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Corporate Governance and Stockholder Abdication: Missing Factors In Tax Policy Analysis

James R. Repetti[*]

I. INTRODUCTION 973

II. THE PROBLEM OF PRODUCTIVITY 975

A. Nonproductive Managerial Activities 977
1. Excessive Compensation 977
2. Risk Aversion and Diversification 978
B. Focus of the Short-Term 980
C. Inefficient Retention of Earnings 983

III. WHY STOCKHOLDERS ABDICATE CONTROL TO MANAGEMENT 984

IV. HOLDING PERIOD REQUIREMENTS AND USING THE TAX SYSTEM TO INFLUENCE STOCKHOLDER BEHAVIOR—THE LONG-TERM CAPITAL GAINS PREFERENCE 992

A. Introduction to Issues Pertaining to the Long-Term Capital Gains Preference 992
B. Short-Term Investors Should Not Want Management to Maximize Short-Term Profits at the Expense

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* Associate Professor of Law, Boston College Law School. The author thanks Professors Hugh J. Ault, David S. Davenport, Scott T. FitzGibbon, Phyllis Goldfarb, Ingrid Hillinger, Judith McMorrow and Alfred Yen of Boston College Law School, Dr. Harold A. Peterson of Boston College, and Paul R. McDaniel of Hill & Barlow for helpful comments on earlier drafts. The author also thanks W. Brett Davis, Steve Gorlechen and Lise Revers for research assistance. Portions of Parts II, III and IV of this article are adapted from an earlier article by the author, James R. Repetti, *Long-Term Capital Gains, The Long-Term Investment Perspective and Corporate Productivity*, 49 TAX NOTES 85 (1990).

of Long-Term Profits 993
1. Investors Investing for Their Own Account 994
2. Rational Investors Who Do Not Invest For Their Own Account—Institutions—Should Also Want Management to Maximize Long-Term Profits 996
C. A Long-Term Capital Gains Preference Encourages the Inefficient Retention of Earnings and Exacerbates Problems Arising from the Separation of Ownership from Control 999
1. Impact of Capital Gains Preference on Retained Earnings 999
2. Impact of Capital Gains Preference on Stockholder Abdication 1007
D. The Questionable Benefit of Holding Period Requirements 1011
1. Taxable Investors 1011
2. Tax-Exempt Investors 1014
3. Efficiency Distortions of Holding Period Requirements 1015

V. USING THE TAX SYSTEM TO INFLUENCE MANAGERIAL BEHAVIOR 1017

A. Incentives to Motivate Behavior—Management Stock Ownership Incentives 1017
1. History of Incentive Stock Options 1017
2. Analysis of Incentive Stock Options 1022
B. Disincentives for Certain Management Activities—Golden Parachute and Greenmail Provisions 1026
1. Problems with the Golden Parachute Rules 1028
2. Problems with the Greenmail Rules 1030

VI. CONCLUSION 1033

I. INTRODUCTION

In formulating tax policy, Congress and analysts have largely ignored the deleterious effect on corporate productivity of the separation of stock ownership from actual control of a public corporation. As a result, tax provisions intended to increase corporate productivity and motivate beneficial managerial behavior have been ineffective and in some cases counterproductive.

Since the stock market crash of 1929, which augured the Great Depression and prompted the classic work by Berle and Means, *The Modern Corporation and Private Property*,[1] it has been generally recognized that management's ability to control publicly held corporations can negatively affect corporate productivity because management objectives may differ significantly from the general wealth maximization objective of stockholders. Commentators have generally viewed the ability of management to control the corporation as resulting from stockholder abdication which they have in turn attributed to defects in the mechanics of corporate governance.[2] Congress has responded to the problem of stockholder abdication in part by the adoption of the federal proxy rules.[3] Moreover, Congress has enacted or considered enacting various tax provisions with three goals in mind: (1) to encourage management to adopt objectives consistent with stockholders' objectives, (2) to encourage stockholders to adopt a long-term perspective with respect to their stock ownership, and (3) to discourage management from insulating itself from the discipline of market forces.

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1 ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

2 *See, e.g.*, ROBERT C. CLARK, CORPORATE LAW 390-400 (1986) (discussing economic incentive for stockholders to sell rather than incur the expense of a proxy battle with management); Richard M. Buxbaum, *The Internal Division of Powers In Corporate Governance*, 73 CAL. L. REV. 1671, 1683 (1985) (blaming the courts for having "limited or eliminated the shareholders' ultimate authority over structural decisions via an expanded definition of 'business judgment'"); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 903 (1989) (discussing deficiencies in federal regulation of proxies); Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 3, 43-55(1988) (discussing structural problems with respect to stockholders voting against management proposals).

3 The federal proxy rules, however, have not been very effective in empowering stockholders to battle management. *See, e.g.*, Jayne W. Barnard, *Shareholder Access To The Proxy Revisited*, 40 CATH. U. L. REV. 37 (1990); Dent, *supra* note 2, at 881.

This Article will show, however, that these tax provisions have, for the most part, been counterproductive and contradictory. Congressional sensitivity to problems arising from the separation of ownership from control has been, at best, incomplete. Congress has repeatedly considered provisions for enhancing corporate productivity without fully considering their impact on the separation of ownership from control issue. In particular, this Article will show that Congress has considered the capital gains preference, the incentive stock option preference, the golden parachute excise tax, and the greenmail excise tax as methods to motivate productive stockholder and managerial behavior without fully analyzing the impact of stockholder abdication on the effectiveness of these provisions.[4]

This Article also analyzes the effects of tax policy on the separation of ownership from control in public corporations. It suggests that tax policy may be a significant contributor to stockholder abdication and, therefore, that the consideration of the separation of ownership from control in public corporations should be a routine part of tax policy analysis.

This Article is organized as follows. Part II describes the impact that stockholder abdication can have on corporate productivity. Part III discusses the mechanisms that cause stockholder abdication. Part IV examines the proposals for a preference for long-term capital gains in order to discourage stockholder abdication of control and shows that such a preference would be counterproductive and actually encourage abdication. Part V then discusses other tax provisions which Congress has adopted to influence managerial behavior in order to remedy problems arising from the separation of ownership from control. Congress has utilized incentive stock options to encourage management to adopt objectives more consonant with those of stockholders and has adopted "golden parachute" and "greenmail rules" to discourage certain managerial behavior. Part V shows that those provisions are at best ineffective, and sometimes counterproductive.

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4 Several tax benefits have also been created to encourage employee stock option plans (ESOPs). *See, e.g.*, I.R.C. §§ 415(c)(6), 404(k), 133, 1042 (West Supp. 1992). Because Congress intended to use ESOPs to influence employee behavior, rather than management behavior, ESOPs are beyond the scope of this article. It is interesting to note, however, that the ESOP provisions have been frequently used by management to achieve its own purposes rather than to benefit employees. *See, e.g.*, 2 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 62.1.4 (2d ed. 1990).

Finally, Part VI concludes by recommending that corporate control issues be routinely considered in analyzing business tax proposals and by suggesting some areas in which such analysis may prove particularly helpful.

II. THE PROBLEM OF PRODUCTIVITY

It has long been observed that management of publicly held corporations controls the corporations with relatively little interference from stockholders.[5] This separation of ownership from control adversely affects corporate productivity because management's objectives frequently differ from stockholders'. objectives.[6] Since management receives the bulk of its compensation from labor, management's objectives usually involve strategies to protect their jobs and maximize their compensation.[7] On the other hand, an important objective of stockholders is to receive an adequate return on their investment.[8] Management's activity in protecting their jobs and maximizing their compensation can often reduce the corporation's profitability and thereby decrease the stockholders' return on their investment.

It is important to note that management is not entirely free to pursue its objectives at the expense of stockholders. Management discretion is partially constrained by competing products which could cause the demise of the corporation (and management jobs) if the firm does not stay relatively competitive.[9] Similarly, the threat of a hostile takeover (the market for control) can partially restrain management.[10] Moreover, the importance of re-

5 *See, e.g.*, BERLE & MEANS, *supra* note 1; Andrei Shleifer & Robert W. Vishny, *Management Entrenchment*, 25 J. FIN. ECON. 123, 123 (1989)

6 *See, e.g.*, Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. LAW & ECON. 301, 303 (1983).

7 *Id.*

8 Profit maximization is not the sole objective of stockholders. It is unlikely that stockholders want profits to be maximized at the expense of human dignity or the environment. However, receiving a "fair" return on their investment is an important objective.

9 Oliver D. Hart, *The Market Mechanism As An Incentive Scheme*, 14 BELL J. ECON. 366 (1983). T. Boone Pickens, Jr., *Takeovers: A Purge of Poor Managements*, 77 MGMT. REV. 52 (1988).

10 David S. Scharfstein, *The Disciplinary Role of Takeovers*, 55 REV. ECON. STUD. 185 (1988); Alfred Rappaport, *The Staying Power Of The Public Corporation*, HARV. BUS. REV. Jan.-Feb. 1990, at 96,100. Management can deflect the impact of takeovers by adopting strategies to entrench itself. Thus, management can cause the corporation to adopt poison pills or to recapitalize by replacing stock with debt. Moreover, the expense of takeovers and the recent collapse of the junkbond market which financed takeovers further negate the efficacy of takeovers. Ronald J. Gilson & Reinier Kraakman, *Reinventing the*

taining a good reputation in order to maintain job mobility is another ameliorating factor.[11]

However, these market forces still leave a great deal of room for management to maneuver because management has been able to devise strategies to shield itself from their full force.[12] Managers of publicly held companies are still able to engage in many practices that feather their nests at the expense of stockholders. Indeed, one commentator has suggested "the disenfranchisement of all shareholders by rapacious management with kept boards of directors—some paid consultants to the very same corporations—has cost shareholders billions upon billions."[13]

It is difficult to quantify the impact of the separation of ownership from control on corporations. It has been suggested that the large premiums paid by management in management buyouts, in some cases 50 percent in excess of the stock value prior to the buyout, are suggestive of the magnitude of the cost of the separation of ownership from control since a management buyout largely eliminates the problem by making management the corporation's controlling stockholders.[14] Others have suggested that the cost of separation of ownership from control may approximate 20 percent of the value of companies by analogy to the fact that closed-end mutual funds often sell for 20 percent less than the value of their portfolio of stock.[15] The remainder of this Part will describe the manner in which management's achievement of its own objectives negatively affects productivity.

Outside Director: An Agenda For Institutional Investors, 43 STAN. L. REV. 863, 870-871 (1991).

11 Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 297-298 (1980); Steven N. Kaplan & David Reishus, *Outside Directorships and Corporate Performance*, 27 J. FIN. ECON. 389 (1990) (finding that top executives of companies who reduce dividends are 50 percent less likely to receive additional outside directorships than are top executives of companies that do not reduce their dividends).

12 Shleifer & Vishny, *supra* note 5, at 122.

13 MARTIN SOSNOFF, SILENT INVESTOR, SILENT LOSER 6 (1986). *See* Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117, 122-126 (1988).

14 Donald H. Chew, *Introduction: The Choice of Management Incentives in Corporate Restructuring*, *in* CORPORATE RESTRUCTURING AND EXECUTIVE COMPENSATION xvii, xx-xxi (Joel M. Stern et al. eds., 1989).

15 Note, *Greenmail: Targeted Stock Repurchases And The Management-Entrenchment Hypothesis* 98 HARV. L. REV. 1045, 1048 (1985).

A. *Nonproductive Managerial Activities*

1. Excessive Compensation

Management compensation is a good example of how the conflict between management's and stockholders' objectives affect corporate productivity. While stockholders prefer that management compensation be closely correlated to the value created by management's services, management generally prefers as much compensation as quickly as possible. Most corporations form a compensation committee composed of outside directors in an effort to control management compensation.[16] However, the failure of stockholders to closely monitor directors has resulted in frequent director abdication of control to management. Since 63 percent of all outside directors on the boards of America's 1,000 largest companies are chief executives of other firms[17], the abdication of the board of directors should be expected. Chief executives who serve as directors for companies other than their own are generous in establishing the salaries of management of those companies because the high salaries can then be used to justify large salaries from their own companies.[18]

The result of managerial control is that although production workers' income increased less than 50 percent from 1980 to 1989, compensation paid to chief executives increased over 150 percent in the same period.[19] Indeed, comparisons to foreign executives are unflattering to United States management. In the United States, the average chief executive officer's income is 35 times more than the average manufacturing employee's while in Japan the ratio is only 15 to 1 and in Europe 20 to 1.[20] If the stockholders had more control over the firm, increases in management compensation would presumably be more in line with that of production workers.[21]

The disparity between management and worker income affects corporate productivity in several ways. Inflated salaries increase the

16 Dana Wechsler Linden & Vicki Contavespi, *Incentivize Me, Please*, FORBES, May 27, 1991, at 208.

17 JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES 18 (1989).

18 *A Survey of Capitalism*, THE ECONOMIST, May 5, 1990, at 10.

