A Critique of Corporate Law

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LEADING ARTICLES

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A central issue in the law of corporations revolves around the costs associated with the separation of ownership and control in the modern corporate enterprise. The law concerning business associations reflects a belief that these costs are best controlled by imposing legal duties on corporate officers to act in the shareholders' best interests. The author argues that market forces police the behavior of corporate managers in a way that makes corporate law doctrine on this point redundant, and in some cases inefficient.

I. INTRODUCTION

Modern corporate law with respect to the publicly held corporation largely reflects an effort to resolve the issue of separation of ownership and control. This issue is the management discretion problem that was popularized by Berle and Means some forty

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years ago.[1] Actually, Adam Smith described the problem two hundred years ago as follows:

> The directors of such [joint stock] companies . . . , being the managers rather of another people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.[2]

The latter-day equivalents of joint stock companies are the large publicly held corporations. In those business units, thousands of public shareholders have little or no direct control over the management decisions of the directors and officers. Conventional knowledge assumes, therefore, that frustrated shareholders desire control. In addition, conventional theory concludes that the insiders (at least in concentrated noncompetitive industries) are free to award themselves not only "excessive" salaries but also such nonpecuniary awards as hunting lodges, friendly secretaries, and congenial, albeit incompetent, associates. Moreover, traditional theory asserts that corporate insiders have discretion to perform "antisocial" acts, such as selling large gas-guzzling automobiles rather than small economy models.[3]

In direct response to this familiar theory, corporate law (in a great variety of cases involving conflict between corporate insiders and public shareholders) has elaborated in sophisticated form the basic fiduciary doctrine known as the duty of loyalty.[4] Equally important are the legislative efforts under way to limit officer power by restructuring corporate governance to require a majority of independent directors for decisionmaking and greater shareholder power and participation.[5]

The case and statutory law are based upon the largely un-

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1. A. BERLE, JR. & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1968).

2. A. SMITH, THE WEALTH OF NATIONS 700 (E. Cannan ed. 1966).

3. *See generally* R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976).

4. *See* W. CARY, CASES AND MATERIALS ON CORPORATIONS 469 (4th ed. 1970).

5. *See* Miller, *At Odds Over Corporate Governance*, N.Y. Times, Dec. 24, 1978, § F (Business and Finance), at 1, col. 3; Russo and Wolfson, *Why Must Boards Change?* N.Y. Times, Jan. 21, 1979, § F (Business and Finance), at 16, col. 4.

proven empirical assumptions that the separation of ownership and control is not economically optimal and that the legal response to the problem lessens or eliminates the inefficiencies at a cost which is less than the benefits obtained. With respect to publicly held corporations, corporate law acts on these assumptions without examining them in the light of coherent economic theory or subjecting them to disciplined empirical tests. Essentially guesswork, these assumptions substitute for the organized theoretical and empirical processes that are routine in other social disciplines, such as economics.

An additional hypothesis, also unproven, is that market controls are not sufficient to circumscribe significantly the insider-management discretion to "feather the nest" at the expense of shareholders and the general public. Indeed much of corporate law can be described as both a reaction to the perceived management discretion problem and as an unproven method to emasculate the assumed significant discretion of management which flows from the separation of management and control.[6]

To begin with, there is the basic proposition of corporate law that directors have a fiduciary duty to maximize shareholder wealth.[7] If in fact the free market operated to accomplish this result, the doctrine would have the same impact as carrying the legendary coals to Newcastle. There are the corollary fiduciary principles, such as the corporate opportunity,[8] sale of control,[9] and going private[10] doctrines, which are designed to prevent management capture of corporate values that belong to the shareholders. The federal securities laws, which in general mandate corporate disclosure and prohibit fraud in the purchase or sale of securities, are focused upon the same target—to circumscribe management discretion—and the same empirical assumption—that legal rules will change behavior in the desired direction at a cost which is less than the benefits obtained.[11]

This paper will examine the fundamental bases of corporate law. In the course of that analysis it will demonstrate that corporate law is "flying blind"—without an empirical basis and with a

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6. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 289-314 (2d ed. 1977).

7. *See Corporate Directors Guidebook,* 33 BUS. LAW. 1595, 1606 (1978).

8. *Id.* at 1600.

9. *See* Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied* 349 U.S. 952 (1955).

10. *See* Securities Exchange Act Release No. 14,185 (Nov. 17, 1977), [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,366.

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

confused notion of economic theory.[12] The analysis will (a) apply modern economic theory to the concept of the corporate form, (b) emphasize the superior efficacy of market forces, as compared to corporate law, to accomplish the corporate law goal of limiting management discretion, and (c) underline the need for proponents of corporate law to make reasonable efforts to estimate its costs before making any significant decision to establish or expand corporate law.

II. FUNDAMENTAL ASSUMPTIONS

A. *Agency Costs*

Corporate law operates on the assumption that the separation of ownership and control is a manifestation of a unique corporate peculiarity. Actually, it is merely a subset of a much wider phenomenon.[13] Whenever an employer hires another person to perform services for him involving some decisionmaking, an agency relationship is created. If the agent is an average individual with an average component of self-interest, he will not always act in the best interest of the employer. Naturally, employers know this and endeavor to monitor the agent's performance in a way that minimizes the cost of shirking ("agency costs") to the employer.[14]

In fact, the same phenomenon occurs whenever two or more people work together. Co-authors of law review articles face the same problem. Author A may sit back, write only one-third of the article, and hope to receive full public recognition for at least half the published work. Author B will have to monitor A's work to prevent these unhappy results.

Agency costs exist in all forms of organization. In large government bureaucracies and universities, employees at all levels may

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12. For a discussion of the empirical failings of securities law in the context of the private offering doctrine, *see* Wolfson, *The Need for Empirical Research in Securities Law*, 49 S. CAL. L. REV. 286 (1976).

13. The materials in this section are based upon the recent seminal article by economics Professors M. Jensen and W. Meckling: Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINANCIAL ECON. 305 (1976).

14. The concepts of "shirking" and monitoring are closely related to the economic theory of agency costs, and were developed by economics Professors A.A. Alchian and H. Demsetz. This section is also based upon their pioneering work. *See* Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972). *See also* Alchian, *Corporate Management and Property Rights*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 337 (H. Manne ed. 1969). For a survey of the recent literature in the fields covered by this section *see also* Furubotn & Pejovich, *Property Rights and Economic Theory: A Survey of Recent Literature*, 10 J. ECON. LIT. 1137 (1972).

endeavor to maximize their personal comfort at the expense of group efficiency. For example, a government bureaucrat may prefer large offices, congenial associates, and a large staff. If citizens had the time and money to detect these actions, they would compel him to produce the same amount of work or more at less cost, or hire someone else willing and able to do it. Since government agencies and universities are not profit-oriented, there is no bottom line profit test to measure management efficiency. Therefore, monitoring of agency costs is more difficult in these nonprofit organizations than in businesses run for profit.

The cost to the organization of the agent's self-interest, in addition to the cost of detecting shirking, represents the agency costs of the enterprise. These costs include: (a) the cost of monitoring expenditures; (b) the cost of incentives to encourage the agent to work for the benefit of the organization; (c) so-called "bonding costs" of the agent which he may sometimes incur to convince the skeptical employer that he will indeed be loyal; and (d) a "residual loss" resulting from the selfish acts of the agent.[15]

Agency costs are also a fact of life in the publicly owned profit-oriented corporation. The shareholders are the owners or principals; the agents are the directors, officers, and employees of the corporation. The owners, *i.e.*, the shareholders, want the management of the corporation to maximize the welfare of shareholders to the same extent as would the shareholders if they managed the corporation. Officers may wish to lead the "quiet" life. They may opt for carpeted hallways, beautiful secretaries (or handsome ones), and five-hour work days. They may be reluctant to take appropriate entrepreneurial risks. They may promote the size of the enterprise rather than net profits and efficiency. They may neglect needed research and development expenditures. They may be more sensitive to the demands of civic groups and labor than to those of a hard-muscled owner-run entrepreneurial enterprise. Managers may work more strenuously than risk-taking shareholder owner-managers would for nonfluctuating or steadily rising dividends and capital gains.

