership and control in large firms, the underlying economic context had changed substantially by the time the 1990s got underway. It was widely believed American corporations were losing ground to German and Japanese rivals.<sup>79</sup> Share ownership in large companies in these countries was considerably more concentrated than was the case in the U.S.<sup>80</sup> This confluence of circumstances implied, contrary to the business logic presumed to underpin the Berle-Means corporation's American dominance, that an ownership and control framework different from that prevailing in the United States was fully capable of delivering

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<sup>78</sup> Ronald J. Gilson and Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 873 (1993).

<sup>79</sup> Ira M. Millstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485, 1487 (1993).

<sup>80</sup> Roe, *supra* note 3, 15.

similar or even superior results.<sup>81</sup> The possibility that successful large firms could be organized in various ways raised, in turn, a question decades of American corporate success had obscured: why was the American system of corporate governance oriented around diffuse share ownership exemplified by a dearth of dominant shareholders?<sup>82</sup> We consider leading explanations next.

#### IV. OTHER EXPLANATIONS FOR THE RISE OF THE BERLE-MEANS CORPORATION

With the unravelling in the 1990s of the implicit consensus that ownership separated from control due to business logic, various theories would be advanced to explain ownership patterns in large firms. It is beyond the scope of this paper to offer any sort of definitive account of why, unlike in most other countries, the Berle-Means corporation came to dominate in the U.S. and remained pre-eminent.<sup>83</sup> Relevant factors can be identified effectively, however, by focusing on three core questions one needs to address to explain why ownership will become divorced from control in corporations.<sup>84</sup> These are: 1) Why might those owning large blocks of shares want to exit or accept dilution of their stake? 2) Will there be demand for shares available for sale? 3) Will the new investors be inclined to exercise control themselves?

Once we have canvassed the core questions in a general way we will use them as our reference point while considering now well-known theories about ownership and control

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<sup>81</sup> Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U.L.Q. 327, 331-32 (1996).

<sup>82</sup> Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1934 (1993).

<sup>83</sup> A monograph might be required to do the topic justice. See BRIAN R. CHEFFINS, *CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED* (2008) (analyzing, primarily from an historical perspective, when and why a separation of ownership and control became the norm in U.K. public companies).

<sup>84</sup> The analysis here draws from *id.* at 8.

arrangements that potentially explain why the Berle-Means corporation moved to the forefront in the United States. In so doing, we will take into account observations of Adolf Berle's that shed light on the leading theory on point, namely that the nature of corporate and securities law is pivotal. We will also consider two variables not otherwise addressed that likely contributed to the separation of ownership and control in American public companies.

#### A. *Core Questions*

With the three core questions that provide insights as to why ownership will tend to separate from control in large business enterprises, the answer to each is by no means obvious. With question #1, substantial blockholders, due to the influence over corporate affairs associated with their voting power, can benefit from their status in ways unavailable to other shareholders by securing "private benefits of control".<sup>85</sup> Given the advantages associated with being a blockholder, why stand down?<sup>86</sup> As a 1926 article in the *Los Angeles Times* indicated, "(n)aturally, the owners of an established business are not anxious to bargain for capital on terms that involves the possible loss of control...."<sup>87</sup>

The basic business logic that up to the 1990s was assumed to underpin the separation of ownership and control in large American firms implied blockholders would be compelled to exit because their firms would lose out in the marketplace to better-run managerially dominated firms. The success German and Japanese companies were enjoying at that point in time undermined this reasoning. The fact that successful corporations from such

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<sup>85</sup> Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006).

<sup>86</sup> MARRIS, *supra* note 50, 9.

<sup>87</sup> Earle E. Crowe, *Public Buys Companies*, L.A. TIMES, Jan. 21, 1926, 13.



jurisdictions frequently had dominant shareholders implied that the presence of such “core” investors in no way precluded faring well against rivals.<sup>88</sup>

Ironically, given that Chandler was the pre-eminent advocate of the contribution managerial hierarchy made to business success, he ultimately acknowledged the unwinding of founder or family holdings was not essential for a corporation to benefit from a sophisticated managerial infrastructure.<sup>89</sup> Instead, so long as suitably effective executives were vested with responsibility for running the business the benefits of managerial hierarchies could be available even if a founder and/or his successors retained a dominant equity stake.<sup>90</sup> Under such circumstances, the core investors would be ongoing beneficiaries of managerial control rather than its victims.

If basic business logic does not compel blockholder exit then why would they opt out? Berle addressed the point, albeit rather briskly, in a 1952 *New York Times* article, saying “(f)ifty years ago American corporations did have identifiable owners. They died, split up their holdings, paid inheritance taxes, sold out, gave away their fortunes and otherwise dispersed.”<sup>91</sup> Given the lure of private benefits of control, it seems unlikely that, death aside, dominant shareholders would have capitulated quite as readily as Berle implied. Why in fact did they “split up their holdings” or sell out completely? Sometimes dominant shareholders will exit because there is a window of opportunity where their firm’s shares are advantageously priced.<sup>92</sup> Other times a blockholder will sell shares because of a need for

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<sup>88</sup> Brian R. Cheffins, *Corporate Law and Ownership Structure: A Darwinian Link?*, 25 U.N.S.W. L.J. 346, 360-61, 376 (2002).

<sup>89</sup> Alfred D. Chandler, *Response to the Contributors to the Review Colloquium on Scale and Scope*, 64 BUS. HIST. REV. 736, 747 (1990).

<sup>90</sup> CHANDLER, *VISIBLE*, *supra* note 55, 491-92.

<sup>91</sup> Adolf A. Berle, *Our Capitalists -- Soviet View and the Reality*, N.Y. TIMES, Sept. 21, 1952, Sunday Magazine, 12.

<sup>92</sup> CHEFFINS, *supra* note 83, 73.

cash to pursue personal goals. For instance, to finance an expensive space rocket project Jeff Bezos, founder of e-tailing powerhouse Amazon, sold \$2 billion' worth of stock in 2017, reducing his stake in the company to 16 percent.<sup>93</sup>

The 1955 quote above from the *New York Times* that referred to taxes and the Depression in the 1930s when discussing the unwinding of control in public companies offers clues likely more relevant to that era as to why dominant shareholders might exit.<sup>94</sup> Sustained erosion of profits and income can leave the dominant shareholder of a business exposed and welcoming the opportunity to sell out despite the theoretical potential for extracting private benefits of control.<sup>95</sup> The combination of tough times during the 1930s and the economic uncertainties and high taxes associated with World War II – from 1942 to 1947 employment and investment income above \$200,000 was taxed at a rate of at least 86.5 percent<sup>96</sup> -- likely meant numerous blockholders were in precisely this position.<sup>97</sup> The fact that capital gains arising from the sale of shares were taxed at a much lower rate than income, with the rate further reduced for assets held for a substantial period of time, provided a further tax-related incentive for blockholders to exit.<sup>98</sup>

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<sup>93</sup> *Control Freaks*, ECONOMIST, Nov. 25, 2017, 72.

<sup>94</sup> *Supra* note 27 and related discussion.

<sup>95</sup> CHEFFINS, *supra* note 83, 67.

<sup>96</sup> Tax Policy Center, *Historical Individual Income Tax Parameters*, available at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=543> (accessed July 15, 2018).

<sup>97</sup> For empirical evidence indicating that high tax rates prompt wealthy investors to sell shares over time, likely in favor of tax-advantaged investments, see Mihir A. Desai, Dhammika Dharmapala & Winnie Fung, *Taxation and the Evolution of Aggregate Corporate Ownership Concentration* in TAXING CORPORATE INCOME IN THE 21ST CENTURY 345 (Alan Auerbach, James R. Hines Jr. & Joel Slemrod eds., 2007).

<sup>98</sup> CHARLES R. GEISST, VISIONARY CAPITALISM: FINANCIAL MARKETS AND THE AMERICAN DREAM IN THE TWENTIETH CENTURY 33 (1990); *U.S. Federal Capital Gains Tax Rates: Historical Data from 1916*, available at [http://forbestadvice.com/Money/Taxes/Federal-Tax-Rates/Historical\\_Federal\\_Capital\\_Gains\\_Tax\\_Rates\\_History.html](http://forbestadvice.com/Money/Taxes/Federal-Tax-Rates/Historical_Federal_Capital_Gains_Tax_Rates_History.html) (accessed July 15, 2018).

As for core question #2, even if blockholders are prepared (or even eager) to exit it is not self-evident why there will be sufficient demand for shares to permit the unwinding of dominant stakes. If those with capital available to invest buy shares in a company which continues to have a dominant shareholder, they can fall victim to extraction of private benefits of control. The circumstances may be no better in a company characterized by a separation of ownership and control because executives owning only a small percentage of the shares will have incentives to put their own interests first and thereby impose what are often characterized as “agency costs” on investors.<sup>99</sup>

Matters are also somewhat complicated with question #3. Assume there is sufficient demand for shares to facilitate exit by incumbent blockholders. There may well be among the new shareholders one investor (or a close alliance of investors) that will want to obtain a dominant stake, whether because of private benefits of control or an intention to profit by setting the company’s strategic direction. One powerful blockholder may thus simply be substituted for another. If this occurs regularly, how does ownership separate from control?

### *B. Key Theories*

In the early 1990s Mark Roe kicked off a lively debate about the determinants of ownership and control in large firms. He did so with a theory that largely took for granted the first two of the core questions that need to be addressed to ascertain why ownership separates from control, implicitly assuming founders and their successors had good reasons to exit and that it was sensible for investors to buy shares in public companies. What he sought to explain was why major financial intermediaries such as banks, insurance companies,

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<sup>99</sup> For a comparison of the pros and cons when companies have dominant shareholders and when they have fully dispersed ownership, see Cheffins, *supra* note 88, 356-62.

mutual funds and pension funds that had the wherewithal to buy enough shares in public companies to accumulate dominant positions failed to follow through.<sup>100</sup>

Roe suggested that at several points in the 20<sup>th</sup> century powerful financial intermediaries were poised to accumulate substantial ownership blocks in American business firms but politicians, mindful of a deeply ingrained popular mistrust of concentrated financial power, derailed the process.<sup>101</sup> Roe identified a series of legislative provisions that at various points in time discouraged financial intermediaries from taking up large ownership stakes in public companies. Examples included rules precluding commercial banks from owning and dealing in securities, legislation discouraging insurance companies from investing in shares and regulations penalizing mutual funds and pension funds minded to accumulate big blocks of shares in a narrow range of companies.<sup>102</sup>

Roe advanced subsequently an additional politically-oriented theory regarding ownership and control that implicitly focused on the second of the three core questions. He hypothesized that public companies with widely dispersed share ownership are less likely to play a key role in “left-wing” social democracies than they are in “right-wing” countries.<sup>103</sup> His logic was that, with social democracies favoring employees over investors, those running

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<sup>100</sup> See, for example, Roe, *supra* note 3; ROE, *supra* note 72.

<sup>101</sup> Roe was not alone in drawing attention to the governance implications of laws imposing restrictions on financial institutions. See, for example, Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89 (1990). Nevertheless, Roe’s work became the dominant influence in the field -- John C. Coffee, *The Future as History: Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. UNIV. L. REV. 641, 643, n. 4 (1999).

<sup>102</sup> For a succinct summary of the key legislative restrictions, see Mark J. Roe, *The Political Roots of American Corporate Finance*, J. APP. CORP. FIN., Winter 1997, 8, 8-9. For a detailed description of the relevant measures, see ROE, *supra* note 72.

<sup>103</sup> Mark J. Roe, *Political Preconditions to Separating Ownership from Control*, 53 STAN. L. REV. 539 (2000); MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003).

large firms in such jurisdictions cater to employee preferences and give shareholders short shrift. Investors in turn steer clear of shares, thereby precluding the development of diffuse share ownership associated with the Berle-Means corporation. According to Roe the United States never fit this pattern, with the class-based economic conflict that gives rise to social democracy failing ever to be sufficiently pronounced. This had the effect of “keeping the pressures low that would make diffuse shareholders wary of leaving their money in managers’ hands.”<sup>104</sup>

A hypothesis first advanced in the late 1990s to explain cross-border differences in stock market development<sup>105</sup> addresses, at least in theoretical terms, all three core questions salient to a determination when ownership will separate from control in large firms. This was what became known as the “law matters” thesis.<sup>106</sup> With respect to ownership patterns, the thinking is that the extent to which corporate and securities law within a particular country protects minority shareholders does much to dictate whether large business enterprises will have diffuse or concentrated share ownership.<sup>107</sup> This would become the most widely-cited and influential explanation for cross-country ownership and control patterns.<sup>108</sup>

To grasp the logic underpinning the law matters thesis, assume a country has laws that regulate closely transactions between companies and their “insiders” (directors and key shareholders), preclude opportunistic conduct by those insiders and impose comprehensive disclosure requirements on companies that offer shares for sale to the public. With such rules

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<sup>104</sup> ROE, *supra* note 103, 104.