19 *Id.*

20 Joani Nelson-Horchler, *The Pay Revolt Brews*, INDUS. WK., June 18, 1990, at 29, 30.

21 *See* Arch Patton, *Those Million-Dollar-A-Year Executives*, HARV. BUS. REV. , Jan.-Feb. 1985, at 56, 60-62.

cost of production. And perhaps more importantly, inflated executive salaries lead to low worker morale.[22] Lastly, management's quest for ever larger compensation causes it to focus on maximizing the sales or growth of corporations rather than long-term profitability, because management's compensation is more closely correlated to the size of the firm than to the profitability of the firm.[23] Management's pursuit of strategies that maximize sales and growth of companies often comes at the expense of long-term profitability.[24]

2. Risk Aversion and Diversification

Other more subtle conflicts also negatively affect corporate productivity. Management may be more risk averse than stockholders with respect to corporate activities because management's wealth is concentrated in its contractual relationship with the corporation.[25] This position differs from that of public stockholders who usually have a small concentration of their wealth in any single corporation. Consequently, management will select corporate strategies which protect their concentration of wealth, but which may be harmful to stockholders. For example, it has been shown that in order for management to preserve their jobs, they will select projects for which the expected income flow is smaller but less erratic than income to be derived from riskier projects.[26] This may result in a wealth transfer from stockholders to bond holders with the result that stockholders are actually paying for

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22 Nelson-Horchler, *supra* note 20, at 34; *The Greed and the Glory of Being Boss*, THE ECONOMIST, June 17, 1989, at 79, 80.

23 Robin Marris, *A Model of the "Managerial" Enterprise*, 77 Q. J. ECON. 185, 187 (1963); Joseph W. McGuire et al., *Executive Incomes, Sales and Profits*, 52 AM. ECON. REV. 753, 760 (1962); Kevin J. Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. ACCT. & ECON. 11, 11-12 (1985).

24 *See, e.g.*, WILLIAM J. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH 46-48 (rev. ed. 1967) [hereinafter BUSINESS BEHAVIOR]; WILLIAM J. BAUMOL, ECONOMIC THEORY AND OPERATION ANALYSIS 383-85 (4th ed. 1977) [hereinafter ECONOMIC THEORY]; GORDON DONALDSON, MANAGING CORPORATE WEALTH, 22-23 (1984); ROBIN MARRIS, THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM 65-66 (1964); Yakov Amihud & Jacob Kamin, *Revenue vs. Profit Maximization: Differences in Behavior by the Type of Control and by Market Power*, S. ECON. J. 838-40 (Jan. 1979); Oliver E. Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032, 1047, 1051 (1963).

25 John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, *in* KNIGHTS, RAIDERS AND TARGETS 78, 84-85 (John C. Coffee, Jr. et al. eds., 1988) [hereinafter KNIGHTS, RAIDERS AND TARGETS]; Yakov Amihud et al., *'Managerialism', 'Ownerism' and Risk*, 7 J. BANKING & FIN. 189, 190 (1983).

26 Yakov Amihud & Baruch Lev, *Risk Reduction As A Managerial Motive For Conglomerate Mergers*, 12 BELL J. ECON. 605-606 (1981).

management's increased job security.[27] On the other hand, if management jobs are threatened as a result of a hostile takeover, management is more willing than stockholders to increase the risk associated with the company by incurring excessive debt in order to preserve their jobs. Since managers are more interested than stockholders in preserving their jobs, they are willing to incur greater risk than stockholders in preserving their jobs.[28]

It is also frequently asserted that managers favor diversification of a corporation's lines of business in order to decrease the risk of losing their jobs in the event one line of business becomes unprofitable.[29] Corporate diversification has been statistically linked to the nature of ownership of the corporation. Studies have compared the incidence of conglomerate type mergers and acquisitions (e.g., mergers with or acquisitions of businesses that are not related to the acquirer) of "manager controlled firms" with "owner controlled" firms. The "manager controlled firms" were defined as firms with widely dispersed ownership over which no shareholder or group exerted significant control. The "owner controlled firms" were defined as firms for which ownership was concentrated. The management controlled firms were found to engage in a significantly larger number of conglomerate mergers than the owner controlled firms.[30]

While these strategies reduce the risk associated with management's employment, they can have a negative effect on stockholder wealth. Studies that analyzed the effect of the diversification of firms in the 1960s show that the diversified firms suffered below average profitability in the 1970s.[31] Similarly, studies that focused on data from the 1980s demonstrate that diversifying acquisitions tended to reduce the stock value of the diversifying corporation.[32] Lastly, a recent study shows a direct statistical

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27 *Id.*

28 Edward S. Herman & Louis Lowenstein, *The Efficiency Effects of Hostile Take Overs*, *in* KNIGHTS, RAIDERS AND TARGETS, *supra* note 25, at 215.

29 GORDON DONALDSON & JAY W. LORSCH, DECISION MAKING AT THE TOP 8 (1983); Amihud & Lev, *supra* note 26, at 605; Coffee, *supra* note 25, at 83; Shleifer & Vishny, *supra* note 5, at 125; Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238, 1241-44 (1979).

30 Amihud & Lev, *supra* note 26, at 612-615.

31 DAVID J. RAVENSCRAFT & F. M. SCHERER, MERGERS, SELL-OFFS, AND ECONOMIC EFFICIENCY 111 (1987).

32 Randall Morck et al., *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31, 44-47 (1990). In this regard, one study has found that the more stock of the buyer held by management (thereby decreasing the separation of ownership from control), the more

relationship between firm diversification and reduced productivity.[33] The study found in an analysis of over 17,000 corporate factories that the greater the number of industries in which the corporations owning the factories operated, the lower the productivity of the factories as measured by the cost of units produced.[34]

B. *Focus on the Short-Term*

A distressing result of stockholder abdication is that management has an economic incentive to focus on the short-term and will, in fact, focus on the short-term without stockholder monitoring. In studying the period 1960 through 1976, Professors Hayes and Abernathy found that United States industrial productivity increased annually at 1.7 percent, while West Germany's increased at a rate of 4.2 percent per year and Japan's productivity increased annually at a rate of 7.5 percent.[35]

Professors Hayes and Abernathy suggest that the relatively poor performance in United States productivity is partly attributable to the American style of management which motivates middle management to focus on the short-term. They state:

> American managers have increasingly relied on principles which prize analytical detachment and methodological elegance over insight, based on experience, into the subtleties and complexities of strategic decisions. As a result, maximum short-term financial returns have become the overriding criteria for many companies.
>
> . . . .
>
> As more companies decentralize their organizational structures, they tend to fix on profit centers as the primary unit of managerial responsibility. This development necessitates, in turn, greater dependence on short-term financial measurements

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likely that the acquisition will increase the value of the buyer. Wilbur Lewellen et al., *Merger Decisions and Executive Stock Ownership In Acquiring Firms*, 7 J. ACCT. & ECON. 209, 209 (1985).

33 FRANK R. LICHTENBURG, INDUSTRIAL DE-DIVERSIFICATION AND ITS CONSEQUENCES FOR PRODUCTIVITY 28-31 (National Bureau of Economic Research Working Paper No. 3231, 1990).

34 *Id.* at 13-15, 28-29.

35 Robert H. Hayes & William J. Abernathy, *Managing Our Way To Economic Decline*, HARV. BUS. REV., July-Aug. 1980, at 67, 69. Hayes & Abernathy studied the period 1960-1978. For the period 1980-1990 manufacturing productivity increased 3.6% in the United States, 5.5% in Japan, and 1.8% in West Germany. STAFF OF JOINT COMM. ON TAX'N, 102D CONG., 1ST SESS., FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES 19 (Comm. Print 1991) [hereinafter FACTORS AFFECTING COMPETITIVENESS].

> like return on investment [ROI] for evaluating the performance of individual managers and management groups. Increasing the structural distance between those entrusted with exploiting actual competitive opportunities and those who must judge the quality of their work virtually guarantees reliance on objectively quantifiable short-term criteria.[36]

Other commentators have joined Professors Abernathy and Hayes in suggesting that part of the blame for United States productivity problems is short-sighted management.[37]

The utilization of short-term financial objectives, such as annual profits to measure the performance of middle management, creates a strong incentive for the managers to maximize short-term annual profits at the expense of long-term profits.[38] For example, it has been shown that increases in research and development expenditures contribute to productivity growth.[39] However, since a research and development expenditure is deducted from gross revenues when calculating profits for financial accounting purposes,[40] the incentive for a manager to incur the expense is minimal because the research will only generate profits in the future[41]

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36 Hayes & Abernathy, *supra* note 35, at 70; *see also* ROBERT B. REICH, THE NEXT AMERICAN FRONTIER 144 (1983) ("Professional managers concentrate on month-to-month profit figures, data on growth in sales, and return on investment."); S. Prakash Sethi & Nobuaki Namiki, *Factoring Innovation Into Top Management's Compensation*, DIRECTORS & BOARDS, Winter 1986, at 22.

37 *See* ROBERT H. HAYES & STEVEN C. WHEELWRIGHT, RESTORING OUR COMPETITION EDGE 5 (1984); LESTER C. THUROW, THE ZERO-SUM SOLUTION 149-50 (1985).

38 Dennis E. Logue, *Shareholder Wealth and Management Compensation*, CORP. ACCT., Winter 1984, at 38; Sethi & Namiki, *supra* note 36, at 22; Andrew Tylecote, *Time Horizons of Management Decisions: Causes and Effects*, 14 J. ECON. STUD. 51, 58 (1987). As an alternative to annual bonuses, many firms reward middle management through promotion. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. ASS'N PAPERS & PROC. 323, 323 (1986). This also encourages short-term profit maximization because the middle manager anticipates that he or she will have different responsibilities shortly as the result of promotion. *Id.*

39 FRANK R. LICHTENBERG & DONALD SIEGEL, THE IMPACT OF R&D INVESTMENT ON PRODUCTIVITY-NEW EVIDENCE USING LINKED R&D-LRD DATA 16 (National Bureau of Economic Research Working Paper No. 2901, 1989).

40 STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 2 (Oct. 1974) generally requires that research and development costs be expensed.

41 James R. Repetti, *Long-Term Capital Gains, the Long-Term Investment Perspective, and Corporate Productivity*, 49 TAX NOTES 85, 95 (1990). *See generally* MICHAEL L. DERTOUZOS ET AL., MADE IN AMERICA: REGAINING THE PRODUCTIVE EDGE 64-65 (1989); David F. Larcker, *Short-Term Compensation Contacts and Executive Expenditure Decisions: The Case of Commercial Banks*, 22 J. FIN. & QUANTITATIVE ANALYSIS 33, 47-49 (1987) (finding that adoption of annual bonus plan based on annual net income is correlated with "modest" decreases in discretionary expenditures).

when the manager may have moved to another job. Reportedly, one-third to one-half of all United States managerial office workers change their job every year. In contrast, the average annual turnover rate in Western Europe is 12 percent and in Japan, 6 percent.[42]

Studies have shown that the adoption of compensation plans which provide deferred compensation for the accomplishment of long-term (3 to 6 years) objectives result in substantial increases in capital investment.[43] Moreover, evidence exists that stockholders *want* management to focus on the long-term. For example, stock prices react positively to announcements by corporations of the implementation of long-term managerial compensation plans.[44] The stock market also reacts strongly to tangible evidence of long range planning by management.[45] Indeed, a study that examined the effect of announcements of increased research and development expenditures found that the stock market, on average, responded favorably to the announcement, even when the earnings of the corporations making the announcements were declining.[46]

Despite the evidence that stockholders want management to focus on the long-term, chief executive officers employ short-term financial ratios to measure the accomplishments of lower level management because it increases the chief executives' job mobility.[47] It has been reported that managers of foreign competitors

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42 Reich, *supra* note 36, at 163. *See also* ROBERT E. HALL, THE IMPORTANCE OF LIFETIME JOBS IN THE U.S. ECONOMY (National Bureau of Economic Research Working Paper No. 560, 1980).