Agency costs may arise in the case of so-called control shareholders also. Control shareholders need not own fifty-one percent of the stock. A ten-percent holder, for example, can be a control shareholder in a corporation where no one else owns a large block of stock. Individual shareholders who own less than all of the eq-

15. Jensen & Meckling, *supra* note 13, at 308.

uity may make operating decisions that do not maximize the utility of the mass of shareholders. The smaller the percentage they own, the greater the divergence of their interest from that of the rest of the shareholders. As Professors Jensen and Meckling have stated:

> If the owner-manager sells equity claims on the cooporation . . . agency costs will be generated by the divergence between his interest and those of the outside shareholders, since he will then bear only a fraction of the costs of any non-pecuniary benefits he takes out in maximizing his own utility. If the manager owns only 95 percent of the stock, he will expend resources to the point where the marginal utility derived from a dollar's expenditure of the firm's resources on such items equals the marginal utility of an additional 95 cents in general purchasing power (i.e., *his* share of the wealth reduction) and not one dollar.[16]

Agency costs also arise in close corporations, where stockholders share ownership and control. Each shareholder must worry about the shirking of the other owner-managers. But since share ownership is less dispersed than in a publicly held corporation, agency costs will tend to be less. The greater the percentage of ownership, the less the divergence of interest from the other shareholders. Furthermore, monitoring is easier. The active shareholder-manager can more readily check the activities of fellow managers than can a passive small shareholder in a publicly held corporation. In addition, monitoring is worth more to the former than to the latter in that the shareholder-manager has more to lose if his monitoring fails. Legal doctrines of agency responsibility and duty of loyalty exist between shareholders in the closely held corporation as a result of, or in reaction to, the existence of agency costs. The legal doctrine, however, is not the key factor in close corporation planning. The principal task of close corporation lawyers is to arrange the charter, bylaws, and shareholder contracts so as to share control effectively among the shareholders and prevent one from freezing out the others. The latter arrangements are not available to public corporations. Indeed, a lawyer who leaves his shareholder-clients from a closely held corporation to the remedies of fiduciary duty, without attempting to structure the corporation to protect them, is open to severe criticism because of the uncertainties and cost of duty-of-loyalty litigation.

16. *Id.* at 312.

Despite the existence of greater agency costs, the corporation owned by dispersed, small shareholders has increased in relative importance. Large, family-owned corporations have radically declined in number and significance. The former has met and passed the test of survivorship. There are several reasons for this success.

To begin with, manager-proprietors are frequently unable to finance large scale business expansion entirely out of their own funds. They must often raise some debt and equity capital from individual and institutional sources to improve and expand their business enterprises. The other side of the coin is that investors find it prudent and rewarding to place their capital under the control of expert and experienced corporate managers. Although there are considerable agency costs involved, it is obviously worthwhile to small public shareholders to hire managers to run business enterprises rather than actively participate themselves.

The existence of agency costs does not mean that the dispersed shareholder corporate enterprise is inefficient. *The costs are an unavoidable price of joint activity or organization. The alternative for shareholders is to actively manage the business. That alternative would be an obvious absurdity.* Even then, as in the case of co-authors of a law review article, some agency costs would be incurred. The only viable alternative is for one person both to own and to run the firm.

In short, the modern corporation—in its widely dispersed shareholder form—is an inevitable result of the willingness and desire of tens of thousands of relatively small investors to entrust their money to skilled, hired managers. It is also a natural product of the desire of large institutional investors, who have no urge to manage the business, to put their finances in the hands of expert corporate officers.

Professors Jensen and Meckling, in their seminal piece on the firm, state:

> In conclusion, finding that agency costs are non-zero (i.e., that there are costs associated with the separation of ownership and control in the corporation) and concluding therefrom that the agency relationship is non-optimal, wasteful or inefficient is equivalent in every sense to comparing a world in which iron ore is a scarce commodity (and therefore costly) to a world in which it is freely available at zero resource cost, and concluding that the first world is "non-optimal" — a perfect example of the fallacy criticized by Coase . . . and what Demsetz . . . character-

izes as the "Nirvana" form of analysis.[17]

Of course, if agency costs could be reduced or eliminated by shareholder monitoring of management at a cost which is less than the benefits derived, the course of action would be simple and clear: always increase the curbs on management. Monitoring, however, is costly and at various levels may not be worth the benefits obtained. Governmentally mandated monitoring in the form of judicial or statutory law and doctrines must always be measured against the cost-benefit test. Too often, as shall be demonstrated in this paper, the cost impact of corporate law is totally ignored.

Furthermore, given the efficient nature of the capital markets, it is likely that the price of shares has been discounted for agency costs. There is considerable economic literature demonstrating that the efficient stock market impounds in the price of shares all significant public information about corporations.[18] Data on quality of management, financial stability, and quality of products are rapidly diffused to investors with almost immediate impact on the price of the stock.[19] There is good reason to believe that the same phenomenon occurs as a result of investors' awareness of the cost of separation of ownership and control. Indeed, the work of Jensen and Meckling[20] makes a formal demonstration of such a phenomenon. Their conclusion is that shareholders invest in such corporations because the benefits from the corporate operation outweigh the disadvantage of agency costs.

B. *Incentives Not to Shirk*

The foregoing discussion assumes that, in fact, agents shirk. In the real world shirking is, for various reasons, far more insignificant than is traditionally assumed.

In the first place, since the price of shares impounds the agency costs, managers have an incentive to prove to the investors that they are shirking less.[21] Otherwise, the cost to the corporation

17. *Id.* at 328.

18. Basu, *Investment Performance of Common Stocks in Relation to Their Price-Earnings Ratios: A Test of the Efficient Market Hypothesis*, 32 J. FIN. 663 (1977); Davies & Canes, *Stock Prices and the Publication of Second-Hand Information*, 51 J. BUS. 43 (1978); Hillison, *Empirical Investigation of General Purchasing Power Adjustments on Earnings Per Share and the Movement of Security Prices*, 17 J. ACCT. RESEARCH 60 (1979); LeRoy, *Efficient Capital Markets: Comment*, 31 J. FIN. 139 (1976).

19. *See generally* THE RANDOM CHARACTER OF STOCK MARKET PRICES (P. Cootner ed. 1964).

20. *See* note 13 *supra*.

21. Benston, *The Market for Public Accounting Services: Demand, Supply and Regu-*

of raising new equity capital will be greater. In addition, management will suffer compensation losses since its incentive arrangements are often in the form of corporate equity. Furthermore, if managers actually shirk less than the market anticipates, they will suffer unjustified losses in the price of the stock. These factors act as powerful incentives for the managers to demonstrate to the market that they are not shirking. Managers have a powerful incentive, for example, to retain independent certified public accountants (CPA's) to audit their financial data. The presence of CPA's signals to potential investors that managers can shirk less. Therefore, the price of the stock will rise.[22]

In this regard, Professor George Benston in a recent article demonstrated that most corporations listed on the New York Stock Exchange (NYSE) voluntarily retained independent CPA's before the passage of the Federal Securities Acts, which mandated use of CPA's.[23] The danger of government regulation is that it will demand *more* monitoring than shareholders would voluntarily pay for.[24]

C. *Empirical Data*

In recent years there has been an effort in the economic literature to compare empirically the performance of owner- and manager-dominated firms in order to test the theory that managers shirk more (*i.e.*, do not strive to maximize shareholder welfare) in corporations not family-dominated.[25] The evidence is hardly conclusive that managers do, in fact, engage in greater shirking than in family-dominated firms.

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lation (March 9, 1979) (unpublished paper presented at the Liberty Fund, Inc. Seminar on Law and Economics of Accounting Regulation, Law and Economics Center, University of Miami School of Law). *See also* Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, in ISSUES IN FINANCIAL REGULATION 177 (F. Edwards ed. 1979).

22. *See* Benston, *supra* note 21, at 10-11.

23. Benston, *supra* note 11.

24. *Id.* at 134.

25. R. LARNER, MANAGEMENT CONTROL AND THE LARGE CORPORATION (1970); Elliott, *Control, Size, Growth, and Financial Performance in the Firm*, 7 J. FINANCIAL & QUANTITATIVE ANALYSIS 1309 (1972); Kamerschen, *The Influence of Ownership and Control on Profit Rates*, 58 AM. ECON. REV. 432 (1968); Monsen, Chiu & Cooley, *The Effect of Separation of Ownership and Control on the Performance of the Large Firm*, 82 Q. J. ECON. 435 (1968); Palmer, *The Profit-Performance Effects of the Separation of Ownership from Control in Large U.S. Industrial Corporations*, 4 BELL J. ECON. & MANAGEMENT SCI. 293 (1973); Sorensen, *The Separation of Ownership and Control and Firm Performance: An Empirical Analysis*, 41 S. ECON. J. 145 (1974).