<sup>105</sup> See, for example, Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer & Robert Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

<sup>106</sup> Jack Coffee was the first to adopt the terminology – *supra* note 101, 707.

<sup>107</sup> CHEFFINS, *supra* note 83, 6, 33-34.

<sup>108</sup> Mark J. Roe, *Corporate Law’s Limits*, 31 J. LEGAL STUD. 233, 236-37 (2002); Luca Enriques, *Do Corporate Law Judges Matter? Some Evidence from Milan*, 3 EUR. BUS. ORG. L. REV. 756, 766-67 (2002).

in place, blockholders should lack scope to extract meaningful private benefits of control and thus may well be prepared to exit. Concomitantly, investors, aware that the law circumscribes exploitation of outside shareholders and knowing disclosure regulation will help to address informational asymmetries that can afflict those who own equity in public companies, should feel “comfortable” buying stocks available for purchase.<sup>109</sup> With few opportunities being available to take advantage of minority shareholders, those investors buying shares would be less inclined to forsake the benefits of diversification by accumulating dominant stakes in a single firm or a small portfolio of public corporations. Diffuse share ownership thus likely would become the norm in public companies.

The law matters thesis appears to fit the facts well in the U.S. It has a stock market-oriented corporate economy (i.e. well-developed equity markets by global standards), diffuse share ownership has been sufficiently prevalent for large firms to be characterized as Berle-Means corporations and it has a legal regime thought to offer substantial protection for investors.<sup>110</sup> But did the configuration of corporate and securities law actually help to prompt the separation of ownership and control that occurred? The law matters thesis implies that having legal rules in place that provide significant stockholder protection is a pre-condition for the blockholder exit and investor demand necessary for diffuse share ownership in large firms.<sup>111</sup> Given that a separation of ownership and control became the standard arrangement

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<sup>109</sup> Brian R. Cheffins, *Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies*, 23 OXF. J. LEGAL STUD. 1, 6, (2003).

<sup>110</sup> Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1568-69 (2000); FRANK B. CROSS & ROBERT A. PRENTICE, LAW AND CORPORATE FINANCE 51, 128, 216-17 (2007); Brian R. Cheffins, Steven A. Bank & Harwell Wells, *Shareholder Protection Across Time*, 68 FLA. L. REV. 691, 732 (2016) (summarizing results of a study measuring levels of shareholder protection across countries using 10 variables).

<sup>111</sup> Brian R. Cheffins, *Does Law Matter?: The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459, 465 (2001).

in large American public companies during the middle decades of the 20<sup>th</sup> century, it follows that the law should have been providing robust protection for shareholders beforehand.

With respect to corporate law, which is state-based, there is a less than ideal fit with the law matters explanation for dispersed share ownership in large American firms. Delaware has been “the corporation homeland of America” at least as far back as 1930.<sup>112</sup> When the quantitative methodology used to measure corporate law for the purposes of testing the law matters thesis across countries is deployed historically it indicates that Delaware offered mediocre protection to shareholders throughout the first half the 20<sup>th</sup> century as well as subsequently.<sup>113</sup> Moreover, according to Berle and Means, with the rights that corporate law did make available the expense and uncertainty associated with litigation left “the stockholder virtually helpless,” meaning “a stockholder’s right lies in the expectation of fair dealing rather than in the ability to enforce a series of supposed legal claims.”<sup>114</sup>

On the other hand, federal reform occurring in the mid-1930s potentially lends credence to a law matters explanation of the separation of ownership and control in the U.S. As part of the “New Deal” Franklin Roosevelt launched shortly after becoming president in 1933 a set of laws was introduced that plausibly would have prompted dominant shareholders to contemplate exit and made investors feel more “comfortable” about buying shares at prices sufficiently generous to make exit seem worthwhile. The federal Securities Act of 1933 required disclosure of material financial information about public offerings companies

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<sup>112</sup> John T. Flynn, *Why Corporations Leave Home*, ATLANTIC MONTHLY, Sept. 1932, 268, 268. See also Brian R. Cheffins, Steven A. Bank & Harwell Wells, *Questioning “Law and Finance”*: *U.S. Stock Market Development, 1930-70*, 55 BUS. HIST. 598, 605 (2013).

<sup>113</sup> Cheffins, Bank & Wells, *supra* note 112, 604-8.

<sup>114</sup> BERLE & MEANS, *supra* note 1, 243. See also E. Merrick Dodd, *Statutory Developments in Business Corporation Law, 1886-1936*, 50 HARV. L. REV. 27, 51 (1936).

made.<sup>115</sup> The Securities Exchange Act of 1934 established the Securities and Exchange Commission (S.E.C.), prohibited various forms of market manipulation and imposed substantial periodic disclosure requirements on publicly traded companies.<sup>116</sup>

Tougher laws, in the form of federal securities regulation, plausibly did intensify the divorce between ownership and control in progress in larger American companies. The federal securities laws enacted in the 1930s have been widely hailed as measures that restored investors' faith in stocks after the harrowing 1929 stock market crash.<sup>117</sup> Moreover, the timing fits well with the separation of ownership and control chronology already sketched out, in that dominant shareholders exited with some regularity in the quarter-century following regulatory reform.<sup>118</sup> Management professors Allen Kaufman and Lawrence Zacharias have indeed suggested "New Deal securities legislation in effect authorized federal officials to reinforce the shareholder's ownership role under state laws and to reduce the risks of separating ownership from control."<sup>119</sup>

Views Adolf Berle offered in the early 1960s regarding federal securities legislation lend credence to a "law matters" explanation for dispersed share ownership in the American context. In particular, he expressed support for the idea that federal reforms had contributed to an environment where investors could be confident about how public companies would be run. He also suggested ideas set forth in *The Modern Corporation and Private Property* had helped to create momentum in favor of introduction of the relevant regulatory changes. He dealt with these points in the 1962 law review article where he acknowledged that the

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<sup>115</sup> 48 Stat. 74.

<sup>116</sup> 48 Stat. 881.

<sup>117</sup> Cheffins, Bank & Wells, *supra* note 112, 610.

<sup>118</sup> *Supra* notes 26-32 and related discussion.

<sup>119</sup> Allen Kaufman & Lawrence Zacharias, *From Trust to Contract: The Legal Language of Managerial Ideology*, 66 BUS. HIST. REV. 523, 543 (1992).



separation of ownership and control had progressed considerably in the 30 years since he and Means wrote:

“I gladly concede that the dishonest conflict of interest between management and shareholder ownership -- that is, abuse by management of a position in which it can divert a part of the profit and income stream to itself -- has not been accentuated. Again, it seems to me, our work may have been partly responsible. By law and stock-exchange regulation, management is now obliged to file and publish annual accounts of its trust, and quarterly interim reports of its progress. It must make general disclosure of its operations (a recommendation made in *The Modern Corporation*). In all respects the businessmen-managers now operate under the glare of perpetual publicity....While human nature probably has not changed much, community standards do develop, and they have. These have been implemented by institutions tending to enforce them (including) the Securities and Exchange Commission....”<sup>120</sup>

While a plausible case can be made that federal securities law contributed to the diffusion of share ownership in large American companies the evidence is not clear cut. There is also reason to doubt whether Berle or *The Modern Corporation and Private Property* contributed substantially to the introduction of federal securities regulation. Considering the latter point first, Berle was by no means alone in suggesting that his work with Means was influential.<sup>121</sup> *Forbes* said in 1958 “(d)amning greedy management for its frequent disdain of stockholders’ interests, Berle was author in fact and spirit of much New Deal legislation controlling corporate insiders.”<sup>122</sup> The *New York Times* review of the 1968 reissue of *The Modern Corporation and Private Property* said “(p)ublic regulation of the

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<sup>120</sup> Berle, *supra* note 32, 437 (footnote omitted).

<sup>121</sup> Hessen, *supra* note 8, 279.

<sup>122</sup> *Brain Trusted*, FORBES, Feb. 15, 1958, 24.

stock exchanges is a large monument to any book.”<sup>123</sup> Richard Posner, having just moved from academia to the bench, wrote in a 1982 judgment “(t)he intellectual patrimony of the Securities Exchange Act (of 1934) includes Berle and Means’ influential book.”<sup>124</sup>

The role *The Modern Corporation and Private Property* played in fostering the introduction of federal securities regulation in fact was rather modest. It identified issues to which a regulatory response might well be thought appropriate.<sup>125</sup> Nevertheless, the book did not set out a case in favor of the sort of statutory and administrative reforms the 1933 and 1934 Acts encompassed.<sup>126</sup>

Berle, for his part, was a member of a “brain trust” advising Roosevelt during the 1932 presidential election campaign.<sup>127</sup> Nevertheless, Berle played little role in the design of the federal securities laws that were enacted.<sup>128</sup> Moreover, when the changes were made Berle was unenthusiastic, as he believed the steps being taken were not sufficiently fundamental and far-reaching.<sup>129</sup> He said of the 1933 Act the year it was promulgated “this form of measure, while salutary, is not of supreme importance.”<sup>130</sup> Berle noted the legislation “cuts off certain illegitimate uses” but said “it leaves unsolved the major questions” such as “the problem of who is entitled to the increment of value arising from

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<sup>123</sup> Lekachman, *supra* note 47.

<sup>124</sup> Sutter v. Groen and Groen, 687 F. 2d 197, 201 (1982).

<sup>125</sup> JORDAN A. SCHWARZ, *LIBERAL: ADOLF A. BERLE AND THE VISION OF AN AMERICAN ERA* 67 (1987).

<sup>126</sup> McCraw, *supra* note 12, 589.

<sup>127</sup> SCHWARZ, *supra* note 125, 71-74, 81.

<sup>128</sup> John W. Cioffi, *Fiduciaries, Federalization, and Finance Capitalism: Berle's Ambiguous Legacy and the Collapse of Countervailing Power*, 34 SEATTLE U. L. REV. 1081, 1099 (2011).

<sup>129</sup> Hessen, *supra* note 8, 281.

<sup>130</sup> A.A. Berle, *High Finance: Master or Servant*, 23 YALE REV. 20, 42 (1933).

organization, or the increment of power arising from control. Those problems are left to the future.”<sup>131</sup>

As for the contribution federal securities reform made to the divorce between ownership and control that was consolidated between the 1932 publication of *The Modern Corporation and Private Property* and the decades immediately following World War II, if legislative change indeed was decisive federal intervention should have elicited a reasonably rapid boost to investor confidence. Such a surge in faith in stocks would have created sufficiently robust demand for shares at prices generous enough to induce blockholder exit. In fact, stock markets in the U.S. were in the doldrums for at least two decades following federal intervention in securities markets. The number of shareholders flat-lined, public offering activity was below historical norms and the number of companies traded on national stock exchanges stagnated.<sup>132</sup> Even by the mid-1950s, with the stock market performing well and the number of shareholders steadily increasing, jitters remained as Congressional testimony by prominent economist John Kenneth Galbraith paralleling conditions with those in place in 1929 prompted a stock market swoon.<sup>133</sup> The hiatus between reform and the full restoration of investor confidence suggests that even if the enactment of federal securities law contributed to the unwinding of large stock ownership stakes following the publication of *The Modern Corporation and Private Property* there were additional causes. Two variables not accounted for thus far stand out, these being regulation of utilities and merger activity.

### C. Additional Variables

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<sup>131</sup> *Id.*

<sup>132</sup> GEISST, *supra* note 98, 27-35; Cheffins, Bank & Wells, *supra* note 112, 600-3, 610.

<sup>133</sup> STEVE FRASER, EVERY MAN A SPECULATOR: A HISTORY OF WALL STREET IN AMERICAN LIFE 495 (2005); *1953 Score: Stockholdings up 2.5%*, FORBES, July 1, 1954, 14 (providing annual data on the number of shareholders extending back to 1930).