43 Elizabeth Jenkins & Robert E. Seiler, *The Impact of Executive Compensation Schemes Upon the Level of Discretionary Expenditures and Growth In Stockholder Wealth*, 17 J. BUS. FIN. & ACCT. 585, 588-89 (1990); David F. Larcker, *The Association Between Performance Plan Adoption and Corporate Capital Investment*, 5 J. ACCT. & ECON. 3 (1983).

44 James A. Brickley et al., *The Impact of Long Range Managerial Plans On Shareholder Wealth*, 7 J. ACCT. & ECON. 115, 116, 123-27 (1985). Stock prices also appear to react positively to the adoption of short-term compensation plans. *See, e.g.*, Hassan Tehranian & James F. Waegelein, *Market Reaction to Short-Term Executive Compensation Plan Adoption*, 7 J. ACCT. & ECON. 131, 141 (1985) [hereinafter *Market Reaction*]; Hassan Tehranian & James F. Waegelein, *Short-Term Bonus Plan Adoption and Stock Market Performance—Proxy and Industry Effects: A Note*, 21 FIN. REV. 345, 352 (1986). The positive reaction does not mean that the market prefers short-term compensation plans to long-term plans, but rather suggests that the market reacts favorably to any plan that will more closely align management with stockholders. *See Market Reaction*, *supra*, at 141.

45 Su Han Chan et al., *Corporate Research and Development Expenditures And Share Value*, 26 J. FIN. ECON. 255, 274-75 (1990); John J. McConnell & Chris J. Muscarella, *Corporate Capital Expenditure Decisions And The Market Of The Firm*, 14 J. FIN. ECON. 399 (1985).

46 Chan et al., *supra* note 45.

47 Rappaport, *supra* note 10, at 99-100; Repetti, *supra* note 41, at 95.

are amazed by the rate at which management changes jobs in the United States.[48] The use of financial ratios helps to decrease management's employment risk by making their skills appear more versatile. Because the methodology of focusing on financial ratios is not industry specific, chief executive officers can quickly move from corporation to corporation or industry to industry.[49] This increased job mobility contributes to the reluctance of chief executive officers to encourage middle management to focus on the long-term because mobility of the chief executives in the short-term will be increased by short-term profits.[50]

C. *Inefficient Retention of Earnings*

The separation of ownership from control also causes firms to retain earnings excessively and utilize those earnings inefficiently. Public corporations that are controlled by management because stock ownership of the corporations is widely disbursed retain a higher percentage of earnings than firms for which control is not separated from ownership.[51] There are several explanations for this phenomenon. First, the retention of earnings as opposed to their distribution enables management to finance diversification of the firm's lines of business. Management favors diversification in order to reduce the likelihood of their jobs being terminated in the event one line of business becomes unprofitable.[52] Moreover, the retention of earnings benefits management because increases in the size of the firm are statistically correlated with increases in management compensation.[53] Managers prefer to retain earnings rather than resort to outside capital to finance diversification and growth in order to avoid subjecting themselves to the discipline (perhaps in the form of a high cost of capital) of the capital markets.[54]

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48 HAYES & WHEELWRIGHT, *supra* note 37, at 10; Ryohei Suzuki, *Worldwide Expansion of U.S. Exports — A Japanese View*, SLOAN MGMT. REV., Spring 1979, at 67-70.

49 Hayes & Abernathy, *supra* note 35, at 74.

50 Repetti, *supra* note 41, at 95. *See generally* REICH, *supra* note 36, at 165.

51 Williamson, *supra* note 24, at 1047-51.

52 DONALDSON & LORSCH, *supra* note 29, at 8; Amihud & Lev, *supra* note 26, at 605-06; Coffee, *supra* note 25, at 83; Shleifer & Vishny, *supra* note 5, at 125; Note, *supra* note 29, at 1243.

53 Marris, *supra* note 23, at 187; McGuire et al., *supra* note 23, at 753; Murphy, *supra* note 23, at 11-12.

54 Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 655 (1984); Jensen, *supra* note 38, at 323; Michael S. Rozeff, *Growth, Beta and Agency Costs as Determinants of Dividend Payout Ratios*, 5 J. FIN. RES. 249, 250-51 (1982).

As discussed earlier, several studies have shown that the diversification of a firm's business has a negative effect on corporate profits,[55] stock value,[56] and factory productivity.[57] Another study has focused on the financial return that a firm earns in investing its retained earnings without regard to the nature of the investment.[58] The study found that the rate of return realized by public corporations on the investment of retained earnings ranged from only 3.0 to 4.6 percent, while the return on the investment of borrowed funds ranged from 4.2 to 14 percent and on newly issued stock from 14.5 to 20.8 percent.[59] The authors of the study subsequently reformulated their analysis in response to criticisms of their methodology[60] and found that the return on retained earnings for firms that issue new equity compared favorably with the returns on debt and equity, but that firms which issued insignificant amounts of new equity had a rate of return of zero on the retained earnings.[61] This indicates that firms which are not disciplined by the process of regularly seeking funds from the capital market are inefficiently investing retained earnings.

III. WHY STOCKHOLDERS ABDICATE CONTROL TO MANAGEMENT

The ability of management to pursue its own objectives results from stockholder abdication. Stockholder abdication in turn arises from the confluence of a number of factors related to corporate governance.

Under the existing form of corporate governance, stockholders elect directors, who are charged with the duty of managing the corporation. However, the notion that stockholders "elect" direc-

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55 RAVENSCRAFT & SCHERER, *supra* note 31, at 111.

56 Morck et al., *supra* note 32, at 45-47. In this regard, one study has found that the more stock of the buyer held by management (thereby decreasing the separation of ownership from control), the more likely that the acquisition will increase the value of the buyer. Lewellen et al., *supra* note 32, at 209.

57 LICHTENBURG, *supra* note 33, at 28-29.

58 William J. Baumol et al., *Earnings Retention, New Capital and the Growth of the Firm,* 52 REV. ECON. & STATS. 345 (1970).

59 *Id.* 353.

60 *See, e.g.*, Irwin Friend & Frank Husic, *Efficiency of Corporate Investment,* 55 REV. ECON. & STATS. 122-27 (1973); G. Whittington, *The Profitability of Retained Earnings,* 54 REV. ECON. & STATS. 152-60 (1972); .

61 William J. Baumol et al., *Efficiency of Corporate Investments: Reply,* 55 REV. ECON. & STATS. 128-31 (1973); *See* Merritt B. Fox, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY 233-37 (1987) (reviewing the literature).

tors is somewhat misleading for public corporations because the candidates for directorships are nominated by the current directors.[62] The current directors are not required to include other nominees on the company's proxy statement.[63] Thus, stockholders wishing to propose alternate candidates can do so only at the considerable expense of preparing their own proxy statements.[64]

The candidates proposed by incumbent directors are generally comprised of the company's chief executives, the so-called inside directors, and individuals who have no affiliation with the company, normally referred to as outside directors. Although one of the roles of outside directors is to provide a perspective more consonant with the view of stockholders than that of the inside directors, the outside directors normally possess no great loyalty to the stockholders who "elect" them. Sixty-three percent of all the outside directors on the boards of America's 1,000 companies are chief executives of other firms.[65] Thus, the sentiments and objectives of the outside directors are likely to be more closely aligned with the company's management than its stockholders.[66]

Supporting the natural proclivity of directors to defer to management is the tendency of stockholders to refrain from pressing their views on management. This state of stockholder abdication has been formalized into the "Wall Street Rule," which states that a stockholder who is displeased with management should sell rather than try to persuade management to alter its activities.[67] The cost associated with influencing management has promoted this rule.[68] For example, consider a stockholder who owns one percent of the stock of a corporation and who opposes a transaction

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62 *See* Barnard, *supra* note 3, at 38-39; Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325, 331 (1987).

63 17 C.F.R. § 240 14a - 8 (c)(8) (1991).

64 *See* Barnard, *supra* note 3; Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REF. 19, 35, 96. *See also* Buxbaum, *supra* note 2, at 1682 (discussing inadequacies in federal and state law with respect to stockholder nomination of directors); Ralph C. Ferrara, *Current Issues Between Corporations and Shareholders: Federal Intervention into Corporate Governance*, 36 BUS. LAW. 759, 762 (1981).

65 LORSCH & MACIVER, *supra* note 17, at 18.

66 Indeed, even those directors who are not officers of the company or other companies may be naturally predisposed to defer to management because they lack management's expertise. *See* Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986) *rev'd on other grounds*, 107 S.Ct. 1637; Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 609-16 (1982).

67 LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET 91 (1988).

68 *Id. See also* MICHAEL T. JACOBS, SHORT-TERM AMERICA 43 (1991).

proposed by management. If the stockholder feels that the transaction will reduce the value of the firm by $1 million, the stockholder might invest up to $10,000 to fight management's proposal assuming a 100 percent probability of success. There are, however, no guarantees of success in the forum available under corporate law for stockholders to express disagreement with management without selling their stock—a proxy battle—and, therefore, the stockholder will have to discount the expected value of success. Suppose, for example, that there is only a 40 percent chance of success. The expected value to the stockholder of winning the proxy contest would then be only $4,000 (40% x $10,000) and the stockholder would be willing to pay only $4,000 to combat management.

Indeed, a 40 percent chance of success is overly generous. In an examination of 96 proxy battles occurring during 1962 to 1977, a study found that dissidents won only 20 percent of the time.[69] One of the reasons that dissident stockholders have such a low success rate in proxy battles is that the governance of corporations is extremely cumbersome. Most corporate transactions do not require approval by stockholders.[70] Moreover in most public corporations, the stockholders do not have the power to adopt a resolution which simply orders management to follow or refrain from following a particular course of action.[71] The directors are given the power to manage the corporation on behalf of the stockholders, and it is the directors who in theory direct the activities of management. Consequently, the only option for a dissident stockholder is to elect a new group of directors who disagree with management.

This task is difficult because in publicly held corporations, most stockholders do not attend stockholder meetings. Instead, they sign proxies which permit the person designated in the proxy to vote their shares.[72] Thus, the dissident stockholders will have to collect more proxies than the incumbent directors in order to

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69 Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401, 434 (1983).

70 The reason for this was eloquently set forth by Professor Buxbaum:

> A large organization, whatever its mission, cannot achieve its goals by constituting its members into an ongoing committee of the whole. Even participatory democracies, worker-owned enterprises, on cultural revolutions except the distinction between mass and cadre, wherever they may at times draw the line between the two.

Buxbaum, *supra* note 2, at 1671.

71 CLARK, *supra* note 2, at 94.

72 *Id.* at 360.

elect new directors. This can be very expensive. If management dominates the current board of directors (which is likely to be the case since the directors are allowing management to effect the transaction), then management in effect controls proxy voting because corporate law generally permits the board of directors to use corporate funds to solicit proxies.[73] The dissident stockholders will have to possess financial resources sufficient to match the corporation's resources. Consequently, the expense of attempting to replace the board with new directors less sympathetic to management is likely to be much higher than a stockholder would be willing to incur.[74]

Obviously, it might behoove the stockholders to act collectively in sharing the expense of the proxy battle. However, the economics of the situation are again tilted against stockholder action because a classic "free-rider" problem exists. A stockholder sympathetic to a dissident stockholder's cause is not required to contribute to the expenses of the proxy battle. Indeed, a rational stockholder may decide not to finance the battle because, regardless of the result, the abstaining stockholder is better off than the participating stockholders. If the stockholders who participate in financing the proxy fight win, the abstaining stockholder benefits without having incurred any cost. On the other hand, if the dissenting stockholders lose, the abstaining stockholder is financially better off than the dissenters because the dissenters have incurred out of pocket the proxy battle expense, while the abstainer has not.[75]

The expense and uncertainty of proxy battles cause stockholders to view stock as essentially a commodity[76] representing an inchoate claim to a portion of the net cash flow of the corporation.[77] Many stockholders do not view stock ownership as pro-

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73 Dent, *supra* note 2, at 903.

74 The stockholder will be reimbursed only if (1) the reimbursement is ratified by a majority of stockholders; (2) the contest is for corporate policy rather than corporate control; and (3) the expense were reasonable both in nature and amount. CLARK, *supra* note 2, at 395.

75 *See* MICHAEL BACHARACH, ECONOMICS AND THE THEORY OF GAMES 61-64 (1977); CLARK, *supra* note 2, at 392-93. It has been noted that the "situation is like the prisoner's dilemma of game theory and may call for solutions similar in strategy to those that would solve that dilemma." *Id.* at 393 (footnote omitted).

76 JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY 147-64 (1936); LOWENSTEIN, *supra* note 67, at 45; Repetti, *supra* note 41, at 96; *see also* JACOBS, *supra* note 68, at 31.