A recent debate in the economic literature between Professors Kania and McKean, on the one hand, and Professor McEachern, on the other, is instructive.[26] Kania and McKean asserted that "with the noted exceptions of the Monsen, Chiu, and Cooley (MCC) and the Palmer studies . . . , statistical findings generally support the position that both firm types performed equally well, or equally poorly, in regard to profit realization."[27] Kania and McKean tested numerous indicators of performance and concluded that "[n]o clear definite difference emerged between owner and manager-controlled corporations for the performance tests overall."[28]

Kania and McKean recognized, however, that the degree of product competition in a given industry might affect the relationship between firm performance and the separation of ownership and control. They ran tests on this variable and concluded that "[t]he hypothesis that latitude for greater discretionary behavior between owner and manager-controlled firms will result when markets are more highly concentrated is not validated."[29]

Professor McEachern contested the validity of the Kania and McKean findings.[30] He emphasized that the separation and control theories "argue that managers must also be relatively free from the product-market constraint" in order to enjoy managerial discretion.[31] McEachern then argued that the Kania and McKean sample was biased in favor of competitive industries. Therefore, their "tests examining behavior based on control . . . are of limited value. The authors cannot reject a hypothesis that has not been properly tested."[32]

Kania and McKean defended their findings in a reply to McEachern.[33] They reassured McEachern, however, that they agreed that the "controversy concerning managerial discretion based upon

26. This debate is contained in the following series of articles: Kania & McKean, *Ownership, Control and the Contemporary Corporation: A General Behavior Analysis*, 29 KYKLOS 272 (1976) [hereinafter cited as Kania & McKean I]; McEachern, *Ownership, Control, and the Contemporary Corporation: A Comment*, 31 KYKLOS 491 (1978); Kania & McKean, *Ownership, Control, and the Contemporary Corporation: A Reply*, 31 KYKLOS 497 (1978) [hereinafter cited as Kania & McKean II].

27. Kania & McKean I, *supra* note 26, at 273.

28. *Id.* at 287.

29. *Id.* at 288.

30. McEachern, *supra* note 26.

31. *Id.* at 492.

32. *Id.* at 493.

33. Kania & McKean II, *supra* note 26.

control type . . . 'is still very much alive.' "[34]

In the exchange between the professors, McEachern claimed that some research had found the rate of return on stock purchased and held for a period of time higher for shares in owner-controlled firms than for shares in manager-run corporations.[35] If he is correct, then the Jensen and Meckling argument that the market impounds such a difference in the price of shares is threatened.

Those results appear suspect. They must mean that shareholders have been unaware of the possibility of management discretion existing in high concentration industries. Given the efficient market, this would be a remarkable phenomenon, if true. Furthermore, the publication of research indicating a significant difference in return would immediately have the result of depressing the share price of manager-run firms, thus eliminating the difference in the future. When that happens, managers will have a powerful incentive to prove that they are shirking less, so as to retard the decline in price of their corporation's shares. Otherwise, the drop will depress their wage package to the extent it is based on stock options and equity incentives. Furthermore, any price drop will impact negatively on their reputation as managers.

There is also a debate in the economic literature concerning the proposition that product monopoly will permit a greater degree of management discretion than is possible where there is product competition.[36] Jensen and Meckling argue:

> The owners of a firm with monopoly power have the same incentive to limit divergences of the manager from value maximization . . . as do the owners of competitive firms. Furthermore, competition in the market for managers will generally make it unnecessary for the owners to share rents with the manager. . . .
>
> Since the owner of a monopoly has the same wealth incentives to minimize managerial costs as would the owner of a competitive firm, both will undertake that level of monitoring which equates the marginal cost of monitoring to the marginal wealth increment from reduced consumption of perquisites by the manager.[37]

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34. *Id.* at 498.

35. McEachern, *supra* note 26, at 494.

36. *Compare* O. WILLIAMSON, THE ECONOMICS OF DISCRETIONARY BEHAVIOR: MANAGERIAL OBJECTIVES IN A THEORY OF THE FIRM 2 (1964) *with* Jensen & Meckling, *supra* note 13, at 329.

37. Jensen & Meckling, *supra* note 13, at 329-30.

Conversely, the presence of product competition will not necessarily eliminate all management discretion. If competitors are forced to incur some agency costs, *i.e.*, some degree of management discretion, then other firms will be able to incur management discretion and yet stay in business.[38]

D. *Market for Control*

One of the key issues in the economic literature is the extent to which the market for control disciplines corporate managers. Professor Manne has written a series of seminal pieces on the power of tender offers and other take-over attempts to discipline corporate insiders.[39] As noted above, all evidence indicates that the stock markets are very efficient, *i.e.*, they rapidly impound all material public data into the price of shares.[40] Directors and officers who take too much out of the corporation in the form of perquisites will tend to drive down the price of the corporation's shares. Honest but inefficient management will depress earnings and, as a result, the market price of the corporation's shares will fall. The company then becomes an attractive target for a tender offer from outside groups that believe they can run the corporation more efficiently than the incumbent management. The outsiders will compare the expected cost of take-over with the expected gain in the value of the firm. If the costs are less than the estimated future increase in the price of the shares that will result from better management, an outside group will make the take-over effort.[41] Of

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38. *Id.*

39. Manne, *Our Two Corporate Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); Manne, *The "Higher Criticism" of the Modern Corporation*, 62 COLUM. L. REV. 399 (1962). Professor Manne was the pathbreaker in legal scholarship in developing analysis of the relationship between corporate law and economics. Recent important contributions by scholars in this field include R. POSNER, *supra* note 6 and R. WINTER, GOVERNMENT AND THE CORPORATION (1978).

40. *See* note 18 and accompanying text *supra*.

41. *See* H. MANNE & H. WALLICH, THE MODERN CORPORATION AND SOCIAL RESPONSIBILITY at 16-17 (1972).

S.J. Grossman and O.D. Hart in recent work raise doubt about the value of state and federal corporate fiduciary principles in the area of tender offers. Grossman & Hart, *Disclosure Laws and Takeover Bids*, 35 J. FIN. 323 (1980); Grossman & Hart, *Takeover Bids, the Free-rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980). They raise the so-called free-rider problem in tender offers. The takeover group proposes to make money from the price appreciation of the purchased shares. Each target shareholder, however, can make money by *not* tendering his shares. To overcome this target shareholder resistance, the takeover group may have to offer too high a price to make the takeover worthwhile. Of course, since many target shareholders and tender offerors disagree about course, the more difficult and expensive it is as a result of government regulation to make a tender offer, the greater the cushion that incumbent management enjoys for its inefficiency.

A recent study of cash tender offers made between January 1956 and June 1974 for firms on the NYSE found that firms which were the targets of take-over attempts generally had abnormally low returns prior to the take-over attempts and that successful take-overs generally led to improved wealth positions for the shareholders of both the acquired and acquiring firms.[42]

E. *Market for Management*

Another potent market check on management discretion is the market for management.[43] The managerial labor market operates

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the future of the target corporation under the new management, many takeovers are attempted and are successful.

Grossman and Hart agree that takeover bids are necessary to maintain the efficiency of incumbent management. How then can the free-rider problem be eliminated? If the law permitted the takeover group to exclude nontendering target shareholders from the benefits of all the takeover group's improvements, target shareholders would have no incentive to refuse to tender their shares. The authors point out that "[o]ne method is . . . to permit a successful raider to sell the firm's assets or output to another company owned by the raider at terms which are disadvantageous to minority shareholders." 11 BELL J. ECON. at 43. Such a squeeze-out merger after a takeover is, of course, prohibited by state corporate fiduciary law principles. Such a transaction is further chilled by the disclosure requirements of the Federal Williams Act (§ 14d of the Securities Exchange Act of 1934), which would require disclosure of such a squeeze-out proposal. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976). Society might benefit, however, from some dilution of such principles because the likelihood of successful takeovers impels incumbent management to be more efficient. This critique by economists of the usefulness of corporate fiduciary principles in certain contexts supports the criticisms of corporate law fiduciary principles set forth in part III of this article.

42. Kummer & Hoffmeister, *Valuation Consequences of Cash Tender Offers*, 33 J. FIN. 505, 514 (1978). Dean Richard West of the Amos Tuck School of Business Administration at Dartmouth College summarized this article as follows:

> The authors studied all cash tender offers made between January 1956 and June 1974 for firms on the New York Stock Exchange meeting certain criteria—eighty-eight firms in all. Using methodology that is now a standard part of the tool kit of financial economists, they tested the following hypotheses: (1) that investors in the common stock of target firms generally experienced abnormally low returns in the period prior to a takeover attempt; (2) that the stockholders of firms which resisted a tender generally experienced particularly abnormal low returns prior to a takeover attempt; and (3) that successful tenders lead to an improved wealth position for the shareholders of both firms involved. Overall, their results supported all three hypotheses . . . .