The Public Utility Holding Company Act of 1935 (PUHCA),<sup>134</sup> a legislative measure designed to simplify the corporate structure of the utilities industry, substantially unwound over time control blocks in a sector where they were particularly prevalent. During the opening decades of the 20<sup>th</sup> century it was uncommon for an American public company to have a dominant corporate shareholder in a pyramidal arrangement.<sup>135</sup> The arrangement was standard, however, in the utility sector, with numerous publicly traded utility companies having another company – typically itself a utility company – as a dominant shareholder. For instance, 14 of the 52 utility companies in Berle and Means’ sample of the 200 largest non-financial companies had pyramidal ownership features, a considerably higher proportion than for other types of companies.<sup>136</sup> Though legal challenges blunted the full force of PUHCA until the 1940s, by the early 1950s reorganizations occurring pursuant to the legislation meant the end of the road for the corporate pyramid in the one economic sector where it truly flourished.<sup>137</sup>

Merger activity also likely helped to foster the separation of ownership and control occurring during the middle decades of the 20<sup>th</sup> century, at least from the late 1940s onwards. Depending on the financing method, mergers can elicit diffusion of share ownership among companies conducting acquisitions.<sup>138</sup> If an acquiring company issues new voting shares to

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<sup>134</sup> 49 Stat. 803.

<sup>135</sup> Steven A. Bank & Brian R. Cheffins, *The Corporate Pyramid Fable*, 84 BUS. HIST. REV. 435, 450-52 (2010). Railroad financiers Oris Paxton Van Sweringen and Mantis James Van Sweringen were, as “noteworthy pyramiders”, an exception: FREDRICK LEWIS ALLEN, *THE LORDS OF CREATION* 248, 299-300 (1935).

<sup>136</sup> Bank & Cheffins, *supra* note 135, 453. See also Eugene Kandel, Konstantin Kosenko, Randall Morck & Yishay Yafeh, *The Great Pyramids of America: A Revised History of U.S. Business Groups, Corporate Ownership and Regulation, 1930-1950*, ECGI Finance Working Paper No. 419, Table 1 (2013).

<sup>137</sup> Bank & Cheffins, *supra* note 135, 455-57.

<sup>138</sup> CHEFFINS, *supra* note 83, 69-72.

carry out a share-for-share exchange with the target company's shareholders, executing the merger will inevitably dilute to some degree a blockholder's stake in the acquiring company. The result will be the same if the target company shareholders are paid in cash raised from a public offering of voting shares by the acquirer, assuming the dominant stockholder does not buy a percentage of the shares matching current holdings.

Merger activity was negligible during the 1930s and the first half of the 1940s but increased during the second half of the 1940s and the 1950s.<sup>139</sup> This surge may well have helped to foster ownership dispersion. A 1959 *Business Week* article on Adolf Berle and share ownership entitled "Where Managers Get Their Power" illustrates contemporary awareness of the impact mergers could have on ownership structure.<sup>140</sup> The article traced the history of a hypothetical firm launched in the late 19<sup>th</sup> century that made metal animal traps. The hypothetical company went public in the early 1940s as American Metalworking to raise capital to meet wartime demand. Descendants of the founders still had a controlling interest. As the 1950s drew to a close the company was a diversified enterprise known as American Products Inc. with 100,000 shareholders and no individual owning more than 1 percent of the stock. What happened? For the hypothetical firm "(p)ostwar growth was a whoosh", with the firm carrying out a dozen acquisitions financed partly by profits but also by a series of public offerings of securities that presumably greatly diluted the stake held by the founders' descendants. To the extent that the American Metalworking hypothetical captured reality for U.S. companies, merger activity would have contributed to the rise of the Berle-Means corporation.

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<sup>139</sup> For merger data, see Peter O. Steiner, *MERGERS: MOTIVES, EFFECTS, POLICIES* 4, 6 (1975); Klaus Gugler, Dennis Mueller & B. Burçin Yurtoglu, *The Determinants of Merger Waves*, unpublished working paper, 41 (Fig. 1) (2006), available at <http://www.econstor.eu/bitstream/10419/51061/1/512793220.pdf> (accessed March 6, 2018).

<sup>140</sup> *Where Managers Get Their Power*, *BUS. WK.*, Sept. 12, 1959, 186.

## V. THE FALL OF THE BERLE-MEANS CORPORATION?

Having gone backwards in time to account for the rise of the Berle-Means corporation we now switch to the present day to consider its possible demise. We will consider initially claims advanced that the Berle-Means corporation will soon be displaced as a symbol of corporate America, if it has not been displaced already. We will then find out that if the fate of the Berle-Means corporation has been sealed, this is not because it has become the norm for public companies to have a single shareholder or a tight coalition of shareholders owning a dominant stake. Instead institutional investors, considered on a collective basis, are ostensibly pivotal. Parts VI and VII canvass the position with institutional shareholders.

### A. The Berle-Means Corporation Under Threat?

While the Berle-Means corporation did not move fully into the ascendancy until the 1950s, it appeared to be a durable construct once pre-eminence was achieved. Mark Roe only developed the nomenclature in the early 1990s,<sup>141</sup> assuming in so doing that it remained relevant at that point. For instance, in his 1994 book *Strong Managers, Weak Owners* he connected Berle and Means with the present day, saying their “classic analysis....announced what came to be the dominant paradigm” and that “Berle and Means ‘discovered’ the modern corporation.”<sup>142</sup>

Others subsequently affirmed the ongoing relevance of Berle and Means’ characterization of the American public company. Economists Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny, in a 1999 article that provided empirical evidence on cross-border ownership patterns indicating that the U.S. was out-of-step with much of the rest of the world because blockholders were a rarity, said of the U.S.

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<sup>141</sup> *Supra* note 3 and related discussion.

<sup>142</sup> ROE, *supra* note 72, 6, 94.

that “(t)he Berle and Means image has clearly stuck” even if it had “begun to show some wear” because there were various empirical studies showing “a modest concentration of ownership.”<sup>143</sup> Law professor Arthur Pinto, in a 2010 synopsis of corporate governance in the United States, remarked upon “(t)he predominance of the Berle-Means Corporation.”<sup>144</sup>

While the Berle-Means corporation had a good run after its ascendance, speculation has been rife that its era will end soon, if it has not ended already. Management professor Gerald Davis argued in a Berle symposium article published in 2011 that “(i)n another generation, the Berle and Means corporation may be just a memory.”<sup>145</sup> Ronald Gilson and Jeff Gordon claimed two years later “(t)he Berle-Means description of the distribution of U.S. equity ownership simply is no longer correct.”<sup>146</sup> Fellow legal academics Lucian Bebchuk, Alma Cohen and Scott Hirst asserted in 2017 that “the scenario of dispersed ownership described by Berle and Means (1932) no longer approximates reality, not even for the largest publicly traded corporations” and suggested “current share ownership is significantly more concentrated than the level described by Berle and Means (1932).”<sup>147</sup>

#### B. The Return of Controlled Corporations?

The funeral rites that have been read to the Berle-Means corporation should not be accepted at face value. It moved to the forefront of the American corporate economy when shareholders with sufficiently large ownership stakes to dictate outcomes when stockholders

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<sup>143</sup> La Porta, López-de-Silanes, Shleifer & Vishny, *supra* note 74, 471.

<sup>144</sup> Arthur R. Pinto, *An Overview of United States Corporate Governance in Publicly Traded Corporations*, 58 AM. J. COMP. L. 257, 260 (2010). See also *supra* note 4 and related discussion.

<sup>145</sup> Gerald F. Davis, *The Twilight of the Berle and Means Corporation*, 34 SEATTLE UNIV. L. REV. 1121, 1122 (2011).

<sup>146</sup> Gilson & Gordon, *supra* note 6, 876.

<sup>147</sup> Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 92 (2017).

voted became the exception to the rule in large companies.<sup>148</sup> Mark Roe has said “a shareholder with 25 percent of the company’s stock could veto empire-building acquisitions, question managerial performance, and in extreme instances, replace the managers.”<sup>149</sup> One might logically expect that the Berle-Means corporation’s supposed demise is due to a revival of shareholders of this sort. Despite speculation that shareholders with dominant stakes are becoming more prevalent in American public companies,<sup>150</sup> there has been no such trend. A 2016 study of ownership patterns in the S&P 1500 stock market index carried out on behalf of the Investor Responsibility Research Center Institute (IRRCI) and Institutional Shareholder Services (ISS) makes this clear.<sup>151</sup>

The IRRCI/ISS study focused on “controlled companies”, with corporations qualifying in one of two circumstances. The first was where a significant shareholder, or cohesive shareholder group, owned 30 percent or more of the voting shares. The second was where there was a multi-class capital structure in place that allocated *de facto* control through share classes providing disproportionately large voting rights or enhanced board election rights.<sup>152</sup> The IRRCI/ISS study found “(c)ontrary to common belief the number of controlled companies has declined recently”, with only 105, or 7 percent, of firms in the S&P 1500 qualifying.<sup>153</sup> As per the Berle-Means corporation characterization, then, stockholders with

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<sup>148</sup> *Supra* notes 19-25, 29-32, 38-39 and accompanying text.

<sup>149</sup> Roe, *supra* note 3, 12-13.

<sup>150</sup> Gutiérrez & Sáez Lacave, *supra* note 74, 5, 32.

<sup>151</sup> EDWARD KAMANJOH, CONTROLLED COMPANIES IN THE STANDARD & POOR’S 1500: A FOLLOW UP REVIEW OF PERFORMANCE AND RISK (2016).

<sup>152</sup> *Id.* at 4, 15.

<sup>153</sup> *Id.* at 15.



sufficient voting clout to dictate outcomes in most circumstances are very much the exception to the rule in sizeable American public firms.<sup>154</sup>

The small number of controlled companies needs to be borne in mind when considering Bebchuk, Cohen and Hirst's claim that ownership and control is currently more concentrated than it was in 1932. When they drew upon Berle and Means' data to compare 1932 with the present day they excluded from their calculations corporations which had a shareholder or tight coalition of shareholders with dominant voting power.<sup>155</sup> While such companies are a rarity among larger public companies today, they made up a majority of the 200 companies Berle and Means considered.<sup>156</sup> Comparing all large companies rather than just those lacking a major shareholder would in all likelihood reveal ownership is considerably more widely dispersed today than it was in 1932.

Among the 105 companies in the IRRCI/ISS study with controlling shareholders, there were 27 firms with a shareholder or shareholder group owning 30 percent or more of the shares and 78 with multi-class capital structures. The growing popularity of multi-class shares among tech-oriented companies going public has been widely reported, with prominent examples including Mark Zuckerberg with Facebook in 2012 and Fitbit Inc. and Box Inc. in 2015.<sup>157</sup> However, only a small minority of companies that join the stock market

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<sup>154</sup> See also Gutiérrez & Sáez Lacave, *supra* note 74, 4 (indicating that among the largest 100 American public corporations as of 2016, 85 percent lacked a shareholder owning 25 percent or more of the shares.)

<sup>155</sup> Bebchuk, Cohen, & Hirst, *supra* note 147, 91-92.

<sup>156</sup> *Supra* note 19 and related discussion.

<sup>157</sup> John Plender, *Governance Lessons Lost on Facebook*, FIN. TIMES, Feb. 28, 2012, FT fm, 27; Kristin Lin, *The Big Number*, WALL ST. J., Aug. 18, 2015, B6.

have such arrangements in place.<sup>158</sup> Indeed, the IRRCI/ISS study indicated the number of S&P 1500 companies where control existed due to a multi-class capital structure actually declined slightly from 79 in 2012.<sup>159</sup>

The IRRCI/ISS study did not take into account an increase in 2017 and 2018 of the number of venture-capital backed tech IPOs that provided for multi-class capital structures, exemplified by Snap becoming the first major company since at least 2000 to go public while offering shares with no voting rights attached.<sup>160</sup> Nevertheless, such arrangements are unlikely to displace single-handed the Berle-Means corporation in the foreseeable future. Multi-class capital structures are too rare and too controversial – S&P Dow Jones announced in 2017 that it would no longer add companies with multi-class shares to its iconic S&P 500 index<sup>161</sup> -- for this to happen.

## VI. THE QUALIFIED RISE OF INSTITUTIONAL SHAREHOLDERS

We now know the Berle-Means corporation's days are not numbered because of the prevalence of shareholders with sufficient voting clout to dictate outcomes with shareholder votes, whether due to major ownership blocs or multi-class capital structures. What threat is there, then? Institutional intermediaries who collectively own large stakes in public companies are said to be responsible. As Bebchuk, Cohen and Hirst maintain, “the trend

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<sup>158</sup> Brian Broughman & Jesse M. Fried, *Do Founders Control Start-up Firms That Go Public?*, European Corporate Governance Institute Law Working Paper No. 405/2018 12 (2018). This study focused on companies financed by venture capital.

<sup>159</sup> KAMANJOH, *supra* note 151, 15.

<sup>160</sup> Maureen Farrell, *Tech Founders Want IPO Cash – and Control*, WALL ST. J., April 4, 2017, A1; Rolfe Winkler & Maureen Farrell, *Tech Founders Gain Power*, WALL ST. J., May 29, 2018, A1.