77 Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management*

viding any meaningful opportunity to exert significant influence on management and, as a result, are unwilling to incur any expenses in monitoring, let alone influencing, management.[78] Although stockholder abdication, as formalized in the Wall Street Rule, may represent rational behavior for individual stockholders, its collective effect is harmful. Management has been able to divert resources away from productivity because of the lack of stockholder vigilance.

Recently, institutional investors, such as pension funds, have shown more concern with management behavior. Institutional investors have started to demand more outside directors,[79] stockholder review of poison pill defenses and golden parachute contracts,[80] and the implementation of secret ballots.[81] In 1988, institutional investors owned 47 percent of the equity of the 1000 largest corporations in the United States, as measured by stock value.[82] However, while the number of resolutions relating to corporate governance that were sponsored by institutional investors and shareholders groups doubled from 1989 to 1991,[83] the total number of such resolutions is still small—153 for the 1991 proxy season.[84] Moreover, the number of victories is smaller still. In 1990, only 13 resolutions sponsored by institutions or shareholder groups were approved.[85]

The paucity of proposals and even fewer victories suggest that the increased activity of institutional investors may not resolve the

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in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1171 (1983); Fama & Jensen, *supra* note 6, at 302-03.

78 LOWENSTEIN, *supra* note 68, at 95-96.

79 Timothy D. Schellhardt, *More Directors Are Recruited From Outside*, WALL ST. J., Mar. 20, 1991, at B1.

80 James A. White, *Shareholder-Rights Movement Sways a Number of Big Companies*, WALL ST. J., Apr. 4, 1991, at C1.

81 *Id.*

82 *Institutional Investors and Corporate America: Conflicts and Resolutions: Hearings Before the Subcomm. on Securities of the Sen. Comm. Banking, Housing and Urban Affairs*, 101st Cong., 1st Sess. 15 (1989) (statement of Carolyn K. Brancato). Others have suggested that institutional ownership of America's 1000 largest companies may approximate 66%. Peter Drucker, *Management and the World's Work*, HARV. BUS. REV. 65, Sept.-Oct. 1988, at 71. For a discussion of the various estimates of the percentage of stock held by institutions, see LORSCH & MACIVER, *supra* note 17, at 3 n.8; A.A. Sommer, Jr., *Corporate Governance In the Nineties: Managers vs. Institutions*, 59 U. CIN. L. REV. 357, 361-62 (1990).

83 *American Investors Getting Uppity*, THE ECONOMIST, March 16, 1991, at 76, 80.

84 White, *supra* note 80, at C16. White reports that more than one-half of the 153 proposals were introduced by members of United Shareholders, which was founded by T. Boone Pickens, Jr. in 1986. *Id.*

85 *American Investors Getting Uppity*, *supra* note 83, at 80.

separation of ownership from control problems. Institutional investors confront the same economic problems discussed above with respect to engaging in a proxy battle.[86] Very few institutions singly own controlling interests in public corporations. Indeed, most institutions are prohibited by law from owning controlling interests in corporations.[87] National banks and state chartered banks that are members of the Federal Reserve System are prohibited from owning stock, except as trustees.[88] In addition bank holding companies cannot own more than 5 percent of the voting stock of a nonbank company.[89] Mutual funds cannot refer to themselves as "diversified" if they own more than 10 percent of the stock of any company.[90] Mutual funds are also restricted by tax provisions which limit the extent to which they can hold significant amounts of stock in other corporations.[91] Insurance companies are usually limited by state law as to the size of their investments in other companies.[92] Lastly, pension funds, while not subject to explicit restrictions, may feel compelled by the prudent person rule to avoid owning a large percentage of stock in a single company that may be rendered illiquid by section 10(b) or 16(b) considerations.[93]

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86 *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 464, 469 (1991).

87 For insightful discussions of legal restrictions on institutions owning stocks or exercising control in corporations, see Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 530-62 (1990); Rock, *supra* note 86, at 476-78; Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

88 California Bank v. Kennedy, 167 U.S. 362, 366-67 (1897); National Bank Act of Feb. 25, 1863, § 11, 12 U.S.C. § 24 (1988); Banking Act of 1933, § 5(c), 12 U.S.C. § 335 (1988); *see* Roe, *supra* note 87, at 17.

89 Bank Holding Company Act of 1956, § 4(c)(4)-(5), 12 U.S.C. § 1843(c)(6) (1988); *see* Roe, *supra* note 87, at 18.

90 Investment Company Act of 1940, § 5(b), 15 U.S.C. § 80a-5(b) (1988); *see* Roe, *supra* note 87, at 19.

91 I.R.C. § 851(b)(4) states that a mutual fund will not be taxed as a flow-through entity unless:

(4) at the close of each quarter of the taxable year—

(A) at least 50 percent of the value of its total assets is represented by

. . .

(ii) . . . securities limited . . . in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, and

(B) not more than 25 percent of the value of its total assets is invested in the securities . . . of any one issuer . . . .

I.R.C. § 851(b)(4) (West Supp. 1992).

92 Roe, *supra* note 87, at 22-23.

93 *Id.* at 26-27; Black, *supra* note 87, at 545-48. Indeed, if an investor is deemed to

Given that most institutional investors are forbidden or discouraged from owning controlling interests in corporations, the same free-rider problems discussed above apply. Institutions cannot be viewed as a single actor in the securities market. Rather, each will seek to achieve the objectives of its own owners[94] (or, more likely, of its management).[95] Why should one institution incur the expense of a proxy battle when all others will benefit without having incurred the expense?

It might be argued that because there are fewer institutional investors than individual investors it is easier for the institutional investors to organize. Consequently, it could be asserted that institutional activism will cure stockholder abdication. But, legal impediments exist to concerted action.[96] A group of investors that owns 5 percent or more of a corporation is required to file Form 13D with the Securities and Exchange Commission. Form 13D identifies the members of the group, their plan of action, and their sources of financing.[97] Institutions may naturally prefer to avoid making these disclosures. Moreover, the mere act of contacting fellow institutional stockholders with the intent of influencing management may be a proxy solicitation which would itself necessitate the use of Schedule 14A.[98] Thus, the expense of preparing Schedule 14A would have to be incurred prior to determining

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"control" a corporation, it can only safely sell securities by filing a registration statement or pursuant to the safe harbor of Rule 144 or Rule 144A. Securities Act of 1933, §§ 2(11), 4(1), 15 U.S.C. §§ 77b(11), 77d(1) (1988); Rule 144(e)(1), 17 C.F.R. § 230.144(e)(1) (1991); Rule 144A(b), *id.* § 230.144A(b). Moreover, a person who "controls" a corporation can be held liable for the company's securities laws violations. Securities Act § 15, 15 U.S.C. § 77o (1988); Securities and Exchange Act of 1934, § 20(a), 15 U.S.C. § 78t (1988). The term "control" is defined as the "power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities . . . or otherwise." Rule 405, 17 C.F.R. § 230.405 (1991); Rule 12b-2, *id.* § 240.12b-2; *see* Black, *supra* note 87, at 548; Conard, *supra* note 13, at 162.

94 Sommer, *supra* note 82, at 362; *see infra* note 180.

95 Rock, *supra* note 86, at 469-76.

96 Roe, *supra* note 87, at 26; *see also* JACOBS, *supra* note 68, at 47-50 (arguing that administrative positions adopted by the FTC have discouraged institutional activism).

97 Rule 13d-1, 17 C.F.R. § 240.13d-1 (1991); Rule 13d-5(b)(1), *id.* § 240.13d-5(b)(1); *see* Conard, *supra* note 13, at 162; Roe, *supra* note 87, at 26.

98 *See* Studebaker Corp. v. Gittlin, 360 F.2d 692 (2d Cir. 1966); *see also* Roe, *supra* note 87, at 26. The SEC has recently proposed amendments to stockholders to communicate with others stockholders about pending proxy solicitations without filing proxy statements so long as the communicating stockholder does not have a material economic interest in the outcome of the proxy solicitations, does not seek a proxy and requests an authorization or consent. Proposed Rule 14a - 2[b][1], 56 Fed. Reg. 28,998 (to be codified at 17 C.F.R. pt. 240) (proposed June 25, 1991).

whether fellow institutional investors are even interested in the initiative.

The legal impediments against institutional control of corporations and the legal bias against joint action by institutions is not merely the result of random and haphazard statutory enactments. Rather, Professor Roe has suggested that it represents the political bias in the United States against the concentration of power in financial institutions.[99] The bias against concentrated power is in sharp contrast to the concentration which exists in Japan and Germany.[100] In Germany, for example, where the law facilitates the transfer of voting rights by stockholders to banks which manage their portfolios, three banks hold the voting rights for approximately 43 percent of all portfolios.[101] Japan also has ownership highly concentrated in financial institutions. A study that examined 135 Japanese corporations found that 28 percent of the stock of those corporations was held by stockholders owning 5 percent or more of the corporation.[102] In contrast, the study found that only 7.5 percent of the stock of large, United States corporations is owned by stockholders owning 5 percent or more of a company's stock.[103] Moreover, stockholder monitoring of management is further strengthened in Japan by virtue of the "Keiretsu," a voluntary association of corporations and banks that engage in business relationships with one another and that own stock in one another.[104]

While the fragmentation of the power of financial institutions may be appropriate for a democratic society, it has inflicted a cost on the efficiency of corporations. Fragmentation leads to less effective stockholder control of management in the United States

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99 Roe, *supra* note 87, at 31-45.

100 *Id.* at 59-60.

101 Hermann H. Kallfass, *The American Corporation and the Institutional Investor: Are There Lessons From Abroad?*, 1988 COLUM. BUS. L. REV. 775, 782-83 (1988); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 220 (1991); Roe, *supra* note 87, at 60.

102 WILLIAM G. OUCHI, THE M-FORM SOCIETY 74 (1984); Roe, *supra* note 87, at 59-60.

103 OUCHI, *supra* note 102, at 74.

104 JOHN SCOTT, CAPITALIST PROPERTY AND FINANCIAL POWER 164-83 (1986); Lipton & Rosenblum, *supra* note 101, at 219; J. Mark Ramseyer, *Takeovers in Japan: Opportunism, Ideology and Corporate Control*, 35 UCLA L. REV. 1, 49-50 (1987); Aron Viner, *Mergers, Acquisitions and Corporate Governance in Japan*, *in* INTERNATIONAL CORPORATE GOVERNANCE 27 (Joseph C. F. Lufkin & David Gallagher eds., 1990); *see also* JACOBS, *supra* note 68, at 67-68 (discussing role that Japan's Ministry of International Trade and Industry and the Ministry of Finance play in monitoring management).

than in Germany or Japan. This has probably contributed to manufacturing productivity growing at an average of only 3.0 percent per year during the period 1960 through 1990 in the United States, while averaging 4.1 percent in West Germany and 7.6 percent in Japan.[105]

IV. HOLDING PERIOD REQUIREMENTS AND USING THE TAX SYSTEM TO INFLUENCE STOCKHOLDER BEHAVIOR—THE LONG-TERM CAPITAL GAINS PREFERENCE

Tax policymakers have dealt haphazardly with the negative effects of the abdication of responsibility by stockholders. As discussed below, Congress has sought to encourage greater stockholder responsibility through the holding period requirements. Moreover, as discussed in Part V, Congress has attempted to relate more closely the objectives of management with those of stockholders by encouraging management stock ownership through incentive stock option plans. Also as explained in Part V, Congress has tried to prevent management from shielding itself against the take-over market by enacting golden parachute and greenmail rules.

A. *Introduction to Issues Pertaining to the Long-Term Capital Gains Preference*

The average daily volume of stock sold on the New York Stock Exchange increased from 46.9 million shares in 1981 to 156.8 million in 1990.[106] Institutional investors account for approximately fifty percent of the trading on the stock exchange.[107] Some have suggested that the increased turnover of stocks reflects the tendency of investors to focus only on the short-term.[108] They argue that the short-term focus of investors is harmful for the United States economy because it forces management to focus on short-term profits while sacrificing the long-term competitiveness of their business. This failure to focus on the long-term has taken the form of decreased funding for research

105 FACTORS AFFECTING COMPETITIVENESS, *supra* note 35, at 19.

106 NEW YORK STOCK EXCHANGE, 1990 NYSE FACT BOOK 78 (1991).

107 *Id.* at 15.