West, *The Federal Securities Code: Some Comments on Process and Outcome*, 33 U. MIAMI L. REV. 1485, 1492 (1979).

43. The material in this and the following section is based upon work by Eugene F. Fama. *See generally* Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

to police the activities of corporate employees. Corporations are constantly on the lookout for new managers. Incumbent managers realize that if they shirk, they will be replaced by non-shirking outside managers. Furthermore, there is an *inside* market which polices management. Corporate employees realize that their chances to receive attractive job offers from other corporations depend upon their present success and reputation. If their corporation does well, their potential wage in the outside market for managers will increase. This consideration provides an incentive to manage their subordinates tightly. Managers will also monitor their superiors since the success of their supervisors will reflect on the reputation of the manager. Moreover, managers have an in-house incentive to expose shirking bosses and take their place. As a result, there is a market for management information. In this market, data are exchanged concerning the abilities of managers. The existence of this market makes it difficult for the shirker to hide his activities.

Acknowledging a market for management weakens the argument concerning the relationship between management equity ownership and management incentives. It is commonly argued that the smaller the percentage of equity owned by management, the more shirking will occur. The market for management, however, may operate independently of equity ownership to compel management efficiency.

F. *Owners or Risk Takers*

There is an even more fundamental objection to the separation of ownership and control hypothesis. It is possible that the separation of ownership and control issue is the product of an erroneous perception of the concept of the corporation. This perception views shareholders as "owners" who in some way have given up control over their business to a group of self-seeking shirkers. Shareholders are not owners; they are risk takers.[44] According to the teachings of modern portfolio theory the most efficient way to invest savings is to diversify holdings. As a result, shareholders invest small holdings in many corporations. Other individuals and groups also make their inputs into each corporation. Labor provides services. Others sell raw materials to the business. Management coordinates the activities and inputs of these groups.

The business firm in this view is a complex of contractual ar-

44. *Id.*

rangements among the owners of the various production inputs. Managers agree to work for a given salary and the risk takers, *i.e.*, the shareholders, agree to pay "X" dollars in return for a residual claim on the firm's earnings. The shareholders resemble lenders, except that the shareholders are more optimistic, that is, they have taken a greater risk than debt holders.

G. *Conclusions*

We can draw a number of significant conclusions from the recent economic literature:

1) The "disadvantages" of separation of ownership and control are merely one example of the inevitable cost of any form of joint effort. Universities, government bureaucracies, and co-authors of law review articles all "suffer" agency costs. Government bureaucracies and nonprofit firms, however, do not enjoy the same free-market constraints on managerial discretion that corporations do.

2) The costs of separation of ownership and control include the cost of monitoring to deter shirking.

3) Monitoring is worthwhile only when the costs of monitoring are less than the benefits derived.

4) Shareholders will voluntarily pay for an amount of monitoring that does not exceed the benefits derived. Government-mandated monitoring may force the incurring of monitoring costs that exceed the benefits obtained.

5) The great success of the corporation with dispersed ownership is evidence that the benefits of these organizations outweigh their agency costs.

6) There is debate in the economic literature as to the effect of separation of ownership and control on the extent of management discretion to ignore shareholder interests. The findings are not conclusive as to the extent of the effect. Many economists believe that significant discretion exists, if at all, only in the absence of product competition.

7) If managers can demonstrate to shareholders and potential investors that they are not shirking, the price of the corporate shares will rise. Therefore, managers have powerful incentives to take steps to prove that they are not shirking. (For example, managers have strong motives to hire independent CPA's to demonstrate a lack of shirking.)

8) The competitive markets for management and control tend to limit the ability of, or incentive for, managers to shirk.

9) The traditional concept of the separation of ownership and control may be based on a totally erroneous view of investors in publicly held corporations. Shareholders are not "owners" but risk takers.

The foregoing section constitutes an analysis of the fundamental problems in corporate law in light of modern economic thought. The following section considers the main themes of corporate law in the perspective of this analysis.

III. THE DUTY OF LOYALTY

The most fundamental responsibility of directors is the duty of loyalty. *The Corporate Director's Guidebook*[45] characterizes that duty as one in which the director pledges his "allegiance to the enterprise and acknowledges that the best interests of the corporation and its shareholders must prevail over any individual interest of his own."[46] More particularly, the *Guidebook* prescribes four specific components of that duty.[47] First, whenever a director has a material personal interest in dealings with the corporation he should disclose the existence of the interest before the board takes action and abstain from acting on the matter himself. Second, he should attempt to resolve conflicting corporate interests fairly, with concern for the treatment of any minority shareholder who might be adversely affected. Third, whenever a business opportunity comes to his attention as a result of his relationship to the corporation, he should present it to the corporation before pursuing the opportunity on his own account. Finally, he should deal in confidence in corporate matters until there has been public disclosure.

The *Guidebook* further declares that the "fundamental responsibility" of the individual corporate director is to represent the interests of the shareholders and that the director is not directly responsible to other constituencies, such as employees, customers, or the community, except as specific responsibilities might be provided by law.[48] It is recognized that economic objectives will "play the primary role" in guiding corporate decisions.[49]

A similar duty is imposed upon controlling shareholders of a corporation. They have the same duty as the directors to commit

45. 33 BUS. LAW. 1595 (1978).
46. *Id.* at 1599.
47. *Id.* at 1599-1600.
48. *Id.* at 1606.
49. *Id.*

their allegiance to the business and recognize that the best interests of *all* of the shareholders (including, of course, the minority shareholders) must prevail over the particular interests of the controlling shareholders.[50] Much corporate law constitutes a development of ramifications of the "loyalty" obligations of directors and control shareholders to the body of all shareholders.[51] The obligation is frequently characterized as a fiduciary responsibility, with directors and controlling shareholders deemed to be fiduciaries in much the same sense as trustees.[52]

The purpose of the fiduciary principle is to compel directors and controlling shareholders to manage the enterprise fairly on behalf of all the owners rather than in the interest of the managers or only some of the shareholders. It is essentially a regulatory attempt to minimize the agency costs of separation of ownership and control. As such it must satisfy a number of crucial tests:

1) Does it, in fact, lessen the ability of management to depart from its obligation to maximize shareholder welfare?

2) If it does accomplish this result, does it do so at a cost which exceeds the benefits of the regulatory structure?

3) Is it needed? That is, are the market constraints on management more efficient than regulation and the legal process?

A. *Management Compensation*

Consider the doctrine in the context of management compensation. While the director's duty of loyalty is intended to place some restraint upon management indulging its self-interest at the expense of shareholders, the doctrine is notoriously difficult to apply in the area of compensation,[53] since corporate law cannot simulate a "just" compensation package. Only the market can do that.

The question concerning compensation for executives is whether it is rationally related to various past and future indicators of business performance, such as net profits. The typical legal case cannot yield empirically valid answers. For example, suppose a steel executive receives ten percent more than apparently similar steel company executives in other companies, but that his company is earning less than many other steel firms. In the absence of truly egregious facts proving gross corruption and incompetence, it

50. *See, e.g.*, Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947).
51. *See generally* W. CARY, *supra* note 4, at 550-693.
52. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 306 (1939).
53. *See, e.g.*, Rogers v. Hill, 289 U.S. 582 (1933).

is impossible in the typical litigation to determine whether the market for management is working badly for that particular corporation, since we do not know a number of relevant facts. Did it place the executives best suited to holding unavoidable losses to a minimum? Will it attract the executives best fitted in the long run to solve the problem? Is the excess compensation necessary to attract managers to a business which for various reasons is perhaps a less attractive place to work than other companies? Is the corporation performing poorly because of factors beyond the control even of able management? Until such questions are answered, the court is without the means to make a rational judgment. As one judge put it:

> Assuming, arguendo, that the compensation should be revised, what yardstick is to be employed? Who or what is to supply the measuring rod? The conscience of equity? Equity is but another name for a human being temporarily judicially robed. He is not omnipotent or omniscient. Can equity be so arrogant as to hold that it knows more about managing this corporation than its stockholders?
>
> Yes, the Court possesses the power to prune these payments, but openness forces the confession that the pruning would be synthetic and artificial rather than analytic or scientific. Whether or not it would be fair and just, is highly dubious. Yet, merely because the problem is perplexing is not reason for eschewing it. It is not timidity, however, which perturbs me. It is finding a rational or just gauge for revising these figures were I inclined to do so. No blueprints are furnished. The elements to be weighed are incalculable; the imponderables, manifold. To act out of whimsy or caprice or arbitrariness would be more than inexact—it would be the precise antithesis of justice; it would be a farce.[54]

When corporate law imposes judicial decision on executive wages it is a form of government price fixing. Such an intrusion into the heart of business distorts demand and supply in the same unfortunate manner as do all other government efforts at setting prices.[55]

In addition, the regulatory apparatus has tremendous costs. The legal process requires the services of attorneys and accountants. The legal expenses are immense. There are also the hidden

54. Heller v. Boylan, 29 N.Y.S.2d 653, 679 (Sup. Ct.) (Collins, J.), *aff'd without opinion*, 263 A.D. 814, 32 N.Y.S.2d 131 (App. Div. 1941).