<sup>161</sup> Chris Dieterich, Maureen Farrell & Sarah Krouse, *S&P 500 Blocks Multiple Classes*, WALL ST. J., Aug. 2, 2017, B1.

toward dispersion has been reversed in subsequent decades by the rise of institutional investors.”<sup>162</sup>

Bebchuk, Cohen and Hirst’s institutional shareholder related critique of the Berle and Means characterization of ownership and control is oriented around the present day. Nevertheless, their reference to “subsequent decades” implies that the death knell for the Berle-Means corporation perhaps is not merely being sounded now. Its fate may instead have been sealed for a considerable period of time. That sort of chronology is at odds with the deployment of the Berle-Means corporation shorthand. Mark Roe coined the term less than thirty years ago and it has been used with some regularity since then.<sup>163</sup> To clarify matters, it is helpful to consider the history surrounding the rise of institutional shareholders in U.S. public companies. We do this here and turn to present day circumstances in Part VII.

Adolf Berle, in his 1959 book *Power Without Property*, said of investors in public companies “these stockholders, though politely still called ‘owners’, are passive.”<sup>164</sup> Others agreed with this pessimistic verdict. Shareholders were described in the 1950s and 1960s as “an apathetic bunch”<sup>165</sup> that played “no active role at all.”<sup>166</sup>

It was hardly surprising meaningful shareholder involvement in public company affairs was a rarity during the 1950s and 1960s. “Household” investors – primarily individuals buying and selling securities for their own personal account-- collectively owned

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<sup>162</sup> Bebhuk, Cohen & Hirst, *supra* note 147, 91.

<sup>163</sup> *Supra* notes 3-4, 143-44 and accompanying text.

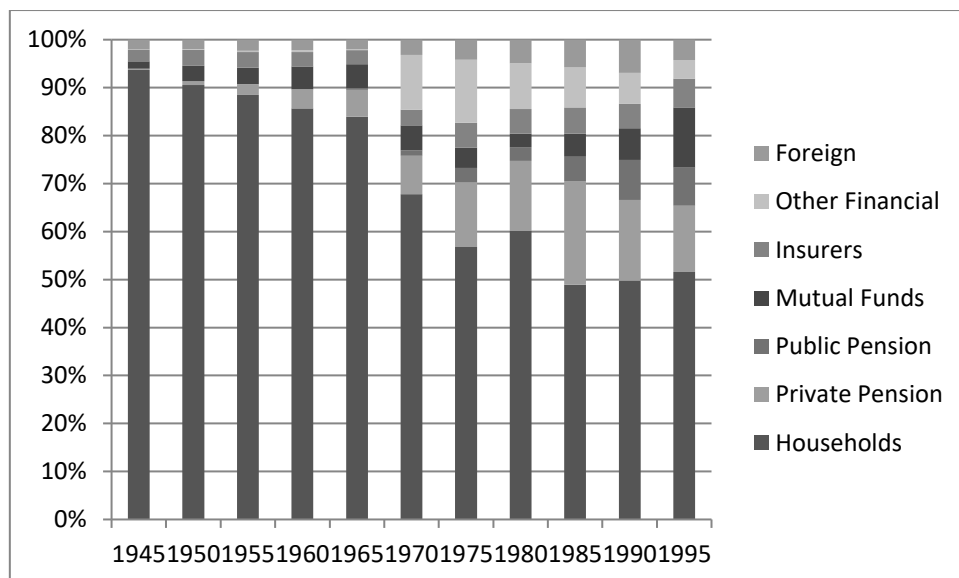
<sup>164</sup> BERLE, *supra* note 30, 74.

<sup>165</sup> Peter B. Greenough, *Stockholders Lax as Voters*, BOSTON GLOBE, March 19, 1964, 20.

<sup>166</sup> HERRYMON MAURER, GREAT ENTERPRISE: GROWTH AND BEHAVIOR OF THE BIG CORPORATION 264 (1955).

most of the shares in publicly traded companies (Figure 1).<sup>167</sup> Such private (“retail”) investors, caustically labelled in 1967 “20 Million Careless Capitalists,”<sup>168</sup> typically lack the aptitude, resources and firm-specific information needed to intervene productively in corporate affairs.<sup>169</sup> They have little incentive to step forward in any case, given the hassle involved and given that the typical private investor owns a tiny stake and thus will only benefit trivially in comparison to shareholders generally from any share price increase associated with a successful intervention.<sup>170</sup>

Figure 1: U.S. Corporate Stock Held by Households and Institutions, 1945-1995



Source: O’Sullivan (2000), OECD (1996)<sup>171</sup>

<sup>167</sup> “Households” is the residual term used by the Federal Reserve, which compiles the data on holders of corporate stock, to categorize owners of shares. See Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 989, 996, n. 24 (2010).

<sup>168</sup> CARTER F. HENDERSON AND ALBERT C. LASHER, *20 MILLION CARELESS CAPITALISTS* (1967).

<sup>169</sup> Brian R. Cheffins, *Introduction*, *THE HISTORY OF MODERN U.S. CORPORATE GOVERNANCE* ix, xix (Brian R. Cheffins, ed., 2011).

<sup>170</sup> *Id.*

<sup>171</sup> MARY O’SULLIVAN, *CONTESTS FOR CORPORATE CONTROL: CORPORATE GOVERNANCE AND ECONOMIC PERFORMANCE IN THE UNITED STATES AND GERMANY* 156

While retail investors dominated share ownership throughout the 1950s and 1960s, institutional investors were growing in importance (Figure 1). There were suggestions then that with institutional ownership increasing a promising source of managerial discipline was emerging. John Kenneth Galbraith, in a review of Adolf Berle's 1959 *Power Without Property*, identified the accumulation of shares by institutional investors as "the one looming threat to the autonomy of the professional managers."<sup>172</sup> The *Christian Science Monitor* maintained in 1966 that "(t)he growing share of institutional shareholders in stock ownership has raised the possibility of making corporate democracy more real."<sup>173</sup>

The institutional shareholders of the 1950s and 1960s, setting a pattern that would prevail over the next few decades, failed to step forward in the manner that seemed possible. Berle said in *Power Without Property* there was "ample evidence" institutional shareholders "do not wish to use the voting power of the stock they have accumulated" and indicated "(w)hen they seriously dislike the managements of corporations....their policy is to sell."<sup>174</sup> Non-intervention in turn served "to insulate the corporate managements."<sup>175</sup> A 1965 study of institutional shareholders concurred with Berle, characterizing them as "silent partners" and indicating "(f)or the most part, institutions are investors not controllers."<sup>176</sup>

The high hopes dashed pattern was repeated in the 1970s. Corporate law scholar Melvin Eisenberg, in his 1976 book *The Structure of the Corporation*, contrasted

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(2000) (1945-75); OECD, OECD ECONOMIC SURVEYS -- UNITED STATES 124 (1996) (1980-95).

<sup>172</sup> J.K. Galbraith, *The Self-Appointed Tenants in the Executive Suite*, N.Y. TIMES, Sept. 6, 1959, Book Review, 3.

<sup>173</sup> David R. Francis, *Large Shareholders Press for Voice in Management*, CHRISTIAN SCI. MONITOR, Nov. 18, 1966, 20.

<sup>174</sup> BERLE, *supra* note 30, 55.

<sup>175</sup> *Id.* at 56.

<sup>176</sup> DANIEL J. BAUM AND NED B. STILES, *THE SILENT PARTNERS: INSTITUTIONAL INVESTORS AND CORPORATE CONTROL* 68 (1965).

“concentrated institutional shareholders” with “highly dispersed individual shareholdings,” saying only the former gave “some hope of a check – a countervailing force – to management.”<sup>177</sup> Similarly, S.E.C. chairman Harold Williams said as the 1970s drew to a close that while “individual shareholder participation is not particularly effective,” “institutional shareholders have a part in vitalizing accountability.”<sup>178</sup>

Institutional shareholders in fact were not much of a “countervailing force” during the 1970s. Edward McSweeney, a management consultant, observed in 1978 that “(s)o far, the managers of institutional funds have declined to interfere with management...preferring, like the ordinary stockholder, to sell when management fails to produce satisfactory earnings.”<sup>179</sup> A 1979 Conference Board study of equity markets that drew heavily on a survey of senior executives confirmed the point, saying “(n)o study respondent expressed the view that institutions try to influence management.”<sup>180</sup>

Expectations regarding the contribution institutional shareholders could and would make in keeping public company executives in check stepped up a gear in the early 1990s. Share ownership patterns were part of the reason, with the proportion of shares retail investors owned having fallen to barely half (Figure 1). Also, hostile takeovers, which kept management on its toes during 1980s amidst hectic deal-making, receded into the corporate governance background as the 1990s got underway.<sup>181</sup> Institutional shareholders were

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<sup>177</sup> MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 61-62 (1976).

<sup>178</sup> Harold M. Williams, *Corporate Accountability and Corporate Power* in *POWER AND ACCOUNTABILITY: THE CHANGING ROLE OF THE CORPORATE BOARD OF DIRECTORS* 9, 28 (1979).

<sup>179</sup> EDWARD MCSWEENEY, *MANAGING THE MANAGERS* 26 (1978).

<sup>180</sup> VINCENT G. MASSARO, *THE EQUITY MARKET: CORPORATE PRACTICES AND ISSUES* 15 (1979).

<sup>181</sup> Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 *DEL. J. CORP. L.* 1, 49-50, 56 (2015).

identified as logical candidates to fill the governance gap.<sup>182</sup> Furthermore, reforms were being undertaken to facilitate shareholder intervention. In 1992 the S.E.C. amended its rules governing parties who solicit proxies (lobby to vote on behalf of stockholders not voting in person at shareholder meetings) to give institutional shareholders scope to discuss privately investee companies without having to comply with potentially onerous proxy solicitation regulations, such as a requirement to file relevant documentation to obtain advance clearance by the Commission.<sup>183</sup>

The rise of institutional investors was hailed regularly during the 1990s as a major corporate governance phenomenon. In 1994, *Forbes* published a story entitled “Good-bye to Berle & Means” that cited a handful of instances where institutional pressure contributed to the dismissal of chief executive officers (CEOs) of a number of prominent public companies to make the point “shareholders and boards of directors showed the boss who was boss.”<sup>184</sup> Management professor Michael Useem suggested in 1996 “(i)nstitutional investors are the new high priests, the new repositories of wealth and power.”<sup>185</sup> Richard Koppes, recently departed general counsel and number two executive at the California Public Employees Retirement System, a powerful public sector employee oriented (“public”) pension fund,

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<sup>182</sup> Victor F. Zonana, *Activist Shareholders Spur Growth of a New Kind of Advice Industry*, L.A. TIMES, July 21, 1991, D3 (citing David Eisner, senior vice president of Providence); John H. Matheson and Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1317-18 (1992).

<sup>183</sup> John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003, 1041 (1993); Joseph Evan Calio and Rafael Xavier Zahraiddin, *The Securities and Exchange Commission’s 1992 Proxy Amendments: Questions of Accountability*, 14 PACE L. REV. 459, 488-89, 495-96 (1994).

<sup>184</sup> Dana Wechsler Linden & Nancy Rotenier, *Good-bye to Berle & Means*, FORBES, January 3, 1994, 100.

<sup>185</sup> MICHAEL USEEM, INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA 38 (1996).

argued in 1997 that “(n)othing has defined the revolution of corporate governance over the last 20 years as the rise of institutional investors.”<sup>186</sup>

Yet again, though, institutional shareholders flattered to deceive. The *Financial Times* observed in 1995 “(u)ntil now, shareholder activism in the U.S. has been a tepid affair.”<sup>187</sup> Law professor Bernard Black, who had been optimistic about the potential for shareholder activism during the early 1990s,<sup>188</sup> indicated in a 1998 survey of the topic “(t)he overall level of shareholder activism is quite low” and pointed out that “(e)ven the most active institutions spend less than half a basis point of assets (0.005%) under management on their governance efforts.”<sup>189</sup> Economists Franklin Edwards and Glenn Hubbard, arguing in 2000 that institutional stock ownership was “a promise unfulfilled”, noted that “institutional investors on the whole have not taken an active role in corporate governance.”<sup>190</sup>

The proportion of shares owned by households (i.e. retail investors) fell to 46% in 2000 and again to 36% in 2008.<sup>191</sup> Moreover, the proportion of public companies which had at least one institutional shareholder owning 10% or more of the shares had increased to 30%

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<sup>186</sup> Richard H. Koppes, *Corporate Governance*, NAT’L. L.J., April 14, 1997, B5.

<sup>187</sup> Richard Waters, *Hostile Offers on Increase*, FIN. TIMES, May 4, 1995, International Corporate Finance, III.