108 Statement of Dennis E. Ross before the Sen. Fin. Comm., *reprinted in* BNA Daily Tax Report, March 15, 1989, at L-4; Statement of Sen. Nancy L. Kassebaum on Senate Floor (Sept., 21, 1989) (Tax Notes Doc. 90-2019); LOWENSTEIN, *supra* note 67, at 42-43.

and development and has contributed to a decline in domestic productivity.[109] Thus, it has been suggested that tax incentives should be used to encourage a longer holding period. Specifically, proponents of these measurements have suggested reenacting a significant preferential tax treatment of long-term capital gains[110] or imposing a tax on the short-term gains of tax-exempt organizations such as pension funds and university endowments.

However, the discussion of holding periods as a mechanism to encourage stockholders to adopt a long-term perspective so that management can concentrate on the long-term, has not focused sufficiently on three problems. First, a preference for long-term capital gains is not needed to motivate stockholders to adopt a long-term perspective. As discussed below, stockholders already have a strong economic incentive to want management to maximize long-term profits regardless of how long stockholders plan to hold their investments. Second, the discussion has largely failed to note that a capital gains preference will, at least conceptually, encourage the inefficient retention by corporations of their profits and exacerbate stockholder abdication. Third, even assuming that stockholders need encouragement to permit management to adopt a long-term perspective, holding period requirements only encourage investors to hold stock for the requisite holding period and that period may at best correspond only randomly with the period needed by management to implement long-term plans. This random correlation is not costless because holding period requirements impose efficiency costs on the securities market.

B. Short-Term Investors Should Not Want Management to Maximize Short-Term Profits at the Expense of Long-Term Profits

An analysis of the economic forces shaping the expectations that investors will have for management behavior has to distinguish between investors who invest for their own account and institutional investors who invest on behalf of someone else.

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109 Statement of Dennis E. Ross, *supra* note 108. For an excellent discussion of this view, see Ellin Rosenthal, *Pension Investment Taxes: Will A Sacred Cow Beef Up U.S. Competitiveness?*, 46 TAX NOTES 1364 (1990).

110 Currently, capital gains of individuals for capital assets held more than one year are taxed at a slightly preferential rate of 28%. I.R.C. § 1(h) (West Supp. 1992). The maximum nominal rate for ordinary income of individuals is 31%. *Id.* § 1(a).

1. Investors Investing for Their Own Account

Rational investors who trade stock for their own account in seeking short-term gains should not want management to maximize short-term profits at the expense of long-term profits because management's failure to maximize long-term profits should impair the ability of the short-term investors to sell at a gain.[111]

Standard financial theory holds that the price of a security is determined by the market based upon the present value of all expected cash flows that the security will generate.[112] The expected future cash flow will arise from two sources: (1) assets in place, and (2) assets in which the firm invests for the future.[113] Obviously, if a buyer expects that future cash flows will be large, the buyer will be more likely to value the security at a higher price. If, on the other hand, the buyer thinks the current cash flow has been created at the expense of future cash flows, the buyer will adjust the valuation downward. Consequently, a trader who purchases stock on one day for resale the next day will still want management maximize long-term profits (or at least create the appearance of maximizing long-term profits) so that the price the trader receives on resale will reflect the maximum possible valuation.

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111 Donald W. Kiefer, *The Security Transactions Tax: An Overview of the Issues*, 48 TAX NOTES 885, 893-94 (1990); Repetti, *supra* note 41, at 89.

112 *See, e.g.*, RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 49-52 (3d ed. 1988); THOMAS E. COPELAND & J. FRED WESTON, FINANCIAL THEORY AND CORPORATE POLICY 544-64 (3d ed. 1988).

It is important to note that the stock market is not always an accurate calculator of stock values. Several commentators have observed that stock prices occasionally vary from the discounted present value of expected cash flows. *See, e.g.*, Robert J. Shiller, *Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?* AM. ECON. REV., May 1981, at 421-36; Kenneth D. West, *Dividend Innovations And Stock Price Volatility*, 56 ECONOMETRICA 37 (1988). Moreover, it should be noted that there are several theories about the manner in which taxation of the cash flow at the stockholder level affects stock valuation. *See, e.g.*, James M. Poterba & Lawrence H. Summers, *The Economic Effects of Dividend Taxation*, *in* RECENT ADVANCES IN CORPORATE FINANCE 227, 232-44 (Edward I. Altman & Marti G. Subrahmanyam eds., 1985) (summarizing various theories about the impact of the taxation of dividends). Further uncertainty about valuation is introduced because of questions about the impact of macroeconomic factors such as interest rate on the appropriate discount rate for calculating the present value of future distributions. *See, e.g.*, Nozar Hashemzadeh & Philip Taylor, *Stock Prices, Money Supply, and Interest Rates: The Question of Causality*, 20 APPLIED ECON. 1603 (1988).

113 McConnell & Muscarella, *supra* note 45, at 400; Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. BUS. 411 (1961).

For example, suppose a trader has purchased a share of stock in X Corp. which represents a claim of $100 per year of X Corp.'s net cash flow for the next five years. It is anticipated that at the end of five years, X Corp.'s cash flow will be zero because its product will become obsolete (X Corp. does not engage in any research and development) and X Corp.'s assets will be worthless at that time. Trader will pay $379.08 for the share of stock, assuming an appropriate discount rate of 10 percent. Assuming that the risk associated with X Corp. does not change and that there are no changes in macroeconomic factors, such as inflation or real interest rates, so that the discount rate does not change, a trader will never be able to sell its share for more than the price it paid of $379.08 because there is no rational expectation of increased cash flow in the future.

Contrast the foregoing situation with one in which X Corp. has engaged in research and development for new products. The stock in X Corp. would be valued based on the correspondingly reduced cash flow from the current product plus the expected cash flow from new products to be developed. If the market's expectations about the results of research and development view the new product development more positively after the trader has bought X Corp. stock, the trader would make a profit. Of course, the opposite is also true; if the market's expectations about the fruits of the research and development turn negative after the trader has purchased the security, the trader would have to sell the security for less than he or she paid for it. However, if management is focused on maximizing long-term profits and selecting the most promising products for future development, presumably the probability of success will be somewhat higher than failure. Consequently, even short-term traders should want management to focus on the long-term.

It is interesting to note that studies have confirmed that the stock market reacts strongly to tangible evidence of long range planning by management.[114] In an analysis of 547 announcements of increases in capital expenditures by 285 corporations pertaining to plant, equipment, and research and development, one study found statistically significant evidence that the stock market reacted positively to the announcement.[115] Another

114 McConnell & Muscarella, *supra* note 45, at 419-21.

115 *Id.* at 405-21.

study found that the stock prices of corporations which announced increases in research and development expenditures increased on the average even where some of the corporations had declining profits.[116] Similarly, the market reacts favorably to indications that management is being motivated to adopt the long-term perspective. A study found a statistically significant correlation between increases in stock prices and announcements by corporations that they were implementing long-term compensation plans which would motivate management to focus on the long-term.[117]

2. Rational Investors Who Do Not Invest For Their Own Account—Institutions—Should Also Want Management to Maximize Long-Term Profits

A large class of investors do not invest for their own account. Rather, these investors—institutions such as pension funds, mutual funds and insurance companies—are managed by professional managers who make decisions about the investment of money which belongs to someone else. Most of the increase in trading in the past fifteen years is the result of increased portfolio turnover by institutional investment managers.[118]

The propensity of institutional managers to churn their portfolios is difficult to explain. A recent study examining the returns on investment of 278 domestic stock funds over the past ten years found that the 25 percent of the funds with the lowest turnover performed significantly better than the average return for all funds and performed slightly better than the 25 percent of the funds with the highest turnover.[119] The study also found, however, that the 25 percent of the funds which traded the most outperformed the average for all funds.[120] The study suggests that although buying and holding is the best strategy, it is only slightly more profitable than a strategy of aggressive trading.[121]

116 Chan et al., *supra* note 45.

117 Brickley et al., *supra* note 44, at 123-26.

118 Donald W. Kiefer, *Lock-In Effect Within A Simple Model of Corporate Stock Trading*, 43 NAT'L TAX J. 75, 79 (1990).

119 *See* Jonathan Clements, *Mutual Funds With Low Turnover Find Penny Saved Is Penny Earned*, WALL ST. J., May 17, 1990, at C1 (reporting on study performed by Morningstar, Inc.).

120 *Id.*

121 *Id.*

One potential explanation for the propensity of investment managers to churn their portfolios excessively is that such activity achieves their personal objectives. For example, it has been suggested that managers trade even when the information they have does not justify such trading in order to create the appearance for their customers that they have nonpublic information about certain securities.[122] In addition, studies have shown that pension fund managers are more aggressive in investment strategies than employees investing their own money.[123] Also, because compensation schemes for institutional investors are frequently tied to annual investment return, rather than long-term investment performance, it is possible that investment managers trade in an attempt to maximize the annual return by capturing appreciation in their portfolio selections.[124]

Regardless of their personal motives for aggressive trading, however, the institutional investment manager should still want corporate management to maximize, or at least appear to maximize, long-term profits. This is because the price at which the institution can sell the securities will depend upon the long-term prospects of the corporate issuer.

It has been suggested that the short-term perspective of institutional stockholders may compel management to focus on the short-term.[125] Messrs. Lipton and Rosenblum have argued that the short-term perspective of investors causes management to select projects with quick payouts instead of long-term payouts because the market is more likely to misvalue the long-term project

122 Brett Trueman, *A Theory of Noise Trading In Securities Markets,* 43 J. FIN. 83, 83-84, 88 (1988).

123 Fred Williams, *Workers Cautious With Investments,* PENSIONS & INVESTMENT AGE, Apr. 15, 1985, at 35, 52-53; *see also* Franco Modigliani & Gerald A. Pogue, *Alternative Investment Performance Fee Arrangements and Implications for SEC Regulatory Policy,* 6 BELL J. ECON. 127, 140 (1975).

124 DERTOUZOS ET AL., *supra* note 41, at 62. Defined benefit plans may also impose pressure on investment managers to capture gain and "beat" the market because defined benefit plans promise to pay their beneficiaries a fixed amount regardless of the income of the plan. If the plan does not earn sufficient income, the employer has to make up the difference. Consequently, employers may pressure investment managers to make superior returns in order to avoid having to fund the defined benefit plan. This pressure may contribute to the investment managers' propensity to churn. *See* THUROW, *supra* note 37, at 156-57, 213.

125 Lipton & Rosenblum, *supra* note 101, at 208-09; *see also,* Andrei Shleifer & Robert W. Vishny, *The New Theory of the Firm—Equilibrium Short Horizons of Investors and Firms,* 80 AM. ECON. REV. 148 (Papers and Proc. of the 102d Annual Meeting of the Am. Econ. Ass'n 1990).

and thereby misvalue the corporation's stock.[126] Management fears misvaluation of its corporation's stock in the form of undervaluation because undervaluation can lead to a hostile takeover.[127] Messrs. Lipton and Rosenblum base their argument on a study that suggests the market is more likely to misprice the long-term project because arbitrage (the act of trading on the belief that the market price for an asset differs from its market value) is less expensive for short-term assets than long-term assets.[128] Since arbitrage is cheaper for short-term assets, more institutional arbitragers will focus on the short-term projects with the result that the market valuation of short-term projects will be more accurate than the market valuation of long-term projects.[129]

The problem with this argument is that it is based on informational asymmetry.[130] Arbitrage for long-term assets is more expensive primarily because the market does not receive enough information about long-term projects.[131] If stockholders were in a position to observe all management activities, any action that maximized short-term profits at the expense of greater long-term profits would lower stock prices.[132] Conversely, if information about long-term projects was made available to the market by management, stockholders and arbitragers would more readily ascertain the appropriate impact of the long-term project on stock prices. Management could correct the informational asymmetry about the long-term projects by simply disclosing the income projections for the long-term project.

A strong argument exists that management does not disclose the profitability of long-term projects because it prefers to focus on short-term projects.[133] As discussed earlier, there are several incentives for management to maximize short-term profits at the

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126 Lipton & Rosenblum, *supra* note 101, at 208-09.

127 Shleifer & Vishny, *supra* note 125, at 148.

128 *Id.*

129 *Id.* at 152.

130 *See* Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61, 62 (1988).

131 *See* Shleifer & Vishny, *supra* note 125, at 149-50.

132 Stein, *supra* note 130, at 62.

133 Further, management may not disclose the profitability of long-term profits because of the potential negative impact on the competitive posture of the company as the result of disclosing strategic plans. *See* Roger J. Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 MD. L. REV. 1197, 1212 (1987).

expense of long-term projects.[134] Moreover, as discussed previously, several studies show that the market eagerly awaits suggestions that management is maximizing long-term profits.[135] Consequently, a capital gains preference or imposition of a holding period requirement is unnecessary. Regardless of the time horizon for investors, investors should want management to maximize or appear to maximize long-term profits.