55. *See, e.g.*, T. SOWELL, KNOWLEDGE AND DECISIONS 167-229 (1980).

costs that may occur if management, in fear of lawsuit, keeps compensation at a lower rate than is efficient. That is, if a higher rate of compensation in the absence of fear of lawsuit would have attracted a proportionately greater management effort, the shareholders will have lost as a result of the legal doctrine.

There is an additional problem. The duty of loyalty/obligation of fairness doctrine assumes that the threat of legal process will have a deterrent effect. The basic hypothesis is that the doctrine will result in "better" behavior by corporate executives. If it does not, then the benefit of the corporate law apparatus is nil. It is not sufficient to prove that corporate law holds down wages. It is necessary to demonstrate that the law chills executive compensation to an efficient level. Needless to say, this author knows of no conclusive evidence that the legal doctrine causes "better," *i.e.*, more efficient, behavior.

There is convincing evidence in the economic literature that a firm's profit performance is the key factor in "explaining variations in the salaries of corporate executives."[56] The empirical evidence supports the thesis that there is an active market for corporate executives.[57] Able candidates compete for the available positions. "Excess" wages are eliminated by the active competition for positions. Poor performers are replaced by more able candidates who are willing to work at equal or lower salaries.

In a recent paper[58] Professors Crain, Deaton, and Tollison undertook to "determine the extent to which the market for corporate presidents as a whole provides a mechanism whereby their conduct is evaluated."[59] The researchers stated:

> To do this, we introduce length of service as the principal means by which executive performance is rewarded through the market. The basic logic of our approach is that stockholders or boards of directors who are dissatisfied with the performance of their appointed company president will seek to replace them [*sic*] . . . .[60]

56. *See, e.g.*, Lewellen & Huntsman, *Managerial Pay and Corporate Performance*, 60 AM. ECON. REV. 710 (1970); Masson, *Executive Motivation, Earnings, and Consequent Equity Performance*, 79 J. POL. ECON. 1278 (1971).

57. Crain, *Can Corporate Executives Set Their Own Wages?* in THE ATTACK ON CORPORATE AMERICA 277 (M. Johnson ed. 1978).

58. Crain, Deaton & Tollison, *On the Survival of Corporate Executives*, 43 S. ECON. J. 1372 (1977).

59. *Id.*

60. *Id.*

Their empirical results show that

> relationships exist between the tenure in office of corporate presidents and measures of firm performance. We found that at a highly aggregated level, the tenure of corporate presidents is positively related in a quite responsive way to profit variations. This suggests that non-profit maximizing behavior in the private sector is not typically tolerated in the market for executive services.[61]

In conclusion, both empirical evidence and responsible economic theory indicate that shirking in the form of "excessive" compensation is controlled by market forces.

B. *Going Private*

The "going private" phenomenon is a famous example involving controversial application of corporate law.[62] The so-called "pure" going private transaction involves a single firm in which the control group desires to eliminate minority shareholders. The goal may be accomplished by a tender offer to the minority shareholders or by a merger or reverse stock split.

The tactic of going private has been opposed by commentators and many courts on the ground that directors or control shareholders violate their duty of loyalty/obligation of fairness to minority shareholders.[63] The argument against going private makes two basic points: first, that the transaction lacks any economic efficiency justification and second, that the control group can dictate the price to the minority shareholders.

First, in the so-called "pure" going private transaction, a single corporation expends corporate funds to buy out the minority group. The transaction never involves the potential synergistic benefits that result from the combination of two independent businesses. Opponents therefore argue that the buy-out is without any economic justification.

In light of the agency cost analysis of corporate structure, this argument fails. In a going private transaction, the acquiring corpo-

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61. *Id.* at 1374.

62. *See, e.g.*, Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977); Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977). *See generally* Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978); Note, *Going Private*, 84 YALE L.J. 903 (1975).

63. *See, e.g.*, Bryan v. Brock & Blevins Co., 490 F.2d 563, 570 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974); Note, *Elimination of Minority Share Interest by Merger: A Dissent*, 54 NW. U. L. REV. 629, 635 (1959).

ration lessens or eliminates the split between ownership and control. As a consequence, agency costs decrease, and monitoring and its cost in all forms are decreased or elminated. This is a powerful economic justification for going private. As Jensen and Meckling state in their article, "In general if the agency costs engendered by the existence of outside owners are positive it will pay the . . . shareholders . . . to sell out to an owner-manager who can avoid the costs."[64] In other words, the newly "gone private" corporation will be more valuable than the publicly held corporation because of the elimination of the costs of the split between ownership and control. When owner-managers estimate that the resources of the gone private firm will be sufficient to continue successfully the business, they will frequently buy out the minority at a price in excess of the prevailing market price of the shares of the publicly held firm. When corporate law prevents that transaction or increases its cost by the imposition of complex legal procedures, the minority shareholders, as well as the public, are hurt. Ironically, many commentators who call for regulatory constraints of the supposed evils of the split between ownership and control, bitterly criticize going private.

Second, the arms-length bargaining contention asserts that the control group, in the absence of a judicial fairness doctrine, can unduly influence the price of the cash-out. Opponents assert that this will occur both in the "pure" going private transaction and in cash-outs of minority shareholders in mergers of two separate corporations. Therefore, minority shareholders need a judicial fairness doctrine.

As emphasized throughout this article, however, the cost of the judicial process must be weighed against its benefits. Furthermore, the corporate law approach must be measured against the benefits of an alternative free market approach. A corporation that gains the reputation of freezing out minority shareholders at an inadequate price will suffer difficulty in raising equity capital in the future. Potential investors will not buy equity shares, or the corporation will be forced to sell the shares at a lower price. That price will reflect investors' estimates of their potential loss if the corporation goes private. The probability of that adverse impact will act as a powerful deterrent against overreaching by corporate insiders.

In rebuttal, opponents will argue that a corporation may go

64. Jensen & Meckling, *supra* note 13, at 333.

public and some years later freeze out the minority at a low price based upon a one-shot short-run psychology that says, "Now that I have gotten public money at ten dollars and the market has since sharply dropped, I will buy back at three dollars, keep the profit and not worry about my loss of reputation." This will seldom if ever be a rational form of thinking. The corporation can never be certain that it will not need additional equity financing in the future. If it goes private at too low a price, however, it will never be able to obtain adequate financing in the future. Moreover, corporations will compete for better reputations. Corporation *X* will contract with potential investors to buy them out, if at all, in the future on more generous terms than corporation *Y* offers.

On the other hand, because complex and costly legal restraints increase the costs of going private, corporate law is likely to produce adverse consequences. Existing minority shareholders will lose the chance to be bought out at a price in excess of current market values. Corporations will be less likely to sell stock to future minority shareholders because of the difficulty of going private in the future. One final consequence is the most certain: as a result of corporations' needs for legal assistance through the bramble bush of state and SEC rules in this area, the corporate lawyers will get wealthier. They will be the chief beneficiaries of corporate law.

C. *Corporate Opportunity*

Yet another example of the doctrine of the duty of loyalty is the corporate opportunity rule. Corporate law essentially states that an economic opportunity which comes to the attention of a person because of his corporate position cannot be personally expropriated by that person when the opportunity falls within the type of activity that is pursued by the corporation.[65] The doctrine may be formulated broadly or narrowly, depending upon the court and the jurisdiction. For example, assume a corporation is interested in possible business acquisitions of type A. If the president learns of a type A deal he cannot pursue it himself. He must first offer to his corporation the opportunity to acquire the type A business.

The doctrine is largely a product of case law. Assume the case law doctrine did not exist and that the Congress or a state legisla-

65. *See, e.g.*, Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934), *cert. denied*, 294 U.S. 708 (1935); Lincoln Stores v. Grant, 309 Mass. 417, 34 N.E.2d 704 (1941).

ture was considering the advisability of establishing the doctrine by statute. The first question should address the extent to which the market accomplishes the desired results. If management followed the practice of appropriating opportunities, shareholders and investors would view this as a form of shirking. The price of the shares would drop. Furthermore, the market for management would reflect the shirking in the form of a lowered value on the future wages of the managers. Management, therefore, would have a strong incentive to advertise, enforce, and follow a policy of conveying all opportunities to the corporation.