<sup>188</sup> Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 814, 828-29 (1992).

<sup>189</sup> Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States* in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, VOLUME 3 459, 460, 463 (Peter Newman, ed., 1998).

<sup>190</sup> Franklin R. Edwards and R. Glenn Hubbard, *The Growth of Institutional Stock Ownership: A Promise Unfulfilled*, J. APP. CORP. FIN., Fall 2000, 92, 93.

<sup>191</sup> Kahan and Rock, *supra* note 167, 996.



by 2008 from 12% in 1980 and 20% in 1995.<sup>192</sup> The bias in favor of passivity nevertheless continued in the 2000s.

A 2005 analysis of corporate governance arrangements in Germany, Japan, France, Britain and the United States said of the U.S. “(a)part from...public...pension funds...there are few signs of shareholder activism”<sup>193</sup> Law professor Steve Bainbridge observed similarly in 2010, “(t)oday, institutional investor activism remains rare. It is principally the province of union and state and local public employee pension funds. But while these investors’ activities generate considerable press attention, they can hardly be said to have reunited ownership and control.”<sup>194</sup> A key practical obstacle to a more robust approach to shareholder activism was that the investment managers with scope to interact with public company executives were typically seeking to maximize risk-adjusted investment returns so as to prevail in an ongoing competition to attract and retain mandates to manage funds.<sup>195</sup> With improved returns in a particular company most often having no more than a marginal impact on a diversified investment portfolio, with activism being time-consuming, costly and not always successful, and with only a small fraction of any gains generated accruing to an enterprising investor who happened to step forward, the sums simply did not add up.<sup>196</sup>

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<sup>192</sup> Kathleen M. Kahle & René M. Stulz, *Is the U.S. Public Corporation in Trouble?*, 31 J. ECON. PERSP. 67, 81 (2017).

<sup>193</sup> JONATHAN P. CHARKHAM, *KEEPING BETTER COMPANY: CORPORATE GOVERNANCE TEN YEARS ON* 272 (2005).

<sup>194</sup> Stephen M. Bainbridge, *Shareholder Activism in the Obama Era* in *PERSPECTIVES ON CORPORATE GOVERNANCE* 217, 227 (F. Scott Kieff & Troy A Paredes, eds., 2010).

<sup>195</sup> Stephen M. Bainbridge, *The Case for Limited Voting Rights*, (2006) 53 UCLA L. REV. 601, 632-33.

<sup>196</sup> Cheffins, *supra* note 169, xx.

What did all of this signify for the Berle-Means corporation? For some observers, the dramatic growth in institutional shareholdings since the mid-20<sup>th</sup> century meant that the Berle and Means characterization of the corporate economy was intrinsically outmoded. For instance, in 1993 *Fortune* drew attention to Berle and Means' work, proclaimed "(t)hat era has ended" and quoted in support of that proposition the trustee of four New York City pension funds, who said of institutional investors "(w)e own the American economy now."<sup>197</sup> Law professor Robert Hamilton, referring to the growth of institutional shareholdings in a 2000 article on corporate governance, said likewise "(o)bviously, with such concentrations of voting power, the Berle and Means model of the publicly held corporation is no longer valid."<sup>198</sup>

The obsolescence of the Berle-Means corporation in fact was not as self-evident as *Fortune* and Hamilton suggested. The nomenclature Roe coined as the 1990s got underway was gaining traction just as the growth of institutional shareholders was supposedly rendering it passé. This was not inherently anomalous; the strong bias in favor of passivity on the part of most institutional shareholders likely meant that public company executives retained substantial discretion despite the shift toward institutional ownership. Indeed, the autonomy of top management was expansive enough to mean that by the end of the 1990s chief executives in large public firms were operating with sufficient swagger to be characterized as "imperial" CEOs.<sup>199</sup> In 1991 law professor Jack Coffee, having acknowledged "the Berle/Means public corporation" was "the dominant American organizational form",

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<sup>197</sup> Thomas A. Stewart *et al.*, *The King is Dead*, FORTUNE, January 11, 1993, 34.

<sup>198</sup> Robert W. Hamilton, *Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 354 (2000).

<sup>199</sup> RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs 71 (2002).

elaborated on why it remained pre-eminent despite the substantial growth in institutional shareholdings:

“Yet if one looks only at the size of institutional holdings, one may commit the classic mistake of confusing an ox for a bull. Although public pension funds are “bulls” who often engage in aggressive, outspoken criticism of corporate management, they constitute only a modest minority of institutional investors. Most other institutional investors seem closer to ‘oxen,’ because they have shown little willingness to oppose corporate managements or even to support dissidents.”<sup>200</sup>

Drawing matters together, with respect to the interplay between the substantial growth of institutional shareholdings and the continued use of the Berle-Means corporation nomenclature, by the early 2000s a division of opinion had emerged. Some – such as *Fortune* and Robert Hamilton -- felt that the large-scale substitution of “careless capitalists” (i.e. retail investors) with institutional shareholders was sufficient to render the Berle-Means characterization of American corporate governance per se obsolete. With the Berle-Means corporation nomenclature gaining favor, however, the prevailing view was that the bias in favor of passivity affecting institutional shareholders meant ownership remained separate from control despite the growth in institutional holdings. We will consider next whether the position with institutional investors has changed sufficiently in recent years to displace this prevailing view, and will see that this has not occurred. We will also find out that the emergence of a fresh source of shareholder pressure on management, activist hedge funds, has not eclipsed the Berle-Means corporation yet and is unlikely to do so for the foreseeable future.

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<sup>200</sup> John C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1287, 1292-93 (1991).

## VII. THE BERLE-MEANS CORPORATION TODAY – AND TOMORROW

We have just seen that various observers were saying “Good-bye to Berle & Means” during the 1990s but the Berle-Means corporation survived as a popular moniker for the American public company even if the nomenclature had begun “to show some wear.”<sup>201</sup> Switching to the present day, a common refrain is that the Berle and Means characterization of ownership and control in U.S. public companies is “now wrong”?<sup>202</sup> What might have changed in the meantime to seal the fate of the Berle-Means corporation? One possibility, a now supposedly dominant collective stake of the largest institutional shareholders, has already been identified briefly.<sup>203</sup> Other candidates are the emergence of activism by hedge funds and the growing prominence of index tracking funds. We will consider each in turn. None in fact are major difference makers with respect to the inter-relationship between ownership, control and managerial discretion, meaning the Berle-Means corporation nomenclature remains apt.

### A. *Concentrated Institutional Ownership*

One point those who have recently been hailing the demise of the Berle-Means corporation make is that the collective stake of the largest institutional shareholders has now become so sizeable the concept’s fate must be sealed. For instance, Bebchuk, Cohen and Hirst, having posited “the prospects for stewardship by shareholders are substantially better today than in Berle-Means corporations,” support their claim by citing share ownership data for 2016 for the 20 largest U.S. corporations lacking a controlling shareholder.<sup>204</sup> They report that, on average, the five largest institutional shareholders owned 21 percent of the

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<sup>201</sup> *Supra* notes 143, 163, 184 and related discussion.

<sup>202</sup> *Supra* notes 6, 145-47 and accompanying text.

<sup>203</sup> *Supra* note 162 and related discussion.

<sup>204</sup> Bebchuk, Cohen & Hirst, *supra* note 147, 93.

shares, the largest 20 owned 33 percent and the largest 50 owned 44 percent.<sup>205</sup> Gilson and Gordon concluded on the basis of similar data they collected for 2009 for the 10 biggest U.S. companies that “representatives of institutions that collectively represent effective control of many large U.S. corporations could fit around a boardroom table.”<sup>206</sup>

Undertakers for the Berle-Means corporation appear to be assuming that collective institutional stakes of the sort currently prevailing in the largest U.S. public companies will translate readily into substantial compromising of managerial discretion. This can by no means be taken for granted, as research on British institutional investors indicates. In the mid-1990s, Bernard Black and Jack Coffee examined levels of institutional shareholder activism in the United Kingdom to gauge the prospects for activism in the United States, citing the fact that there were fewer barriers to intervention in Britain.<sup>207</sup> One such consideration was the prevalence of sizeable institutional stakes. According to Black and Coffee, it was typical for the 25 largest institutional shareholders to hold a majority of the stock of a U.K. public company,<sup>208</sup> a higher ownership concentration than Bebchuk, Cohen and Hirst cite for large U.S. public companies today. Nevertheless, a separation of ownership and control remained a hallmark of corporate Britain. Black and Coffee acknowledged there was not “the complete passivity announced by Berle and Means” but emphasized “the reluctance of even large shareholders to intervene.”<sup>209</sup>

The bias in favor of passivity that prevailed among powerful institutional shareholders in 1990s corporate Britain is paralleled today in the United States. Gilson and Gordon

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<sup>205</sup> *Id.* at 92.

<sup>206</sup> Gilson & Gordon, *supra* note 6, 875.

<sup>207</sup> Bernard S. Black & John C. Coffee, *Hail Britannia? Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2001-2 (1994).

<sup>208</sup> *Id.* at 2002.

<sup>209</sup> *Id.* at 2086.

acknowledge that while theoretically the substantial collective stakes held by major institutional shareholders in U.S. public companies “should mitigate the managerial agency cost problems of the Berle-Means corporation....(r)eality has fallen short.”<sup>210</sup> Gilson and Gordon say of the possibility of U.S. institutional investors acting as “real” owners or “stewards”, “institutions have continually failed to play this role; despite the urging of academics and regulators, they remain stubbornly responsive but not proactive.”<sup>211</sup>

Other observers concur. John Bogle, founder of the giant mutual fund group Vanguard, cited in 2005 the potentially “awesome power” of institutional investors and referred to the largest institutional holders as “the King Kong of investment America.”<sup>212</sup> He conceded in 2012 that “the strong voice I expected to hear is barely a whisper.”<sup>213</sup> Investment bankers Joseph Perella and Peter Weinberg wrote in the *New York Times* in 2014 “the big shareholders, the institutional shareholders who invest for pension funds and the like, need to stop being silent and speak out.”<sup>214</sup> The *Economist* said in 2015 of major American asset managers “their business is running diversified portfolios and they would rather sell their shares in a struggling firm than face the hassle of fixing it.”<sup>215</sup>

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<sup>210</sup> Gilson & Gordon, *supra* note 6, 889.

<sup>211</sup> *Id.* at 888.

<sup>212</sup> JOHN C. BOGLE, *THE BATTLE FOR THE SOUL OF CAPITALISM* xxi, 76 (2005).

<sup>213</sup> JOHN C. BOGLE, *THE CLASH OF CULTURES: INVESTMENT VS. SPECULATION* 66-67 (2012).

<sup>214</sup> Joseph Perella & Peter Weinberg, *Powerful, Disruptive Shareholders*, N.Y. TIMES, April 9, 2014, A23.

<sup>215</sup> *An Investor Calls*, ECONOMIST, Feb. 7, 2015, 19. McCahery, Sautner and Starks report on the basis of responses to questionnaires sent in 2012 and 2013 to representatives of institutional shareholders “widespread use of behind-the-scenes engagement” – Joseph A. McCahery, Zacharias Sautner & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2908 (2016). Given that the survey response rate was only 4.3 percent and that only 24 percent of the institutional shareholders were based in the U.S. (see at 2908, 2910) the extent to which this conclusion can appropriately be generalized in the American context is impossible to gauge.

The bias against activism amongst institutional investors is evidenced by the fact that even the largest asset managers acting on behalf of mutual funds and pension funds have for the hundreds of corporations in which they invest only a small department dedicated to shareholder voting and other governance-related stewardship activities.<sup>216</sup> Modest staffing reflects, as the *Financial Times* said of the situation in the U.S. in 2015, “the Cinderella status of governance within fund management businesses. While trumpeted as important, it is not an area on which institutions have historically lavished pay and investment.”<sup>217</sup> With a small governance contingent in place it is feasible for major asset managers to make reasoned decisions whether to back firm-specific proposals activist shareholders periodically make and to adopt a voting stance opposing generic management-friendly governance mechanisms such as “staggered” boards where only a designated proportion of directors stand for election each year and “plurality” voting where an unopposed board nominee need not obtain a majority of votes cast to be elected.<sup>218</sup> Shareholders, however, almost never exercise rights they might have to veto transactions executives propose.<sup>219</sup> More generally, taking a sufficiently close interest in a particular company to offer detailed guidance on strategy or spearhead a public activism campaign will be off the agenda.<sup>220</sup>

Mutual funds and pension funds do pretty much always vote their shares, due in large part to a strong steer to do so from the S.E.C. and Department of Labor rules.<sup>221</sup> The level of

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<sup>216</sup> Bebhuk, Cohen & Hirst, *supra* note 147, 101.