C. *A Long-Term Capital Gains Preference Encourages the Inefficient Retention of Earnings and Exacerbates Problems Arising from the Separation of Ownership from Control*

The previous Section has shown that holding periods are not needed to motivate stockholders to adopt a long-term perspective. This Section illustrates that rather than remedy problems in corporate productivity, a long-term capital gains preference may actually exacerbate problems. Conceptually, this would occur for two reasons. First, a long-term capital gains preference will provide a tax-related justification for management to retain corporate earnings even though it may inefficiently invest those retained earnings. Second, a long-term preference creates a tax bias for noncorporate stockholders to realize profits of the corporations in which they hold stock by selling their stock, rather than holding their stock and receiving dividends. This bias may increase the reluctance of stockholders to devote resources to monitoring management and, therefore, may exacerbate the separation of ownership from control. Exacerbating the separation of ownership from control would actually decrease, rather than increase, corporate productivity.

1. Impact of Capital Gains Preference on Retained Earnings

One phenomenon arising from the separation of ownership from control is management's propensity to retain earnings and utilize them inefficiently. Firms that are controlled by management retain a significantly higher percentage of earnings than firms for which ownership and control are not separated.[136] As discussed

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134 *See supra* text accompanying notes 35-42 and 49-50.

135 *See supra* text accompanying notes 44-47.

136 *See, e.g.*, BUSINESS BEHAVIOR, *supra* note 24, at 46-48; ECONOMIC THEORY, *supra* note 24, at 383-85; DONALDSON, *supra* note 24, at 22-23; MARRIS, *supra* note 24, at 64;

earlier, management may prefer to retain earnings rather than distribute them because distribution would force them to resort to the capital markets for cash and subject themselves to monitoring by those markets.[137] Moreover, the fact that increases in the size of the firm are statistically correlated with increases in management compensation provides an additional incentive to retain earnings.[138] Lastly, management may prefer retaining earnings to finance diversification in order to decrease the risk of losing their jobs in the event one line of business becomes unprofitable.[139]

Management's propensity to retain earnings is not costless. As discussed earlier, excessive retention of earnings can have a deleterious effect on productivity.[140] Reenacting a significant capital gains preference would provide a tax-related justification for management to retain earnings.[141] Management could assert that dividends should not be distributed since they are taxed at a higher rate than capital gains to noncorporate taxable stockholders.[142] Retaining earnings may permit stockholders to benefit from the reduced capital gain rate by simply selling the stock and receiving the value of the retained earnings at a reduced tax rate[143] or waiting for a liquidation distribution or redemption which qualifies for capital gain treatment. Indeed prior to the temporary repeal of the preference for long-term capital gains in the Tax Reform Act

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Amihud & Kamin, *supra* note 24, at 838-46; Williamson, *supra* note 24, at 1047, 1051.

137 Easterbrook, *supra* note 54, at 655; Jensen, *supra* note 38, at 323; Rozeff, *supra* note 54, at 250-251.

138 Marris, *supra* note 23, at 187; McGuire et al., *supra* note 23, at 753; Murphy, *supra* note 23, at 11-12.

139 DONALDSON & LORSCH, *supra* note 29, at 8; Amihud & Lev, *supra* note 26, at 605, 612-15; Coffee, *supra* note 25, at 83; Shleifer & Vishny, *supra* note 5, at 125; Note, *supra* note 29, at 1241-94.

140 *See supra* text accompanying notes 22-24.

141 *See* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT SUBCHAPTER C 349-51 (1982); CHARLES E. MCCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 22 (1979); Alan J. Auerbach, *Capital Gains Taxation and Tax Reform*, 42 NAT'L TAX J. 391, 397 (1989); Lee A. Sheppard, *Corporate Tax Integration, the Proper Way to Eliminate the Corporate Tax*, 27 TAX NOTES 637, 641 (1985).

142 Corporations are generally entitled to a dividends-received deduction of 70% of the amount of the dividend under I.R.C. § 243 (West Supp. 1992). Thus, corporate stockholders will generally prefer dividends to capital gains since capital gains recognized by corporations are currently taxed at the same rate as ordinary income. *Id.* § 1201(a). The reasons that corporate stockholders do not demand increased dividends are discussed *infra* at text accompanying notes 151-158.

143 This, of course, assumes that the price at which the stock could be sold reflects the discounted present value of the future distributions taxed at a preferential rate. *See infra* note 184 for a discussion of the literature pertaining to the tax rate the market actually applies to anticipated distributions in valuing securities.

of 1986,[144] economists had a difficult time understanding why corporations ever paid dividends.[145] Some have suggested that taxes were irrelevant to dividend policies because marginal investors who determine the price of securities were able to avoid paying taxes on dividends and capital gains through the utilization of pension funds and insurance contracts or because marginal investors were taxed at the same rate on dividends and capital gains.[146] Others have theorized that the different tax rate applied to dividends, versus distributions taxed as capital gains, has no impact on the decision to pay dividends because the decision to pay dividends is based solely upon whether the corporation has excess cash after financing its investment needs.[147] Still others have suggested that, despite the heavy tax bias against dividends, corporations pay dividends in response to stockholders' wishes to impose on management the discipline of resorting to the capital markets for additional financing[148] and because stockholders fear that management will squander the retained earnings.[149]

Certain "tax-favored" stockholders may also be partly responsible for corporations' payment of dividends. Corporations are entitled to receive dividends at a reduced tax rate because of the dividends-received deduction.[150] This treatment of dividends for

144 The Revenue Reconciliation Act of 1990 raised the maximum tax rate for individuals to 31%. I.R.C. § 1(a) (West Supp. 1992). Because I.R.C. § 1(h) provides that the maximum marginal rate on capital gains cannot exceed 28%, the Revenue Reconciliation Act in effect reintroduced a preference for long-term capital gains. *Id.* § 1(h).

145 For thoughtful discussions of various explanations, see Sasson Bar-Yosef & Richard Kolodny, *Dividend Policy and Capital Market Theory*, 58 REV. ECON. & STATS. 181 (1976); Poterba & Summers, *supra* note 112, at 232-44.

146 This is commonly referred to as the "tax irrelevance" view; *see, e.g.*, Merton H. Miller & Myron S. Scholes, *Dividends and Taxes*, 6 J. FIN. ECON. 333, 349-54 (1978); *see also* Poterba & Summers, *supra* note 112, at 235-44 (summarizing the theories).

147 This is frequently referred to as the "new" or "tax capitalization view." *See, e.g.*, Alan J. Auerbach, *Wealth Maximization and the Cost of Capital*, 93 Q. J. ECON. 433 (1979); David F. Bradford, *The Incidence and Allocation Effects of Tax on Corporate Distributions*, 15 J. PUB. ECON. 1 (1981); *see also* Poterba & Summers, *supra* note 112, at 237-40, 265 (summarizing the "new" view).

148 *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Hersh M. Shefrin & Meir Statman, *Explaining Investor Preference For Cash Dividends*, 13 J. FIN. ECON. 253, 255-58 (1984). Others have also suggested that the payment of dividends conveys additional information to stockholders about the prospects of the corporation. *See, e.g.*, Ramasastry Ambarish et al., *Efficient Signalling with Dividends and Investments*, 42 J. FIN. 321, 321-24 (1987).

149 Marshall E. Blume, *Stock Returns and Dividend Yields: Some More Evidence*, 62 REV. ECON. & STATS. 567 (1980); Jean Crockett & Irwin Friend, *Dividend Policy In Perspective: Can Theory Explain Behavior?*, 70 REV. ECON. & STATS. 603, 610-11 (1988).

150 I.R.C. § 243(a)(1) (West Supp. 1992) generally allows a corporation receiving a

corporate stockholders is in stark contrast to capital gains, which are taxed to corporate stockholders at the same rate as ordinary income.[151] Thus, corporate stockholders may be partly responsible for the level of dividend payment that does occur. Moreover, tax-exempt investors, such as qualified pension funds and university endowments, may also pressure management for dividends since the dividends will be entirely tax-free to them.

However, corporate and tax-exempt stockholders probably do not in practice exert significant pressure on corporations to pay dividends for two reasons. First, the transaction costs and "free rider" problems of stockholder activism discussed earlier[152] outweigh any benefits associated with dividend income. Tax-exempt investors can capture part of the benefit of earnings that are retained by the corporation (rather than paid out as dividends) by selling the stock of the corporation and thereby avoiding the transaction costs of forcing a dividend.[153] Similarly, although stockholders taxed as corporations benefit from the dividends-received deduction, the size of that benefit may not be significant because of the alternative minimum tax imposed on corporations. The dividends-received deduction is generally ignored in calculating the alternative minimum tax for corporations.[154] Second, management of corporate stockholders has little incentive to compel other corporations to pay dividends on common stock. To the extent corporations seek to benefit from the dividends-received deduction, they probably purchase preferred stock which has a higher probability of paying dividends than does common stock. Usually, preferred stock provisions re-

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dividend to deduct an amount equal to 70% of the dividend with the result that only 30% of the dividend is taxable income to the corporation. If the corporation receiving the dividend owns 20% or more of the stock of the corporation paying the dividend, the recipient corporation may deduct 80% of the dividend. *Id.* § 243(c)(1). If the corporation receiving the dividend and the corporation paying the dividend are members of an "affiliated" group, as defined in § 243(b)(2), the recipient corporation may deduct 100% of the dividend. *Id.* § 243(a)(3). The benefit of the dividends-received deduction is partially reduced by the fact that the dividends-received deduction is generally ignored in calculating the alternative minimum tax for corporations. *Id.* § 56(g)(4)(C).

151 *Id.* § 1201(a).

152 *See supra* text accompanying notes 75-78.

153 The tax-exempt investor can probably only capture part of the benefit of the retained earnings. Studies suggest that the price at which the stock may be sold is determined by taxable investors who discount the value of the retained earning to reflect the tax liability they will pay when they realize the benefit of the retained earnings. *See infra* note 183 for a discussion of the literature pertaining to the tax rate the market actually applies to anticipated distributions in valuing securities.

154 I.R.C. § 56(g)(4)(C) (West Supp. 1992).

quire that dividends be paid on the preferred stock before dividends may be paid on the common stock.[155] When a corporate stockholder holds sufficient dividend-paying preferred stock to meet immediate cash flow needs, management will use the corporation's investment in common stock for another purpose. If income from corporate operations has not met the annual profit objectives needed for additional management compensation, management can sell the common stock to generate additional income. This ability to time the recognition of income for purposes of calculating annual corporate profits (as well as taxable income) may account for the failure of corporate stockholders (or more pointedly, its management) to pressure corporations in which they hold common stock to pay dividends on the common.

The tax benefit to noncorporate stockholders, including noncorporate stockholders of mutual funds,[156] arising from the retention of earnings when a significant preference for long-term capital gains exists is illustrated by the following example. Assume that all corporate ordinary income and individual ordinary income is subject to the same tax rate of 30 percent, while capital gain income is subject to a lower tax rate of 20 percent. Assume further that a corporation has $100 of after-tax income. The corporation can either distribute this income currently as a dividend, or retain the income and invest it in a project which yields 7 percent after tax. Management would prefer to retain earnings to increase the size of the corporation through diversification, thereby increasing their compensation and reducing employment risk. If management retains the $100 of earnings and invests in a project which yields 10 percent of ordinary taxable income before tax (7 percent after tax), the corporation would have $140.25 at the end of five years. If that amount is then distributed in liquidation of the corporation or in a form otherwise qualifying for capital gain treatment under I.R.C. section 302,[157] the stockholders would have $112.20 after paying the capital gain tax.

155 *See, e.g.*, VICTOR BRUDNEY & MARVIN A. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 222-23 (3d ed. 1987).

156 Mutual funds which qualify as "regulated investment companies" are generally taxed as flow-through entities. I.R.C. §§ 851, 852 (West Supp. 1992). Thus, long-term capital gain income realized by the mutual fund which is distributed to the stockholders (or deemed to be distributed to the stockholders) is not taxable to the mutual fund and is taxable to the stockholders as long-term capital gain. *See id.* § 852(b)(3).