Only if managers could successfully hide the fact that they seize corporate opportunities for themselves might they possibly follow a different route. Since opportunities come from and are known to parties outside the corporation, there is little reason to believe that even in the short run managers could frequently keep their action secret. Furthermore, other managers have incentives to monitor their superiors since the good reputation of their supervisors will enhance their own reputation.[66]

Even if that is not always true, the question to ask is whether a law would significantly improve directorial behavior at a cost which is exceeded by the benefits to be derived. If the acts are indeed easily hidden, then the legal process could not smoke them out except by use of a considerable force in the form of expensive attorneys and accountants. The cost of litigation, some of it groundless or erroneous, would significantly increase the cost of doing business. This would result in higher prices and lower business productivity.

The doctrine may have other adverse side effects. Directors may force the corporation to take worthless opportunities, for fear of lawsuits and bad publicity. Judges may be called upon to evaluate whether the opportunity was suitable or worthwhile for the corporation, involving an impossible effort at second-guessing free market decisions. Alternatively, if the courts ignore the suitability or worth of the opportunity, they could establish a harsh doctrine which would most certainly accentuate the incentive for directors to load bad business deals on corporations.

Drafters of a new law as well as proponents of a new judicial doctrine should have some burden of proving that it will accomplish the desired results. Because there is an obvious possibility that the cost of the legal process necessary to implement the op-

66. *See* text following note 43 *supra*.

portunity doctrine will be greater than the benefits derived, failure to measure those costs would appear to be irresponsible. The corporate opportunity doctrine has developed by the accretion of case law. It is fair to say that not one of the questions raised in this section has been adequately answered by the courts. This pattern permeates corporate law: case-made or statutory regulation is imposed upon the corporate system without sufficient regard to empirical data and relative cost or benefit.

D. *Parents and Subsidiaries*

The class of cases involving dealings between parent corporations and subsidiaries provides an additional example of the fairness doctrine. The issue frequently turns on whether the parent corporation's actions are "fair" to the minority shareholders of the subsidiary.[67] For example, the dispute may relate to whether the parent should develop deals which include the Venezuelan subsidiary or be free to organize developments in other geographical areas which exclude the Venezuelan subsidiary.[68] In another transaction, a parent may be accused of drawing out an excessive amount of dividends from the subsidiary. This allegedly drains the subsidiary of cash and chills its ability to grow and expand. Minority shareholders, of course, receive their pro rata share of dividends based on the number of shares in the subsidiary which they hold. The application of the fairness doctrine is inevitably amorphous and subjective. The payment of large dividends by the subsidiary obviously drains it of cash necessary for business expansion, which may hurt the minority shareholders at least in the short run. It may benefit them in the longer run as the enterprise in its totality prospers due to the parent's wise use of resources. The payout of dividends to the parent, however, benefits the larger enterprise, *i.e.*, the operation of the parent and its other subsidiaries. The latter action benefits the mass of shareholders of the parent. "Fairness" to the minority shareholders of the subsidiary means *less* dividends to the parent. "Fairness" to the parent and its shareholders means *more* dividends to the parent. It is impossible to establish an objective judicial test of fairness; the search for judicial fairness pursues a will-of-the-wisp goal. If the market constraints (*e.g.*, product competition, market for control, and market for manage-

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67. *See, e.g.*, Case v. New York Cent. R.R., 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965).

68. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

ment) are operating, the opportunities for management shirking will be limited. Moreover, the price of the shares held by the minority will reflect the impact of decisions that may benefit majority shareholders of the parent more than minority shareholders of the subsidiary. Therefore, shareholders' returns on equity may be just as great as returns on the higher priced shares of the parent.

E. *Sales of Control*

When a control shareholder sells his control interest in a corporation, the sale is usually at a premium over market price. For example, if the price of a share of common stock of the *XYZ* Corporation on the NYSE is thirty dollars a share, the control shareholder (owning, say, thirty-five percent of the issued and outstanding stock), may sell his block at thirty-seven dollars a share to the buyer. Minority shareholders frequently take the position in litigation that the premium represents a corporate asset, *i.e.*, the right to control the corporation, which must be shared with all the minority shareholders. They rely heavily on the often debated thesis of Professor A.A. Berle that "the power of control is an asset which belongs only to the corporation; . . . payment for that power, if it goes anywhere, must go in the corporate treasury."[69]

Probably the most famous case is *Perlman v. Feldmann*,[70] in which the Feldmann family sold control of the Newport Corporation at a premium to a group of end steel users. The time was the Korean War, when steel was in short supply. Newport was a newcomer in the steel industry, its physical plant consisting of old installations in the process of being supplemented by newer facilities. Except in times of scarcity Newport was unable to compete profitably for customers outside its immediate location. The Feldmann family, as the district judge found, had no reason to believe that Wilport, the purchaser, intended to injure or loot Newport. As a result of the purchase, the take-over group acquired the power to buy an assured supply of steel from the steel corporation. The court held that the minority stockholders of Newport could compel an accounting for their share of the premium.[71]

One interpretation of the case is a variant of the corporate opportunity theory. Newport had adopted the "Feldmann Plan" pur-

69. Berle, *"Control" in Corporate Law*, 58 COLUM. L. REV. 1212 (1958). For a sampling of the debate surrounding the sale of control issue, see Andrews, *The Shareholders' Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965).

70. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

71. *Id.* at 178.

suant to which Newport received interest-free cash advances from steel users who in return were assured a source of supply. Further, there was some possibility that Newport could utilize the period of short supply to obtain the good will of customers with whom it was dealing, which patronage might extend into a period when the scarcity ended. These were opportunities, the court asserted, which the sale of control eliminated. The effective rebuttal to that argument is that the marriage of Newport with its corporate purchaser was advantageous, because Newport would be assured of a customer in the form of its new parent.

A more fundamental point is the inability of judges and the judicial process to evaluate the relative business advantages or disadvantages of a sale of control. That evaluation is a business decision which should be left to the business process. It might be argued that the original control group of Newport was selfishly interested in the transaction and therefore the court should apply some form of intrinsic fairness test or invoke some per se rule against the sale of control. The crucial point about sale of control, however, is that the selfishness of the seller cannot result in a transaction unless the new control group purchases. The new control group will not purchase unless it believes in its ability to manage the corporation profitably in the future. In an efficient securities market, the price of the corporation stock reflects all of the material public information pertaining to the corporation, including management performance.[72] The hefty premium over that price paid for the stock of the old control group is evidence that the new control group believes that it can improve upon the performance of the old, thereby increasing the price of the stock in the marketplace and recouping the premium.

Another interpretation of *Perlman* is that it indeed held that the "pure" sale of control is a corporate asset which must be shared with minority stockholders. Although the weight of authority in other courts and other jurisdictions would appear to be contrary to such a theory,[73] the sale of control is always circumscribed by legal uncertainties and caveats, and the constant threat of costly litigation. Although courts may intone the rule that sales of control are not per se illegal, the penumbra of the per se theory impels the courts to a very close scrutiny of such transactions.

Sales of control are a method by which more efficient manage-

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72. *See* note 18 and accompanying text *supra*.
73. *See, e.g.*, Thompson v. Hambrick, 508 S.W.2d 949, 954 (Tex. Civ. App. 1974).

ment groups may displace less efficient groups. It is frequently a method by which management shirking will decrease, because the new control group will seek to recoup the premium paid for their stock by shirking less than old management. As a result, society will benefit. Furthermore, improved performance will result in an increase in the price of the stock acquired by the new control group. That increase will be reflected in the increased price of the minority shares as well. Sales of control, therefore, will tend to have the same beneficial effects as successful take-over attempts.[74] When corporate law chills the process, minority shareholders are harmed.

F. *Egregious Situations*

It is not even self-evident that corporate law can deal with the most egregious situations. When control shareholders or directors take advantage of their position to reap shortrun gain at the expense of the shareholders in a gross manner, it has been argued that the legal process can deter, detect, and punish the effort.[75] For example, if a control shareholder-director sells a piece of land obviously worth fifty thousand dollars at a price of ten million dollars to the corporation, it is assumed that the self-dealing can be effectively reached by the legal process. There is no evidence, however, that the cost of corporate law is less than the benefits derived from occasionally detecting and dealing with the egregious cases. In any event, more subtle agency costs will not be effectively reached by the legal process under the duty of loyalty doctrine. It might be better to let the free market discipline even the most *egregious* cases. Corporate managements which develop a reputation for gross misconduct would find it increasingly difficult to attract investors and raise new capital. Furthermore, shareholders and management would, of course, if they desire, be free to enter into contractual arrangements requiring insiders to avoid certain egregious acts at the risk of contractual suits for damage.