<sup>217</sup> Jonathan Ford, *Dimon's Criticisms Over Proxy Advisers Deserve Consideration*, FIN. TIMES, June 1, 2015, 18.

<sup>218</sup> John C. Coffee, *Preserving the Corporate Superego in a Time of Stress: An Essay on Ethics and Economics*, 33 OXF. REV. ECON. POL. 221, 230 (2017).

<sup>219</sup> Sujeet Indap, *Board Directors are Enjoying a More Permissive Climate*, FIN. TIMES, June 5, 2018, 14.

<sup>220</sup> Coffee, *supra* note 218, 230.

<sup>221</sup> *Id.*; James K. Glassman, *Regulators Are a Proxy Adviser's Best Friend*, WALL ST. J., Dec. 18, 2014, 19; Dorothy Shapiro Lund, *The Case against Passive Shareholder Voting*, 43

engagement with the issues, however, is decidedly modest. To manage the costs associated with the potentially daunting number of resolutions on which public companies ask their shareholders to vote – 250,000 per year by one count -- asset managers rely heavily on advice they pay to receive from proxy advisors such as Institutional Shareholder Services and Glass Lewis.<sup>222</sup> Jamie Dimon, CEO of megabank JPMorgan Chase, has accused investment managers of being “lazy capitalists” due to the farming out of voting decisions to these advisory services.<sup>223</sup> The extent to which fund managers adopt proxy adviser recommendations differs depending on the circumstances but departures from what is prescribed are uncommon.<sup>224</sup> Justin Fox, a financial journalist and Jay Lorsch, a Harvard Business School expert on corporate governance, have said of the result “(i)t’s better than nothing, which is what most individual investors do, but it’s a standardized and usually superficial sort of oversight.”<sup>225</sup>

If, despite substantial collective holdings, large institutional shareholders are not compromising markedly managerial autonomy, why might it be that, as Gilson and Gordon and Bebchuk, Cohen and Hirst posit, that the Berle-Means corporation is passé? According to Gilson and Gordon, what has emerged is a regime of “agency capitalism” where institutional shareholders, as agents for end investors, are “not ‘rationally apathetic’...but

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J. CORP. L. 493, 526 (2018) (indicating that, contrary to common perception, S.E.C. rules introduced in 2003 did not directly compel voting).

<sup>222</sup> McCahery, Sautner & Starks, *supra* note 215, 2907, 2924-26; SUNEELA JAIN *ET AL.*, THE CONFERENCE BOARD CORPORATE GOVERNANCE CENTER WHITE PAPER: WHAT IS THE OPTIMAL BALANCE IN THE RELATIVE ROLES OF MANAGEMENT, DIRECTORS AND INVESTORS IN THE GOVERNANCE OF PUBLIC CORPORATIONS? 23 (2014).

<sup>223</sup> *Reinventing the Deal*, ECONOMIST, Oct. 24, 2015, 23.

<sup>224</sup> John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 558 (2016).

<sup>225</sup> Justin Fox & Jay W. Lorsch, *What Good Are Shareholders?*, HARV. BUS. REV., July/Aug. 2012, 48, 55-56.



instead are ‘rationally reticent’.’<sup>226</sup> With respect to the discretion available to executives running public companies, this could well be a distinction without a difference. Unless institutional shareholders begin conducting themselves in the manner that would be expected of “real” owners, the managerial accountability challenges that characterize the Berle-Means corporation will remain live issues despite substantial and quite concentrated institutional ownership. Correspondingly, absent concrete evidence of shareholders regularly taking meaningful steps to keep management in check, the term “Berle-Means corporation” remains appropriate short-hand for the paradigmatic American public company. We will consider next whether hedge funds that specialize in shareholder activism might be changing the game.

### *B. Hedge Fund Activism*

We have just seen that, from the rise of the Berle-Means corporation through to the present day, “mainstream” institutional investors have forsaken stepping forward in the manner those optimistic about institutional shareholder involvement in corporate governance have envisaged. In the 2000s, however, a sub-set of hedge funds – lightly regulated collective investment vehicles marketed to sophisticated investors -- began launching with some frequency campaigns to pressure public company executives to engage in shareholder-friendly change.<sup>227</sup> The typical tactic was to build up quietly a sizeable but by no means dominant holding in a suitable target and then agitate for change, with common demands being that management return cash to shareholders by way of a stock buyback or a one-off dividend payment, sell weak divisions to improve the bottom line and even put the company

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<sup>226</sup> Gilson & Gordon, *supra* note 6, 867.

<sup>227</sup> Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 56, 75, 80-82, 89-90 (2011).

itself up for sale.<sup>228</sup> Hedge fund interventions were sufficiently prominent to be characterized as “the newest big thing in corporate governance” in the 2000s.<sup>229</sup>

The turmoil associated with the 2008 financial crisis posed challenges for hedge fund activists but activism continued, albeit without quite the same intensity as during the mid-2000s.<sup>230</sup> Hedge fund activism then went into overdrive as the 2010s got underway. Jack Coffee and financial economist Darius Palia said in 2016 hedge fund interventions had “recently spiked, almost hyperbolically.”<sup>231</sup>

The efforts of hedge funds play an important part in Ronald Gilson and Jeff Gordon’s claim that the Berle-Means corporation has been relegated to a historical curiosity. Having acknowledged that mainstream institutional shareholders fail to act like “real owners” despite substantial collective ownership, they hail hedge fund activists as “governance intermediaries” who identify underperforming firms and put forward concrete proposals for changes intended to improve shareholder returns.<sup>232</sup> As Gilson and Gordon point out, mainstream institutional investors are often favorably disposed toward such initiatives and institutional backing in its turn frequently represents sufficient voting power to swing around otherwise recalcitrant executives of targeted companies.<sup>233</sup> This “happy complementarity” generates, according to Gilson and Gordon, effective shareholder-related governance unknown to the Berle-Means corporation.<sup>234</sup>

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<sup>228</sup> *Id.* at 88.

<sup>229</sup> JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* 241 (2008).

<sup>230</sup> Cheffins & Armour, *supra* note 227, 95-96.

<sup>231</sup> Coffee & Palia, *supra* note 224, 548.

<sup>232</sup> Gilson & Gordon, *supra* note 6, 866, 896.

<sup>233</sup> *Id.* at 896-97.

<sup>234</sup> *Id.* at 898-900, 916-17.

Gilson and Gordon likely over-estimate the transformative effect of activist hedge funds on shareholder/management relations. For instance, hedge fund interventions are something of a rarity in the case of big public companies. With very large prospective targets typically too many eggs have to be put in one investment basket for it to be worthwhile for a hedge fund to buy up the sort of sizeable minority stake likely required to capture management's attention and needed to yield meaningful profits in the event of success.<sup>235</sup>

The *New York Post* did warn in 2013 that “no company is safe as corporate cage rattlers take aim at some of the biggest names in business.”<sup>236</sup> The *Economist* provided readers with examples in 2015, saying “Americans encounter firms that activists have targeted when they brush their teeth (Procter & Gamble), answer their phone (Apple), log in to their computer (Microsoft, Yahoo and eBay), dine out (Burger King and PepsiCo) and watch television (Netflix).”<sup>237</sup> Such interventions are, however, aberrations. According to FactSet, a financial data company, in 2016 among 319 “high intensity” activist interventions (those where a shareholder activist sought to obtain board representation, dismiss top executives or otherwise campaign strongly to bolster shareholder value) affecting U.S. public companies, only 5 percent involved a target with a market capitalization exceeding \$10 billion.<sup>238</sup> \$10 billion may sound like a large number, but as of mid-2018, among the largest 100 companies in the S&P 500 stock market index, the market capitalization of the smallest

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<sup>235</sup> Cheffins & Armour, *supra* note 227, 63.

<sup>236</sup> Kaja Whitehouse, *Street Fightin' Men*, N.Y. POST, March 9, 2013, 24.

<sup>237</sup> *Capitalism's Unlikely Heroes*, ECONOMIST, Feb. 7, 2015, 11.

<sup>238</sup> FactSet, *2016 Shareholder Activism Review*, Feb. 1, 2017, 7, available at [https://insight.factset.com/hubfs/Resources/Research%20Desk/Market%20Insight/FactSet%207s%202016%20Year-End%20Activism%20Review\\_2.1.17.pdf](https://insight.factset.com/hubfs/Resources/Research%20Desk/Market%20Insight/FactSet%207s%202016%20Year-End%20Activism%20Review_2.1.17.pdf) (accessed March 1, 2018).

was \$32.1 billion.<sup>239</sup> Correspondingly, while activist hedge funds are significant corporate governance intermediaries, their activities are insufficient in isolation to displace with any sort of regularity the reticence (or apathy) among shareholders that would be expected in a large public company.

Hedge fund activism may also have reached an inflection point marking the end of the upward trajectory that began in the 2000s.<sup>240</sup> Public company executives, realizing they can end up on the back foot once a hedge fund activist arrives, are increasingly taking advance precautions. Reputedly, “‘think like an activist’ has become a boardroom mantra as companies strive to anticipate potential hedge fund demands and address perceived weaknesses.”<sup>241</sup> Numerous companies have, for instance, begun engaging in activist “fire drills”, identifying areas of vulnerability and making changes so as to try to forestall a hedge fund foray.<sup>242</sup> With public companies reading the activism playbook and taking anticipatory measures, hedge funds seem to be pulling back as they realize there are fewer instances where intervening will add value.<sup>243</sup> The number of activist forays indeed declined

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<sup>239</sup> S&P Dow Jones Indices, *Equity – S&P 100*, June 29, 2018 (accessed July 20, 2018). Updated versions of this factsheet are posted regularly at <https://us.spindices.com/indices/equity/sp-500>.

<sup>240</sup> Stephen Foley, *The So-Called Death of Event-Driven Investing*, FIN. TIMES, March 7, 2016, FT fm, 10.

<sup>241</sup> Ajay Khorana, Anil Shivdasani & Gustav Sigurdsson, *The Evolving Shareholder Activist Landscape (How Companies Can Prepare for It)*, J. APP. CORP. FIN., Summer 2017, 8, 10.

<sup>242</sup> David Gelles, *Boardrooms Rethink Tactics to Defang Activist Investors*, N.Y. TIMES, Nov. 12, 2013, F10.

<sup>243</sup> Stephen Foley, *The Hard Task of Working Out Where Activists Will Pounce*, FIN. TIMES, Jan. 24, 2017, 28; David Benoit, *Activists Start Thinking Smaller*, WALL ST. J., Nov. 15, 2016, A1.

substantially in 2016 and 2017 as compared to 2014 and 2015, including among large public companies.<sup>244</sup>

Data for the first few months of 2018 suggest the decline in hedge fund interventions may have ended, at least temporarily.<sup>245</sup> Another trend, however, should, if it persists, preclude a meaningful enduring surge in hedge fund activism. Activist hedge funds have, on average, been generating poor returns lately.<sup>246</sup> Perhaps with public company executives endeavoring to think like activists there are now few instances where underperformance is sufficiently egregious for intervention to yield bumper returns. Whatever the explanation, investors, disappointed with results activist hedge funds have been delivering, have begun taking their money out of the sector, a trend that inevitably would throw the brakes on activist hedge fund growth if it continues in earnest.<sup>247</sup> Hedge fund activism thus appears to be stalling, even if there is no full-scale retreat on the horizon. This means, in turn, that if hedge fund activists have not already dealt the fatal blow to the Berle-Means corporation they are unlikely to do so in the foreseeable future.

### C. Index Trackers

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<sup>244</sup> FactSet, *supra* note 238, 7-8 (the proportion of campaigns involving companies with market capitalizations exceeding \$10 billion fell from 8 percent in 2015 to 5 percent in 2016); Khorana, Shivdasani & Sigurdsson, *supra* note 241, 8; Mike Coranto, *2017 Proxy Fights: High Cost, Low Volume*, FACTSET INSIGHT, November 6, 2017, available at <https://insight.factset.com/2017-proxy-fights-high-cost-low-volume> (“high impact” campaigns fell from 382 in 2015 to 328 in 2016 and 273 in 2017) (accessed June 28, 2018).

<sup>245</sup> Cara Lombardo, *Activists Turn Up Heat in Drive for Returns*, WALL ST. J., July 13, 2018, B1.