157 I.R.C. § 302 (West 1988).

If, instead, the corporation immediately distributes the $100 as a dividend taxable as ordinary income at the assumed rate of 30 percent, the stockholders would have $70 of income to reinvest. If they then invest that amount in an investment yielding 10 percent of ordinary taxable income (7 percent after tax), they would have $98.17 at the end of five years. Thus, under these facts, the stockholders would be better off letting the corporation accumulate the income and distribute the earnings in a form eligible for capital gain treatment since they would derive a net economic benefit. Moreover, if the stockholders can in fact sell the stock for a price reflecting the discounted present value of the distributions taxed at the capital gain tax rate or some other "blended" rate which is lower than the ordinary income tax rate,[158] the stockholders could realize immediately the benefit of the capital gains preference without waiting for the distribution.

The accumulated earnings tax could possibly be applied to the retained earnings and nullify the benefit to be derived from the corporation's retention of earnings.[159] However, the tax is not applied to earnings accumulated "for the reasonably anticipated needs" of the business.[160] Applicable Treasury regulations define "reasonable needs of the business" to include "bona fide expansion of business."[161] Management's desire to retain earnings to increase the size of the business would, therefore, not trigger application of the accumulated earnings tax so long as the plans to expand are sufficiently "specific, definite and feasible."[162]

The foregoing examples assumed that the maximum marginal rate for corporations equalled the maximum marginal rate for individuals. Since the Tax Reform Act of 1986, the top corporate marginal rate (34 percent) has been higher than the maximum individual rate for ordinary income (28 percent for the period 1982 through 1990, 31 percent for 1991). Also, prior to 1991, the same tax rate was applied to capital gains and ordinary income for individuals. Thus, for the taxable years 1987 through 1990, there

158 *See infra* note 183 for a discussion of whether stock market prices reflect tax rate differentials on different types of distributions.

159 Section 531 imposes a penalty tax of 28% on a corporations retained earnings that are not necessary to fund the reasonably anticipated needs of the business. I.R.C. § 531 (West Supp. 1992).

160 I.R.C. §§ 533(a), 537(a) (West 1988).

161 Treas. Reg. § 1.537-2(b)(1) (as amended in 1986).

162 Treas. Reg. § 1.537-1(b) (as amended in 1986).

was a tax incentive to distribute dividends on a regular basis, assuming that the effective tax rate for corporations was similarly higher than the effective tax rates for individuals and that individual stockholders had the same investment opportunities as the corporations.[163] However, this incentive may have been partially offset by the benefit that stockholders realized from deferring corporate distributions to a time that taxation of the distribution will be minimized.[164] It is nevertheless interesting that one study has concluded the percentage of corporate profits paid out as dividends rose significantly in the years immediately following the Tax Reform Act of 1986.[165]

For taxable years beginning in 1991, the maximum marginal rate on corporate income (34 percent) remains higher than the maximum tax rate on ordinary income for individuals (31 percent). However, capital gains of individuals are now taxed at only 28 percent. The reinstatement of a small preference for capital gains has the effect of once again encouraging retentions of corporate earnings, even though corporate tax rates are higher than

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163 *See* Alvin C. Warren, Jr., *Recent Corporate Restructuring And the Corporate Tax System*, 42 TAX NOTES 715, 716 (1989). For example, consider a corporation with an effective tax rate of 30% and its stockholders with an effective tax rate of 10%. Assume that the corporation has $100 which it can distribute to stockholders or retain in a project which yields 10% before tax. If the corporation retains the $100, at the end of 5 years it will have $140.25. If that amount is distributed to the stockholders, they will have $126.22 after they pay their 10% tax.

On the other hand, if the corporation immediately distributes the $100 to the stockholders, they would have $90 to invest in a project which yields 10% pretax. Because the stockholders' income is taxed at a rate (10%) which is lower than the corporation, at the end of 5 years the stockholders will have $138.48, an amount greater than the amount they would have if the corporation had retained the $100.

When the stockholder has an effective tax rate of zero, such as tax-exempt organizations, there will be an even stronger incentive to distribute earnings, unless of course that corporation's return on investment is significantly larger than other investment opportunities available to the tax-exempt organization.

164 *See* Kenneth R. Ferris & William R. Reichenstein, *A Note On The Tax-Induced Clientele Effect And Tax Reform*, 41 NAT'L TAX J. 131 (1988).

165 ROGER H. GORDON & JEFFREY K. MACKIE-MASON, EFFECTS OF THE TAX REFORM ACT ON CORPORATE FINANCIAL POLICY AND ORGANIZATIONAL FORM 25 (National Bureau of Economic Research Working Paper No. 3222, 1990). It is difficult to ascertain, however, whether this increase was attributable to the repeal of the large capital gains preference which existed prior to the Tax Reform Act or to the increase of the maximum marginal rates for corporations to an amount greater than individual rates. The study by Gordon and Mackie-Mason focused on the increase in the capital gains rate as an explanation for the increased pay out of earnings. *Id.* at 20-25. *But see* Stephanie Abrutyn & Robert Turner, *Taxes and Firm's Dividend Policies: Survey Results*, 43 NAT'L TAX J. 491, 495 (1990) (reporting that 85% of companies surveyed did not intend to increase dividend payments in response to the Tax Reform Act of 1986).

individual rates. For example, consider a corporation which earns $1,000 of income and assume that the income is subject to the maximum corporate rate of 34 percent. Assume further that the corporation's individual stockholders are subject to the maximum individual rate of 31 percent on ordinary income (including dividend income) and 28 percent on capital gain. The corporation will pay a tax of $340 on the $1,000 of income, leaving the corporation with $660.

If the corporation distributes the $660 as a taxable dividend, the stockholders will pay a tax of $204.60, leaving a net $455.40 for the stockholders. If the stockholders then invest the $455.40 in a one-year investment which yields 10 percent pretax to the stockholders, the stockholders will have a net after-tax income of $31.42,[166] resulting in the stockholders having $486.82 after one year.

Contrast this with what happens if the corporation retains the $660 and invests it in a one year project which yields 10 percent pretax. At the end of one year, the corporation would earn $43.56 after tax,[167] leaving the corporation with a total of $703.56 ($660 + 43.56). If the corporation then distributes the $703.56 in a transaction which qualifies for capital gain treatment,[168] or the stockholders are otherwise able to realize the value in the corporation through a sale, the stockholders would have $506.56 after tax.[169] Because the stockholders obtained only $486.82 when there was a current distribution versus $506.56 when the corporation retained and reinvested the distribution, the stockholders would generally prefer retention.

If the earnings are retained for a sufficiently long period, however, the higher tax rate applied to corporate income will eventually negate the advantage of the lower rate for capital gains. In the above example, the stockholders would be better off with a current distribution which is taxable as a dividend if the corporation intends to retain the earnings for more than approximately fifteen years.[170] However, it is important to note that the reten-

166 Pretax investment income of $45.54 (10% of $455.40) less tax of $14.12 (31% of $45.54) results in $31.42 of after-tax income.

167 Pretax investment income of $66.00 ($660 x 10%) less income tax of $22.44 (34% of $66) results in $43.56 of after-tax income.

168 Such as a redemption described in I.R.C. §§ 302(a) or 303(a) (West 1988).

169 The receipt of $703.56 by an individual stockholder in a transaction in which the entire $703.56 was recognized as capital gain would cause the stockholder to pay tax of $197 (28% of $703.56) leaving $506.56.

170 This is calculated by setting up the following simultaneous equation where (1)

tion of earnings by the corporation permits the taxpayer to time the recognition of the retained earnings in years when he or she may be subject to an effective tax rate even lower than the 28 percent capital gain rate, or to defer tax on the retained earnings until death.[171] Thus, a stockholder could benefit even if the earnings in the above example are retained for more than fifteen years because of the advantage in selecting the time at which the stockholder would realize the corporation's earnings at a tax rate lower than 28 percent.[172]

2. Impact of Capital Gains Preference on Stockholder Abdication

The previous section has shown that if a significant capital gains preference is adopted, taxpayers will be more predisposed to permit management to retain earnings so long as they can realize the value of those retained earnings at the preferential rate by selling their stock.[173] This may exacerbate stockholder abdication in two ways. First, the preferential tax rate for capital gains motivates taxable stockholders to be more tolerant of management inefficiency in investing retained earnings.[174] Recall an earlier example[175] in which we assumed that all corporate and individual ordinary income was subject to the same tax rate of 30 percent while capital gain was subject to a lower tax rate of 20 percent. We saw that where a corporation distributes as a dividend $100 of its after-tax income to a noncorporate stockholder, the stockholder will have $70 after tax. If the stockholder invests that $70 amount

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the net after tax return to the stockholder assuming a current dividend distribution of the $660 to the stockholder and investment of that amount for N years equals (2) the net after tax return to the stockholder assuming capital gain treatment for the retention of the $660 for N years by the corporation and then calculating the value of N:

$660(1.069)^N(.69) = 660(1.066)^N(.72)$

The above equation assumes, of course, that the stockholder has investment opportunities that will yield a pretax return to the stockholder equal to the pretax return of investments available to the corporation.

171 I.R.C. § 1014(a) (West 1988) permits a deceased stockholder's estate to step up the basis in the stock to the stock's fair market value.

172 *See generally* Ferris & Reichenstein, *supra* note 164, at 134.

173 It is important to note that even without the preferential tax rate, our current unintegrated system of taxing the distribution of corporate profits still contains a bias against distributions because taxable stockholders can time their sale of stock in low tax years, thereby minimizing their tax liability for the retained earnings. *See id.* at 131.

174 *See* MCCLURE, *supra* note 141, at 148-49. *See also* Eric M. Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839, 844 (1988).

175 *See supra* text accompanying notes 156-158.

in an investment yielding 10 percent pretax (7 percent after tax), the stockholder will have $98.17 after tax at the end of five years.

Contrast this $98.17 result with the amount the stockholder would receive if the corporation, instead of distributing the $100 as a dividend, retained the $100 and invested it on a project that has the same level of risk as the 10 percent yielding investment available to the stockholder, but that yields only 8 percent pretax (5.6 percent after tax). The corporation will have $131.32 after tax to distribute at the end of five years. If the distribution qualifies for capital gain treatment, the stockholder would pay a tax at the rate of 20 percent and have $105.05 after tax. In effect, the capital gains preference subsidizes the inefficient retention of corporate earnings—the larger the preference for capital gains, the larger the subsidy.

The fact that noncorporate stockholders will benefit from an inefficient management's retention of earnings with a capital gain preference may reinforce the reluctance of noncorporate stockholders to incur significant costs in monitoring management's investment of retained earnings. An attempt to control management would force stockholders to incur costs, such as the costs of a proxy battle, in what would likely be a losing effort. Given the findings of some commentators that the aggravation people experience in losing money seems greater than the pleasure they experience in gaining the same amount,[176] the stockholders may well decide to settle for "half a loaf" rather than risk the costs of a proxy dispute with management. Indeed, the rate preference for capital gains creates the potential for management to in effect "punish" troublesome stockholders by increasing dividends and thereby reducing the stockholders after-tax return.[177]

Mutual funds, as well as individual stockholders, would be reluctant to incur costs in controlling management of corporations in which they hold stock because sixty-six percent of all mutual

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176 Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis Of Decision Under Risk*, 47 ECONOMETRICA 263, 279 (1979).

177 This would be particularly true if the corporation had attracted a clientele of stockholders particularly averse to dividends. Some studies suggest that corporations may attract a clientele of investors whose tax preferences match the corporation's dividend policies (i.e. tax exempt stockholders would purchase dividend-paying stock while taxable stockholders would prefer stock not paying dividends). *See, e.g.*, Costas P. Kaplanis, *Options, Taxes and Ex-Dividend Day Behavior*, 41 J. FIN. 411 (1986). However, the evidence regarding the existence of clienteles for corporations based on their dividend policies is generally regarded as weak. *See, e.g.*, Crockett & Friend, *supra* note 150, at 604; Poterba & Summers, *supra* note 113, at 276.

fund assets are held by individuals.[178] Because mutual funds are generally taxed as flow-through entities,[179] their noncorporate stockholders directly benefit from the capital gains subsidy. Consequently, to the extent management of mutual funds is seeking to maximize the investment return of mutual fund stockholders,[180] mutual funds would prefer that the corporations in which the mutual funds hold stock retain earnings as long as the after-tax economic return from retention of earnings exceeds the after-tax return from immediate distribution of earnings.