G. *Conclusion*

In all areas of corporate law, the fiduciary duty doctrine is permeated by uncertainty and arbitrariness because of its fundamentally impossible goal: to simulate the arrangements that would en-

74. *See* notes 39 to 41 and accompanying text *supra.*
75. *See* notes 6, 11, 65 and accompanying text *supra.*

sue if shareholders actively managed the business. It is difficult to believe that judges and the cumbersome legal process can act as proxies for shareholder self-interest in efficient management. Judges are not entrepreneurs, nor are they shareholders. They do not ordinarily share the incentives for profit maximization that such groups share. It is unlikely that their interpretations of the duty of loyalty will be consistent with what shareholder-owners would desire. Indeed, the fiduciary doctrine may perversely *increase* the gap between ownership and control because of the inability of the judicial process to effectively simulate the desire of shareholders for maximized profits.

Essentially, corporate law is a tool used by the legal profession to displace the free market process. It is a method by which lawyers and judges can regulate prices and other factors of production under the rubric of "fairness." Businessmen have difficulty recognizing this function of corporate law because the doctrine is clouded in arcane legal jargon.

In addition, corporate law is defective because it has evolved haphazardly without serious attention to cost-benefit analysis and empirical data. The need for empirical findings seems obvious, but has only recently become apparent to the members of the legal profession. A group of United States senators, including Senator Ribicoff, recently introduced a bill to reform the federal regulatory process. Senator Ribicoff stated:

> Government regulation has grown dramatically—and it has sometimes grown haphazardly . . . . Today people are questioning what Government can and should do . . . .
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> . . . .
>
> One important provision in this bill is the requirement that all Federal agencies conduct a regulatory analysis before issuing regulations.
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> . . . .
>
> [T]he analysis shall contain a preliminary description of projected economic . . . effects.
>
> . . . .
>
> It is logical and reasonable to estimate costs . . . before making any significant decisions.[76]

This requirement should extend to all of corporate law.

76. 125 CONG. REC. S858, 859 (1979) (remarks of Sen. Ribicoff).

IV. Corporate Governance

A. *Independent Directors*

The separation of ownership and control issue has spawned strenuous efforts to reform corporate governance. Senator Howard M. Metzenbaum, Chairman of the Subcommittee on Citizen and Shareholder Rights and Interests, supports legislation to ensure greater corporate accountability to guard shareholders' rights and to establish public faith in corporate governance.[77] The Securities and Exchange Commission (SEC) has dealt with the area both in recent amendments to its proxy rules and in settlements of Commission enforcement actions.[78] In this regard the reform most often recommended is the requirement that a majority of the board of directors be composed of independent directors.[79] A corollary principle is that certain key board committees—audit, nominating, and compensation—should be comprised of a majority or, better yet, exclusively of the independent directors. In particular, the received wisdom is that the audit committee should be staffed exclusively by independent directors.

The Business Roundtable is a group of 180 persons, each of whom is the chief executive officer of a major corporation. Recently, they issued a report called *The Role and Composition of Directors of the Large Publicly Owned Corporation*.[80] They stated in relevant part as follows:

> On the one hand we reject extreme notions which would disqualify as directors all members of operating management or all members except the CEO [Chief Executive Officer] . . . .
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> . . . .
>
> The corresponding notion on the other side is represented by a recent suggestion that all directors should devote full time to directorship affairs and that there should be no "outsiders." . . . It seems to us that outside directors (directors who devote only a part of their time to board responsibilities) can perform a very valuable service to the corporation. They are windows on the world who provide a protection against insularity and lack of vision. . . .
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> [W]e begin with two minimum propositions: 1. The number

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77. Russo & Wolfson, *supra* note 5.

78. *Id.*

79. *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, Statement of the Business Roundtable*, 33 Bus. Law. 2083 (1978).

80. *Id.*

of outsiders should be at least sufficient to have a substantial impact on the board decision process . . . .
2. . . . We believe both the Audit and Compensation Committees should be composed entirely of non-management directors and that the Nominating Committee should have a majority of non-management directors . . . . It is our belief that in most instances . . . it is desirable that the board be composed of a majority of non-management directors . . . .[81]

A recent Conference Board study reveals that eighty-three percent of manufacturing companies now show a majority of outside directors.[82] "The same study shows that if former or retired employees on the board are not considered outsiders, the numbers are 60 percent for manufacturing companies and 80 percent for non-manufacturing companies."[83] Furthermore, the NYSE now requires all domestically listed corporations to establish and maintain audit committees composed exclusively of independent directors.[84]

At the outset it must be emphasized that the industry trend toward independent directors under the pressure of the NYSE, Congress, and the SEC continues despite the lack of proof that independent directors produce better results than management directors. In fact, Professor Stanley C. Vance in a study concluded that "*In major manufacturing enterprises, there is no quantitative evidence supporting the claim that outside boards of directors are superior in performance to inside boards of directors.*"[85] Moreover, as this author stated recently:

The most frequently given reason for change is the extent of corporate scandal, yet there is no proof . . . that corporate misconduct is greater today than it has been at other times in history. The only arguments the S.E.C. and others have offered are anecdotal accounts of occasional corporate misbehavior, hardly a convincing reason for fundamental modifications of corporate governance.

. . . .

What has happened is that the proponents for change have subtly shifted the burden of proof. Corporate leaders must prove by a preponderance of the evidence that change should *not* be

81. *Id.* at 2107-08.
82. *Id.* at 2109.
83. *Id.*
84. *Id.* at 2109-10.
85. S. VANCE, BOARDS OF DIRECTORS, STRUCTURES AND PERFORMANCE 45 (1964) (emphasis in original). *See also* studies cited in W. CAREY, *supra* note 4, at 207-14.

> made. This is a burden that is difficult to meet and one that has been shifted so easily because of the anti-business bias prevalent in our society. It has also shifted because Government officials and corporate attorneys (many of whom are alumni of Government regulatory agencies) have grown up in an atmosphere of pervasive Government regulation.[86]

In addition to the lack of empirical proof, there is grave doubt, on a theoretical basis, as to the efficacy of independent directors. Outside directors do not have the same incentives as do employee directors to maximize shareholders' gain. Compare the case of an inside director with a large equity investment in the corporation, or a compensation package closely related to profit performance, to an outside director who has no investment in the corporation and no personal stake in success except insofar as he is an outside director. How will the two compare on willingness to take entrepreneurial risks, sensitivity to pressure from legislators, attitude toward dividend pay-out rates, willingness to dilute profit maximization with their own social or political goals, and desire to pay large rewards to attract and hold brilliant performers?

Outside directors by definition have no financial interest in the corporation. They are disinterested. That is the problem, not the solution. They are not only likely to be less interested in maximizing profits, but will probably be more inclined to represent nonshareholder interests, such as the desires of SEC regulators, than are inside directors. They will also be more inclined to be conservative in business decisions, more sensitive to all outside pressures, and be preoccupied with their role as second-guessers of management rather than entrepreneurs.

If corporations wanted to take the risks implicit in the conservative role of outside directors, then the pressures of the market for control and management would act as an effective restraint on errors by outside directors. Also, shareholders would be free to select investments in the same or different industries, based in part on the market's assessment of the success of outside-director dominated corporations. A mandatory government regulatory program, on the other hand, will have the effect of loading the monitoring costs of outside directors on corporations without room for alternative shareholder choice.

> Increased regulatory costs often lead to either smaller profits or higher prices, both of which create jobs for lawyers and

86. Russo & Wolfson, *supra* note 5 (emphasis in original).

Government regulators and not for the shareholders or the general public. Indeed, this operates as a kind of retrogressive tax on consumers with low incomes who find it increasingly difficult to pay the higher prices.[87]

Professor George Benston pointed out in a recent article[88] that managers of publicly owned corporations have incentives to increase visible monitoring costs voluntarily. As they increase such costs, for example in the form of audits by independent accountants, the public will have more confidence in the business and will be willing to pay a higher price for its equity shares. In a recent study, Benston demonstrated that publicly owned corporations retained independent auditors and prepared adequate financial statements even before the federal securities legislation was placed on the books.[89] In short, there is a powerful self-interest motivation for managers of publicly owned corporations to incur noticeable monitoring costs in order to maintain and increase the price of issuers' shares.