<sup>246</sup> *Id.*; Gretchen Morgenson & Geraldine Fabrikant, *A Top Investor Is Tripped Up by a Bold Bet*, N.Y. TIMES, March 20, 2017, A1; Leslie Picker, *Hedge Fund Industry’s Stars are Stumbling as Stock Picks and Proxy Fights Fizzle*, CNBC.COM, January 23, 2018, available at <https://www.cnbc.com/2018/01/23/wall-streets-star-activists-stumbled-in-2017.html> (accessed June 27, 2018); David Benoit, *Investors Flee Star Activist Ackman*, WALL ST. J., April 6, 2018, A1; Gregory Zuckerman, *A Hedge-Fund Star Dims, And Investors Bolt*, WALL ST. J., July 5, 2018, A1.

<sup>247</sup> Foley, *supra* note 243; Benoit, *supra* note 246.

Whatever the position turns out to be with hedge funds, with mainstream institutional shareholders there is a recent twist in the plot of which account must be taken. Dramatic growth in the popularity of “passive” index tracking funds has resulted in fears of “a concentration of ownership not seen since the days of the Rockefeller Trust” oriented around Standard Oil at the turn of the 20<sup>th</sup> century.<sup>248</sup> Perhaps this “re-concentration of corporate ownership” is “a fundamental reorganization of the system of corporate governance”<sup>249</sup> that could yet spell doom for the Berle-Means corporation.

From an investor perspective, index tracking funds have much to recommend them. Big tracker funds drive down fees by exploiting economies of scale and by deploying a plain vanilla investment approach, namely matching the performance of a stock market index such as the S&P 500.<sup>250</sup> For instance, the expense ratio for the main S&P tracker fund which the Vanguard Group operates is 0.04 percent of the fund’s assets, as compared with 0.8 percent for the average actively managed American mutual fund.<sup>251</sup> If actively managed funds outperformed the market, the higher fees would be good value. They usually do not, however. Passive funds typically deliver superior returns over time, even discounting the fee advantage a plain vanilla tracking strategy provides.<sup>252</sup>

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<sup>248</sup> Burton G. Malkiel, *Index Funds Still Beat ‘Active’ Portfolio Management*, WALL ST. J., June 6, 2017, A17.

<sup>249</sup> Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POLITICS 298, 302 (2017).

<sup>250</sup> BOGLE, *supra* note 213, 179, 319-20; *The Big Squeeze*, ECONOMIST, May 13, 2017, 74.

<sup>251</sup> *Big Squeeze*, *supra* note 250.

<sup>252</sup> J.B. Heaton, *All You Need is Passive: A Response to Professors Fisch, Hamdani, and Davidoff Solomon*, unpublished working paper, 2, 6, available at SSRN: <https://ssrn.com/abstract=3209614>.

Investors have increasingly been swung around by the logic of index tracking funds. In 2016, of the more than \$400 billion of new retail investments coming through financial advisers, 82 percent was placed in index funds and their close relative, exchange trading funds.<sup>253</sup> With the money pouring in, the proportion of the S&P 500 owned by U.S.-based index trackers increased from 4.6 percent in 2005 to 13.9 percent in 2017.<sup>254</sup>

BlackRock, Vanguard, and State Street, the three largest U.S.-based asset management firms, dominate the rapidly growing index tracking industry.<sup>255</sup> With a substantial majority of the assets under management of each of “the Big Three” invested in passive index funds,<sup>256</sup> the dramatic growth of index tracking funds has meant their stakes in public companies have increased substantially recently. Vanguard’s passive funds alone held a stake of 5 percent or more in 468 S&P 500 companies as of 2016, up from just three in 2005.<sup>257</sup> The proportion of S&P 500 companies where BlackRock, Vanguard, and State Street combined would constitute the largest shareholder increased from 25 percent in 2000 to 88 percent in 2015.<sup>258</sup>

The large collective stake the Big Three hold in U.S. public companies has been referred to as “(a)n economic blockbuster” that “has recently been exposed.”<sup>259</sup> In particular,

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<sup>253</sup> Jason Zweig, *Mindless Robots, Overblown Worries*, WALL ST. J., Feb. 25, 2017, B1.

<sup>254</sup> Dieterich, Farrell & Krouse, *supra* note 161.

<sup>255</sup> Fichtner, Heemskerck & Garcia-Bernardo, *supra* note 249, 299, 304.

<sup>256</sup> *Id.*; Hortense Bioy *et al.*, *Passive Fund Providers Take an Active Approach to Investment Stewardship*, MORNINGSTAR, Nov. 2017, 4.

<sup>257</sup> Sarah Krouse & David Benoit, *Passive Funds Embrace Their New Power*, WALL ST. J., Oct. 25, 2016, A1.

<sup>258</sup> Lund, *supra* note 221, 496, 509; Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 2026, 2029 (2018).

<sup>259</sup> Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1267 (2016). Elhauge also treats Fidelity, a major asset manager which does not specialize in passive investing, as part of the “economic blockbuster” phenomenon.

the anti-competitive effects of “common ownership”, which exists where a single investor owns shares of competing firms, have set off alarm bells.<sup>260</sup> An investor in this position will potentially prefer that the co-owned corporations refrain from competing intensely so as to create scope for charging higher prices that will bolster profits and shareholder returns.<sup>261</sup> With the Big Three having ostensibly emerged as “the dominant capital market players of our time”<sup>262</sup> concerns exist that their collective common ownership is substantial enough to impact upon the behavior of market leaders in key industries and create substantial anti-competitive effects throughout the U.S. economy.<sup>263</sup>

Regardless of who the shareholders might be, executives running firms that dominate an industry with oligopolistic features have incentives to throw the competitive brakes on so as to avoid difficult decisions and enjoy a “quiet life”.<sup>264</sup> The manner in which the Big Three operate indicates that they are unlikely to do much, if anything, to reinforce whatever tendencies already exist for rivals in an industry to ease off competitively.<sup>265</sup> With respect to the governance of public companies any highly diversified investment fund will have a bias in favor of passivity. Intervening may not yield a beneficial outcome, the benefits arising from successful interventions have to be shared amongst all shareholders and the expense and

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<sup>260</sup> Jacob Gramlich & Serafin Grundl, *Testing for Competitive Effects of Common Ownership*, Board of Governors of the Federal Reserve System Finance and Economics Discussion Series 2017-029 2 (2017); *Europe Targets U.S. Asset Managers*, WALL ST. J., March 28, 2018, A16 (discussing an investigation European Union competition law officials were launching).

<sup>261</sup> Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 249, 322.

<sup>262</sup> Eric A. Posner, Fiona Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669, 669 (2017).

<sup>263</sup> See, for example, Elhauge, *supra* note 259; Posner, Morton & Weyl, *supra* note 262; José Azar, Martin C. Schmalz & Isabel Tecu, *Anti-Competitive Effects of Common Ownership*, unpublished working paper (2017).

<sup>264</sup> Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POL. ECON. 1043, 1047 (2003).

<sup>265</sup> *Europe Targets U.S. Asset Managers*, *supra* note 260.



distractions associated with stepping forward could result in losing out in terms of relative performance to less energetic, free-riding rivals.<sup>266</sup> Index tracker funds have particularly weak incentives to act as engaged shareholders.<sup>267</sup> Operators of index funds do not compete over the performance of the index they are set up to mimic, which is taken as a given, and instead focus on keeping costs as low as possible and eliminating tracking errors.<sup>268</sup>

Correspondingly, if those running an index fund expend resources to identify and correct underperformance in particular companies, any gains will be shared with the market at large, fees will likely increase and, in an industry where price competition has a significant effect on investor inflows, market share could well be lost rapidly to cheaper, fully passive rivals.<sup>269</sup>

Operators of index tracking funds insist they are not mere “professional snoozers.”<sup>270</sup> Larry Fink, BlackRock’s CEO, who reputedly wants “to be the conscience of Corporate America,”<sup>271</sup> maintains “(t)he time has come for a new model of shareholder engagement—one that strengthens and deepens communication between shareholders and the companies that they own.”<sup>272</sup> Similarly Vanguard Principal and Fund Controller Glenn Booraem has said its funds seek to be “passive investors but active owners.”<sup>273</sup> Booraem reasons

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<sup>266</sup> *Supra* notes 195-96 and related discussion; Gilson & Gordon, *supra* note 6, 889-93; STEPHEN M. BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE CRISIS* 243-46 (2012).

<sup>267</sup> Bebchuk, Cohen & Hirst, *supra* note 147, 90.

<sup>268</sup> Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance*, New York University School of Law Law and Economics Research Series Working Paper No. 17-05, 7, 27 (2017).

<sup>269</sup> Bebchuk, Cohen & Hirst, *supra* note 147, 98; *Passive, Aggressive*, *ECONOMIST*, Nov. 18, 2017, 69; Chris Flood, *Price War Becomes “Winner Take All”*, *FIN. TIMES*, May 7, 2018, FT fm, 1.

<sup>270</sup> On the characterization, see *Snaptrap*, *ECONOMIST*, Feb. 11, 2017, 58.

<sup>271</sup> *BlackRock: Ebb and Flow*, *FIN. TIMES*, April 13, 2018, 12.

<sup>272</sup> Sarah Krouse, *BlackRock’s Fink Pledges to Intensify Shareholder Activism*, *WALL ST. J.*, January 17, 2018, B12.

<sup>273</sup> *Reinventing the Company*, *ECONOMIST*, Oct. 24, 2015, 11.

Vanguard and other investment firms operating index tracking funds must exercise their voices because with the level of investment in companies being pre-determined by the market “(w)e’re riding in a car we can’t get out of” and “(g)overnance is the seat belt and air bag.”<sup>274</sup> Fear of criticism provides an additional incentive to speak up. A State Street official has said “(w)e are stewards of a large part of the U.S. economy, and it’s important that we do that properly. If we didn’t do that, we’d open ourselves up to opprobrium from our investors.”<sup>275</sup>

The Big Three have added staff recently to deal with governance and stewardship.<sup>276</sup> Nevertheless, each of the firms is poorly situated to impinge substantially on the discretion of public company executives, whether to encourage those executives to throw the competitive brakes on or otherwise. BlackRock’s governance team is comprised of around 35 employees tasked with overseeing the 14,000 companies in which BlackRock owns shares.<sup>277</sup> Vanguard has just over 20 people for its 13,000 companies and State Street has approximately a dozen for its 9,000.<sup>278</sup> The Big Three’s governance staffers carry out dozens of engagements each year with management of companies in which their index tracking funds own shares.<sup>279</sup> Nevertheless, with most portfolio companies it is not feasible to arrange a meeting even

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<sup>274</sup> Amy Deen Westbook & David A. Westbook, *Unicorns, Guardians, and the Concentration of the U.S. Equity Markets*, 96 NEB. L. REV. 688, 736 (2018). See also Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *Passive Investors*, University of Pennsylvania Institute for Law and Economics Working Paper 18-12, 14-19 (2018).

<sup>275</sup> Attracta Mooney & Robin Wigglesworth, *Biggest Fund Managers Face Showdown in US Gun Debate*, FIN. TIMES, March 5, 2018, FTfm, 6.

<sup>276</sup> Fisch, Hamdani & Davidoff Solomon, *supra* note 274, 26; Jason Zweig, *This Index Argument Does Not Hold Water*, WALL ST. J., April 21, 2018, B1.

<sup>277</sup> Bioy *et al.*, *supra* note 256, 19; Krouse & Benoit, *supra* note 257.

<sup>278</sup> Lund, *supra* note 221, at 516; Bioy *et al.*, *supra* note 256, 19; Mooney & Wigglesworth, *supra* note 275.

<sup>279</sup> Bioy *et al.*, *supra* note 256, 16 (listing 1480, 817 and 611 for BlackRock, Vanguard and State Street respectively for 2016). See also Fisch, Hamdani & Davidoff Solomon, *supra* note 274, 25.

annually.<sup>280</sup> Public company executives notice. A CEO told the *Financial Times* in 2017 “(w)e’d love to talk to the passive guys, they control 20 per cent of our shares, but they don’t want to see us.”<sup>281</sup>

Given the modest amount of direct contact between the Big Three indexers and public companies in which they own shares, anything approaching the sort of firm-specific meddling in which activist hedge funds engage is unrealistic. BlackRock’s head of corporate governance has acknowledged “(i)t’s not the shareholders’ role to second guess what management is doing in every single issue.”<sup>282</sup> The largest passive investors do throw their weight around sometimes.<sup>283</sup> For instance, votes against board nominees companies put forward occur with some regularity.<sup>284</sup> Critics nevertheless charge index trackers with failing to devote any more attention to the voting process than is required to satisfy regulators “or perhaps to satisfy their own conscience and boost their firm’s image.”<sup>285</sup> Whatever their attentiveness level, most often leading passive investors back management.<sup>286</sup> In 2017, BlackRock supported management’s stance 91 percent of the time, State Street did so with 86 percent of resolutions and Vanguard’s support level was 94 percent.<sup>287</sup> The *Financial Times*

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<sup>280</sup> Lund, *supra* note 221, at 516, 519.

<sup>281</sup> John Authers, *How Passive Investors Morphed Into the Bad Guys*, FIN. TIMES, Oct. 14, 2017, 24.

<sup>282</sup> Krouse & Benoit, *supra* note 257.

<sup>283</sup> Reshma Kapadia, *Passive Investors Are Turning Active*, BARRON’S, July 10, 2017, L10.

<sup>284</sup> Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 249, 318 (indicating that on nearly half of the occasions where the “Big Three” voted against management recommendations a board nomination was involved).

<sup>285</sup> Dick Weil, *Passive Investors, Don’t Vote*, WALL ST. J., March 9, 2018, A9.

<sup>286</sup> Authers, *supra* note 281; Lindsay Fortado & Anna Nicolaou, *Peltz’s P&G Loss Unlikely to Stop Activist Tide*, FIN. TIMES, Oct. 12, 2017, 15.

<sup>287</sup> Bioy *et al.*, *supra* note 256, 13.

has said of this pattern that it signals “a degree of inattention at odds with dynamic stewardship claims.”<sup>288</sup>

Voting patterns on executive pay confirm the tendency among the largest passive investors to support management. Under the Dodd Frank Act of 2010, a “say on pay” scheme was introduced giving shareholders of publicly traded companies the right to vote on executive pay policy on an advisory basis at least once every three years.<sup>289</sup> When shareholders have the opportunity to vote they rarely oppose the approach being taken. From 2011 through 2017 with corporations in the Russell 3000 stock market index the company lost outright only 1.9 percent of time.<sup>290</sup> In the case of S&P 500 companies shareholder support levels for management on say on pay resolutions were 91 percent in 2016 and 92 percent in 2017.<sup>291</sup> BlackRock and Vanguard have been particularly strong backers. During 2016 each voted 98 percent in favor of pay practices at S&P 500 companies.<sup>292</sup> The *New*

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<sup>288</sup> Lex, *Index Funds – Cut Price Consciences*, FIN. TIMES, Dec. 29, 2017, 12.

<sup>289</sup> Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, 124 Stat. 1376, § 951(c).

<sup>290</sup> See SEMLER BROSSY, 2017 SAY ON PAY RESULTS, Aug. 30, 2017, available at <http://www.semlerbrossy.com/wp-content/uploads/SBCG-2017-SOP-Report-08-30-2017.pdf> (accessed July 5, 2018) (calculated using annual data for 2011 through to 2017).

<sup>291</sup> EY Center for Board Matters, *Corporate Governance by the Numbers*, Sept. 30, 2017; EY Center for Board Matters, *Corporate Governance by the Numbers*, Jan. 31, 2018. The most recent versions of this data are available at <http://www.ey.com/us/en/issues/governance-and-reporting/ey-corporate-governance-by-the-numbers> (accessed July 3, 2018).

<sup>292</sup> Gretchen Morgenson, *Your Fund Has Your Say, Like It or Not*, N.Y. TIMES, Sept. 25, 2016, Business, 1. See also Jason Zweig, *This Index Argument Doesn’t Hold Water*, WALL ST. J., April 21, 2018, B1 (citing a study indicating that with “leading S&P index funds” the approval rate with executive pay proposals was 97 percent in 2016).

*York Times* has said of BlackRock’s voting power on executive pay that its “big stick is more like a wet noodle.”<sup>293</sup>

Executive pay has increased noticeably since say on pay’s introduction, with the median pay of S&P 500 CEOs rising from just under \$9 million in 2010 to \$11.6 million in 2017.<sup>294</sup> This trend, combined with strong shareholder support for policies upon which they have been asked to vote, has prompted harsh verdicts on the say on pay experiment such as “tinkering at the edges at best,”<sup>295</sup> “a bust,”<sup>296</sup> and “ineffective.”<sup>297</sup> Say on pay has nevertheless not been a corporate governance irrelevance.<sup>298</sup> As the *Wall Street Journal* noted in 2014, even though the votes are nonbinding “most corporate boards consider a negative vote a black eye and work hard to respond to shareholder concerns.”<sup>299</sup> The say on pay process has correspondingly prompted many companies to increase board outreach to shareholders, accompanied by the opening of new lines of communication.<sup>300</sup> Boards in their turn have been prepared to make modifications to head off dissent, which likely has bolstered

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<sup>293</sup> Gretchen Morgenson, *Wet Noodle Where a Stick Ought to Be*, N.Y. TIMES, April 17, 2016, Business, 1.

<sup>294</sup> Theo Francis & Joann S. Lublin, *CEO Pay Reached New High in 2017*, WALL ST. J., March 22, 2018, B1.

<sup>295</sup> Steven M. Davidoff, *Furor Over Executive Pay Is Not the Revolt It Appears to Be*, N.Y. TIMES, May 2, 2012, B5.

<sup>296</sup> Jesse Eisenger, *In Shareholder Say-on-Pay Votes, Whispers, Not Shouts*, N.Y. TIMES, June 27, 2013, B5.

<sup>297</sup> James Surowiecki, *Why CEO Reform Failed*, NEW YORKER, April 20, 2015, available at <https://www.newyorker.com/magazine/2015/04/20/why-c-e-o-pay-reform-failed> (accessed March 5, 2018).

<sup>298</sup> James D. Cox & Randall S. Thomas, *Corporate Darwinism: Disciplining Managers in a World With Weak Shareholder Litigation*, 95 N.C. L. REV. 19, 50 (2016).

<sup>299</sup> Emily Chasan, *Companies Say “No Way” to “Say on Pay”*, WALL ST. J., Aug. 26, 2014, B1.

<sup>300</sup> Vipal Monga, *Boards Cozy Up to Investors*, WALL ST. J., Jan. 8, 2013, B7; Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1432 (2014).

the high approval rates which have been obtained.<sup>301</sup> The fact that executive pay is a key topic for discussion with nearly half of the engagements BlackRock has with public companies despite BlackRock rarely actually voting against management on executive pay lends credence to this conjecture.<sup>302</sup>

The say on pay regime, where public companies listen to their shareholders but retain considerable scope to proceed in the manner they see fit, reflects broader trends concerning mainstream institutional investors. Rav Gupta, a former CEO of a *Fortune* 500 chemical concern and an outside director of additional *Fortune* 500 companies, likely was correct when he suggested in 2016 that due primarily to large institutional intermediaries “shareholders are exerting a more effective and powerful influence on corporate management than in the past.”<sup>303</sup> On the other hand, there remains a continued bias against engagement that means public company executives have wide discretion to run their firms without provoking active pushback.<sup>304</sup> For instance, Jeffery Immelt managed to remain chief executive of American corporate icon General Electric for 16 years despite the corporation’s share price never being higher than it was in 2001, the year he was appointed.<sup>305</sup> Correspondingly, despite institutional shareholders owning a large proportion of shares in public companies and despite the collective stake of the biggest institutions being substantial,

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<sup>301</sup> MICHAEL B. DORFF, *INDISPENSABLE AND OTHER MYTHS: WHY THE CEO EXPERIMENT FAILED AND HOW TO FIX IT* 245 (2014).

<sup>302</sup> Caleb Melby, *A Millionaire Is Telling BlackRock to Say No to Big CEO Pay*, BLOOMBERG, May 20, 2016, available at <https://www.bloomberg.com/news/articles/2016-05-20/a-millionaire-is-telling-blackrock-to-say-no-to-big-ceo-pay> (accessed March 8, 2018).

<sup>303</sup> *The Role of Corporate Boards: A Roundtable Discussion of Where We’re Going and Where We’ve Been*, J. APP. CORP. FIN., Winter 2017, 22, 25.

<sup>304</sup> *Supra* notes 211-15 and accompanying text.

<sup>305</sup> Thomas Gryta, Joann S. Lublin & David Benoit, “*Success Theater*” *Masked Rot at GE*, WALL ST. J., Feb. 22, 2018, A1.

there remains a separation of ownership and control in public firms not very far removed from the Berle and Means' 1930s version.

Assuming the popularity of index tracking funds continues to grow, the trend likely will reinforce the institutional bias against activism despite their collective ownership stake growing in size. Only time will tell exactly what corporate governance role BlackRock, Vanguard and State Street will assume.<sup>306</sup> Given the business model underpinning index tracking funds, however, it is unlikely that the voting power available to passive indexers will substantially compromise existing managerial prerogatives in the foreseeable future. Concrete, sustained evidence of shareholders taking meaningful, proactive steps to keep management in check would mean that it would no longer be appropriate to refer to the paradigmatic American public company as the Berle-Means corporation. That evidence is currently lacking and, despite the attention index tracking funds have garnered, likely will be for some time yet.

## VIII. CONCLUSION

Adolf Berle and Gardiner Means famously declared in 1932 that America's largest corporations were characterized by a separation of ownership and control. Their call on this was somewhat premature. Even among the largest companies at the start of the 1930s only a minority lacked a shareholder that owned a sufficiently large stake to exercise meaningful influence. Nevertheless, Berle and Means would set the tone for debates about public company governance for decades to come.

Having documented that many public companies lacked large shareholders, including amongst the executive cohort, Berle and Means mused in *The Modern Corporation and*

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<sup>306</sup> IRA M. MILLSTEIN, *THE ACTIVIST DIRECTOR LESSONS FROM THE BOARDROOM AND THE FUTURE OF THE CORPORATION* 20 (2017).

*Private Property* “if all profits are earmarked for the security holder, where is the inducement for those in control to manage the enterprise efficiently?”<sup>307</sup> They also asked their readers “have we any justification for assuming that those in control of a modern corporation will also choose to operate it in the interests of their owners?”<sup>308</sup> It would soon become the norm for large U.S. corporations to lack stockholders with ownership stakes sufficiently substantial to create the incentive to monitor executives closely and to provide the voting clout needed to exercise meaningful influence. Given, as Berle and Means indicated, the potential for abuse of managerial discretion where share ownership is diffuse, the separation of ownership and control was destined to become what Mark Roe described in 2005 as “the core fissure” in American corporate governance.<sup>309</sup>

The “Berle-Means corporation”, the term Roe coined in the early 1990s as shorthand for the large public company where ownership is divorced from control, was the locale for the core governance fissure he identified. Ironically, at the time Roe developed the Berle-Means corporation nomenclature, its position at the center of the American corporate governance firmament was under threat in a manner unprecedented since a separation of ownership and control became the norm in large U.S. firms in the 1940s and 1950s. The 1990s was a period when institutional investors became sufficiently prevalent as stockholders to prompt suggestions share ownership in public companies had coalesced in a way that made the Berle-Means characterization of the large firm passé. In addition, a prevailing assumption that a separation of ownership and control in big companies was the product of basic business logic was displaced. Roe, by arguing in the early 1990s that the dominance of

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<sup>307</sup> BERLE & MEANS, *supra* note 1, 301.

<sup>308</sup> *Id.* at 113.

<sup>309</sup> Mark J. Roe, *The Inevitable Instability of American Corporate Governance*, 1 CORP. GOV. L. REV. 1, 2 (2005).



the Berle-Means corporation was at least partly a product of political context, began to upend the received wisdom and launched a still continuing debate on determinants of ownership structure in large firms.

We have now moved on nearly 30 years since the Berle-Means corporation entered the corporate governance lexicon and since challenges to its conceptual dominance began occurring in earnest. Doubts continue to be cast on the appropriateness of invoking Berle and Means to characterize ownership and control arrangements in larger American public companies. This is not because shareholders with sufficiently large ownership stakes to be both inclined and capable of exercising dominant influence over management have moved (or more accurately returned) to the forefront in large American public companies. Instead, hedge fund activism and collective institutional stakes sufficiently large to mean that investment intermediaries representing close to a majority of outstanding shares could sit around a boardroom table are ostensibly prompting the Berle-Means corporation's demise.

It in fact is premature to write the obituary for the Berle-Means corporation. Hedge funds are significant corporate governance intermediaries but challenges to large firms remain rare and hedge fund activism may well have peaked after a lengthy surge. As for "mainstream" institutional shareholders, departures from the hands-off approach to governance associated with the Berle-Means corporation have been modest overall, with these investors showing little inclination to engage in meaningful stockholder-oriented stewardship. With index-tracking funds, given their business model, continued growth in their ownership stake seems likely to fortify the institutional investor bias in favor of passivity rather than hasten the arrival of "real" owners in large American public companies. The upshot is that, despite the wear and tear the Berle-Means corporation has suffered in recent decades, it has yet to fall by the wayside and seems unlikely to do so for the foreseeable future.