Therefore, managers of some publicly held corporations may have an interest in voluntarily appointing and electing some independent directors to the board in order to maintain the confidence of public investors. If the structure is governmentally mandated, however, the likelihood is that the mandated structure will impose greater costs as compared to the structures that would be devised voluntarily in a free market.

There is in the nature of a governmentally mandated system no limit on cost. Independent auditors monitored the discretion of insider management before SEC regulation was put in place. SEC regulations now require independently audited statements which contain more detail than the older voluntarily prepared documents.[90] Yet, in the opinion of the SEC, the NYSE, and Nader groups, these regulations have proven insufficient.[91] Repeating the classic problem of who will guard the Platonic guardians, the SEC is moving toward requiring that boards and board audit committees be composed exclusively of outside directors who will monitor the monitoring ability of the independent accountants.[92] The

87. *Id.*

88. *See* Benston, *supra* note 21.

89. *See* Benston, *supra* note 11.

90. *See* Securities Act of 1933, 15 U.S.C. §§ 77aa (25), (26), (27) (Schedule A) (1975).

91. *See* R. NADER, M. GREEN, & J. SELIGMAN, *supra* note 3, at 157-69.

92. *See* Address by H. Williams, Chairman of the SEC, *Corporate Accountability One Year Later*, Sixth Annual Securities Regulation Institute (Jan. 18, 1979).

reader can be sure that government will not rest with this. The next wave of reform will probably mandate government directors to monitor the monitoring of the independent directors who monitor the CPA monitors.

B. *Shareholder Democracy*

Another proposal calls for a drastic modification in the composition of boards of directors to include so-called constituency directors who will represent local communities, women, suppliers, customers, and so on. Professor Ralph K. Winter has argued that this proposal will, contrary to the expressed desires of the reformers, act to widen the gulf between control and ownership.[93] He believes that the directors will represent interests different from, and often opposed to, the interests of the shareholders, establishing a wide gulf between the desire of shareholders for maximum profits and the interests of the outside constituencies.

There is a related campaign to increase the direct control of shareholders over directors and senior management. This category of change includes recommendations for direct shareholder nomination of directors, corporate financing for the election campaigns of such directors, and independent-director control over the nominating committees of the board.[94]

As in the case of independent directors, discussed above in Part A, there would be no fundamental objection if this approach were truly voluntary. Under state law shareholders are free to establish corporate structures which will grant greater power and authority to shareholders. If such freely contracted-for management arrangements resulted in greater profits for shareholders, the system would undoubtedly spread. A governmentally mandated system, however, will increase the monitoring costs of the owners without a proportionately greater increase in corporate profits and shareholder wealth.

There is no empirical evidence that granting more rights to widely dispersed shareholders increases shareholder wealth. Indeed, the evidence is to the contrary. As Professor Allen Hyman has pointed out, stock prices of corporations that announced their intent to reincorporate in Delaware outperformed the Standard &

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93. R. WINTER, *supra* note 39, at 50. *See generally* Chayes, *The Modern Corporation and the Rule of Law*, in THE CORPORATION IN MODERN SOCIETY 25, 38-39 (E. Mason ed. 1959).

94. *See* R. NADER, M. GREEN & J. SELIGMAN, *supra* note 3. *See also* P. BLUMBERG, THE MEGACORPORATION IN AMERICAN SOCIETY: THE SCOPE OF CORPORATE POWER (1975).

Poor's average at the time of the public statement.[95] Delaware is notoriously generous in granting powers to management rather than to shareholders.[96] If earnings suffered from such a structure, corporations would choose other states. The move to Delaware is empirical evidence of the irrelevance of the arguments for more shareholder power.

Shareholder-owners hire managers to run the enterprise for the benefit of the owners. Agents perhaps fall short in maximizing shareholder wealth. The managers, however, act within the constraints of the market for control and management. Many economists also believe that product competition acts as a powerful constraint on management discretion. Further, the managers themselves have an incentive to hire monitors voluntarily. This increases both the shareholders' confidence and the price at which the corporation can sell shares to the public.

Governmentally mandated steps to increase shareholder power should pass the cost-benefit test before they are adopted. If government politicizes the corporate structure by, for example, forcing corporations to fund shareholder proxy fights for election of directors, the corporation pays a price. The price includes the direct costs of the proxy battles as well as the indirect costs of pseudo-political party strife. In effect, these are increased monitoring costs. They must be balanced against the benefits, if any, to be derived.

The ostensible purpose for increasing shareholder power is to strengthen the shareholders' ability to monitor directly the wealth-maximizing efforts of the managers. Shareholders, however, have little interest in, or time for, such monitoring. Modern portfolio theory recommends that shareholders diversify their holdings as much as possible.[97] Intelligent investors become relatively small stakeholders in numerous enterprises. An investor who has purchased five hundred dollars worth of common stock in each of many corporations has only a limited ability to concentrate on each of his investments. His time is better spent in deciding when to hold, sell, or buy rather than in participating in corporate politi-

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95. Hyman, *Do Lenient State Incorporation Laws Injure Minority Shareholders?* in THE ATTACK ON CORPORATE AMERICA 166 (M. Johnson ed. 1978). *See also* R. WINTER, *supra* note 39.

96. *See generally* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

97. *See* Wolfson, *New Theories of Portfolio Management Challenge SEC Doctrine*, 1 CORP. L. REV. 67 (1978).

cal contests. Indeed, it would be against his self-interest to devote considerable time to selecting nominees for each board and joining in numerous campaigns for their elections. He has a much better route to investment success. If the price of the stock in a particular corporation falls, he can effortlessly sell his stock and invest elsewhere. Similarly, if the price rises he can sell and make a profit.

When enough shareholders sell, a powerful message is transmitted to the anxious managers who closely watch the price movement of the shares. Price drops may be the signal to outsiders to wage a take-over bid to capture control of the corporation in the belief that they can run the corporation better than incumbent management.

In light of the evidence developed in this paper for the efficacy of the current corporate structure, the arguments for shareholder reform appear unconvincing. Many of the proponents are groups and individuals with little or no interest in investors and the value of the private corporation. Rather, they are interested in wresting control from the private sector and transferring it to the government.

Cooperative behavior necessarily results in agency costs. The costs are an inevitable concomitant of the act of joint endeavor. It is clear that increased monitoring of these costs does not automatically result in greater shareholder wealth. Otherwise, the problem would never exist—it would be a non-issue. Owners enter into the agency relationship because it is more efficient than trying to run the business without managers. When they do so, they cannot spend their entire lives monitoring the agents. They cannot stand at the agent's side throughout the day. This would be patently absurd. Excessive monitoring would be identical to elimination of the agency relationship.

Absurd as this example is, it is relevant to the shareholder democracy argument. The purpose of the structure separating control and ownership is to capture the efficiencies and benefits that flow from the arrangement. Shareholders invest in the expectation that the trade-off between agency shirking and agency effort will be worth the investment. When the trade-off ceases to be attractive, the shareholder sells and either enters into another investment or spends the money on goods. The objective of "shareholder democracy" proponents is to force shareholders into greater monitoring efforts, regardless of the cost. If the reformers succeed in their legislative efforts, shareholders will intelligently respond in the form of massive indifference to the new system. They will not vote.

They will not even read the election literature. They will become "alienated" voters. This will be a signal, not of their "sinfulness," but of their wise choice as to where they should direct their energies. In that regard they will, of course, continue to wield their potent and effective weapon—the power to sell.

The irrelevance of the shareholder democracy argument is a symptom of a deeper malaise in the current theory about corporate law. The section on fundamental assumptions refers to the concept of shareholders as risk takers rather than owners. Except for being more optimistic, they are like bank lenders. The concept of ownership is irrelevant to shareholders. Indeed, pursuit of shareholder democracy will only load additional unwanted costs on this particular class of risk takers, thereby increasing their risks, not their gain.

V. CONCLUSION

Corporate law is to a considerable extent a reaction to the separation of ownership and control issue, as well as an effort to resolve it. As such, corporate law offers essentially a questionable solution to an exaggerated problem. Modern economic theory demonstrates that all joint endeavor involves "agency costs." The modern publicly held corporation is no exception. The corporation of widely dispersed shareholders, however, draws its strength, not weakness, from the separation of ownership and control. Thousands of investors in their role as risk takers voluntarily place their capital into the hands of skilled managers. The markets for management and control constrain management discretion within reasonable limits. The self-interest of managers stimulates them to incur significant monitoring costs as a signal to the public that the managers are performing efficiently. Much of corporate law operates without heed to cost and market constraints in a case-by-case effort to control managers. It is likely that much of corporate law produces more harm than good and frequently interferes with the benefits that would flow from the competitive forces of the marketplace.