The second way in which a capital gains preference may contribute to stockholder abdication is the manner in which a capital gains preference motivates stockholders to realize corporate profits. The incentive created by the preference to sell stock rather than receive dividends over a period of time is not conducive to encouraging stockholders to view the relationship with the corporation as long-term. Rather, the buy-sell investment strategy may reinforce the view that stock is merely another commodity to be traded, rather than part ownership of a business whose activity should be monitored.[181] Without the preferential tax rate for long-term capital gains, stockholders would not be as motivated to realize gains in lieu of receiving dividends and, as a result, would perhaps be more likely to take an active interest in the corporation's retention of earnings and the investment of those earnings. It is interesting to observe that the number of shareholder resolutions made annually by institutional investors tripled in the four years after the repeal of the capital gains preference in 1986.[182] It will be interesting to see whether the reintroduction in 1991 of the small preference for capital gains (28 percent for capital gains versus 31 percent for ordinary income) will reduce the number of stockholder resolutions in the future.

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178 INVESTMENT COMPANY INSTITUTE, 1991 MUTUAL FUND FACT BOOK 53 (1991).

179 *See supra* note 156.

180 Management of mutual funds, like management of corporations, may not always be responsive to stockholders. *See* Rock, *supra* note 87, at 469-78. However, mutual fund management will generally welcome any opportunity to reduce costs; *Id.* at 474, and, therefore, would welcome an excuse to avoid battling with corporate management about dividend payments.

It should be noted that some mutual funds have as their stated objectives investment in dividend-paying stocks. Those mutual funds would not invest in corporations that retain earnings regardless of the capital gains preference because of their stated investment objectives.

181 *See supra* notes 76-78 and accompanying text.

182 *See* Brett D. Fromson, *The Big Owners Roar*, FORTUNE, July 30, 1990, at 66, 67.

It is important to note that the existence of the tax bias created by the capital gains preference in favor of the retention of earnings is based on an important assumption. The assumption is that stockholders can realize the value of the retained earnings at a preferential tax rate when they sell their stock. In other words, the above analysis assumes that the market places a higher value on the stock of corporations that do not pay dividends compared to identical corporations which do pay dividends. The higher value is based on the expectation that distributions from the retaining corporation will ultimately be received in situations eligible for the favorable capital gains tax rate. Studies support this assumption, although the evidence is not conclusive.[183]

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183 There are two competing schools of thought about the manner in which taxes on corporate distributions affect stock prices. One theory (the tax-irrelevance theory) postulates that prices are determined by marginal investors who face equal tax burdens on dividends and capital gains. *See* Miller & Scholes, *supra* note 147, at 333. Under this theory, therefore, stocks which pay dividends should not sell at lower prices than identical stocks which do not pay dividends since the marginal investors should not require higher pretax returns to induce them to purchase stocks which pay dividends. James M. Poterba, *Tax Policy and Corporate Savings*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY 455, 466 (1987). The second school of thought theorizes that shares which pay dividends sell at lower prices because the marginal investor faces a higher tax on dividends than on capital gains. *Id.*

The majority of studies suggest that stocks of corporations which retain earnings sell at prices higher than the stock of identical corporations which regularly distribute earnings. *See, e.g.*, BREALEY & MYERS, *supra* note 113, at 370-73 (summarizing the studies); Roger H. Gordon & David F. Bradford, *Taxation and the Stock Market Valuation Of Capital Gains And Dividends*, 14 J. PUB. ECON. 109 (1980); Robert H. Litzenberger & Krishna Ramaswamy, *The Effects of Dividends On Common Stock Prices: Tax Effects Or Information Effects*, 37 J. FIN. 429 (1982); I.G. Morgan, *Dividends and Capital Asset Prices*, 37 J. FIN. 1071 (1982); Lambert Vanthienen & Theo Vermaelen, *The Effect of Personal Taxes On Common Stock Prices*, 11 J. BANKING & FIN. 223, 243 (1987). However, the studies are somewhat controversial because of the difficulties of screening out the other factors which could also have affected stock prices. *See* Nai-Fu Chen et al., *Changing Risk, Changing Risk Premiums, and Dividend Yield Effects*, 63 J. BUS. S51, S68 (1990); Merton H. Miller, *Behavioral Rationality In Finance: The Case Of Dividends*, 59 J. BUS. S451, S460-62 (1986).

Another related line of inquiry to determine whether marginal investors are in fact taxed at a higher rate on dividends than on capital gains has been to examine price changes around ex-dividend days for stock. If dividends are taxed at higher rates to marginal investors, those investors will demand a higher pretax premium from dividend income than from capital gains in establishing the price at which the stock trades. Theoharry Grammatikos, *Dividend Stripping, Risk Exposure, and the Effect of the 1984 Tax Reform Act on the Ex-Dividend Day Behavior*, 62 J. BUS. 157, 159 (1989). They can obtain this premium if stock prices decrease on ex-dividend days by less than the amount of the dividend. *Id.* Several studies indicate that stock prices fall by less than the pretax amount of the dividend, indicating that the marginal investors who establish the trading price treat dividends as less valuable than capital gains. *See, e.g.*, Michael J. Barclay, *Dividends, Taxes, and Common Stock Prices: The Ex-Dividend Day Behavior of Common Stock Prices before the Income Tax*, 19 J. FIN. ECON. 31, 39-40 (1987); Kenneth M. Eades et al., *On Interpreting Securities Returns During the Ex-Dividend Period*, 13 J. FIN. ECON. 3, 11 (1984); Edwin J.

D. *The Questionable Benefit of Holding Period Requirements*

Even if one assumes that stockholders need encouragement to permit management to adopt a long-term perspective, holding period requirements for tax incentives have to be approached cautiously. As discussed earlier, stockholders should already want management to maximize long-term profits because it is in their best economic interests.[184] If stockholders are acting irrationally in churning their portfolios and in demanding that management maximize short-term profits, it is unlikely that they will respond rationally to tax incentives linked to holding period requirements. On the other hand, if stockholders are acting rationally and want management to maximize long-term profits but are trading stock like commodities because their cost-benefit analyses suggest that it is too expensive to influence management, holding period requirements for tax incentives might be utilized to alter their cost-benefit analyses in a manner that maximizes social welfare. However, policymakers have generally failed to analyze the effect of holding period requirements on stockholders' cost-benefit analyses or on social welfare. To analyze further the effect of holding period requirements, it is useful to divide investors into two new categories—taxable investors and tax-exempt investors.

1. Taxable Investors

The empirical studies clearly show that a holding period requirement combined with a significant capital gains preference induces taxable investors to hold appreciated securities for the requisite holding period. In 1968, a report that examined the effect of a six month holding period requirement for a capital gains preference that taxed long-term gains at one-half the rate applied to ordinary income found a significant impact on the timing of gain realizations.[185] The report discovered that after

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Elton et al., *The Ex-Dividend Day Behavior of Stock Prices: A Re-Examination of the Clientele Effect*, 39 J. FIN. 551, 551-56 (1984); Poterba & Summers, *supra* note 113, at 252. However, these findings are also controversial because they fail to show conclusively that the ex-dividend day phenomenon is attributable to taxes and not other factors. *See, e.g*, Giovanni Barone-Adesi & Robert E. Whaley, *The Valuation of American Call Options and The Expected Ex-Dividend Stock Price Decline*, 17 J. FIN. ECON. 91, 110 (1986); Miller & Scholes, *supra* note 147, at 1139-40.

184 *See supra* part IV.B.

185 J. Eric Fredland et al., *The Six Month Holding Period For Capital Gains: An Empirical*

the acquisition of stock, sales were relatively high in the first month of acquisition, but then steadily declined until the sixth month of the holding period.[186] Realized gains then increased markedly in the seventh month when they were eligible for preferential treatment as long-term capital gain.[187] Similar results were obtained in a 1981 study.[188]

Although a holding period requirement for a large capital gains preference encourages taxable investors to hold securities for the requisite holding period, it is unlikely that the taxpayers' "long-term" perspective will be any *longer* than the required holding period.[189] The studies show that after the holding period is satisfied there is a strong incentive to sell because of the preferential tax rate applied to gains.[190] This is not surprising because, as discussed earlier,[191]a significant capital gains preference generally encourages taxpayers to prefer capital gain over dividend income.[192] The Staff of the Joint Committee on Taxation has noted that the average holding period for stock may decrease after the adoption of a significant capital gains preference because the preference increases the incentive to sell at the end of the holding period.[193] If the average holding period in fact decreases in

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Analysis of Its Effect on the Timing of Gains, 21 NAT'L TAX J. 467, 468-70 (1968).

186 *Id.* Sales increased slightly in the sixth month apparently because some taxpayers mistakenly calculated their holding period.

187 *Id.*

188 STEVEN KAPLAN, THE HOLDING PERIOD DISTINCTION OF THE CAPITAL GAINS TAX (National Bureau of Economic Research Working Paper No. 762, 1981).

189 For a survey of the literature and a discussion of the complexities pertaining to the relationship between a tax on capital gains and the effect of such a tax on stockholders holding periods, see Eric W. Cook & John F. O'Hare, *Issues Relating To The Taxation Of Capital Gains*, 40 NAT'L TAX J. 473, 477-78 (1987).

190 *See, e.g.*, Fredland et al., *supra* note 186; Kiefer, *supra* note 119, at 82-83.

191 *See supra* part IV.C.1.

192 Indeed, Congress included the capital gains preference in the Revenue Act of 1921 because it believed that fully taxing gain on the sale of appreciated capital assets deterred sales. *See* H.R. REP. NO. 350, 67th Cong., 1st Sess. 10, 11 (1921), *reprinted in* 1939-1(2) C.B. 168, 176. The reduction in the tax on capital gains would encourage more sales and result in more tax revenues. *Id.*

193 STAFF OF THE JOINT COMM. ON TAX'N, 101ST CONG., 1ST SESS., TAX TREATMENT OF CAPITAL GAINS AND LOSSES 22 (Comm. Print 1989). The Staff noted: "If a reduction in the tax rate on capital gains induces taxpayers to realize gains in their portfolios more frequently and to realize gains which they otherwise would have held . . . until death, then taxpayers' average holding periods for all assets in their portfolios may decline." *But see* Kiefer, *supra* note 119, at 88-90 (concluding that under the author's model for stock trading, a reduction of the maximum tax rate on capital gains to 15% for qualifying assets, held for one year, and then increasing the requisite holding period to two years on January 1, 1993, and to three years on January 1, 1995, would increase the average holding period while at the same time encouraging increased realizations of capital

response to the enactment of a capital gains preference, then management's planning horizon will become shorter rather than longer.

If policymakers wish to maximize the period which management will have to achieve its long-term objective, it will be necessary to impose a longer holding period than has been used in recent years. In most instances, holding period requirements of one year or less will not achieve the stated goal of permitting management to adopt a long-term perspective because perfecting new production methods or developing new products usually takes significantly longer than one year.[194] However, lengthening the holding period poses additional problems. Since investors also desire potential liquidity during the period of their investment (the liquidity preference theory), they will expect to be compensated for reducing their liquidity in order to satisfy the holding period requirement.[195] Thus, the longer the holding period requirement is, the greater the tax benefit will have to be in order to induce investors to hold their securities. This is not a new concept. For example, the Revenue Act of 1934 employed a graduated scale for taxing capital gains depending on the length of the holding period.[196] The amount of capital gains included in ordinary income ranged from 80 percent for assets held longer than one year down to only 30 percent for assets held for over 10 years. Similarly, several bills introduced in Congress in recent years utilize a graduated scale.[197]

The problem with providing a larger tax benefit for longer holding periods is that it is extremely difficult to relate the size of

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gains).

194 *See generally* Jeff Moad, *Navigating Cross-Functional IS Waters*, DATAMATION, March 1, 1989, at 73, 75 (After implementing computer aided design and manufacturing systems, Xerox has been able to cut its product development cycle from 5 years to 2 1/2 years.); Daniel Valentino & Bill Christ, *Teaming Up For Market: Cheaper, Better, Faster*, MGMT. REV., Nov. 1989, at 46, 46-49 (RCA has been able to reduce its product development cycle from 4 years to 2.5 years.).

195 *See, e.g.*, EDWIN J. ELTON & MARTIN J. GRUBER, MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS 462-64 (3d ed. 1987); Yakov Amihud & Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 J. FIN. ECON. 223, 224 (1986). For an excellent discussion of the literature documenting the value of liquidity, see Rebecca S. Rudnick, *Who Should Pay the Corporate Tax In a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1103-27 (1988-89).

196 Revenue Act of 1934, ch. 277, § 117, 48 Stat. 680, 714 (1934) (current version in scattered sections of 26 U.S.C.).

197 *See, e.g.*, H.R. 3652, 102d Cong., 1st Sess. (1991); H.R. 3972, 101st Cong., 2d Sess. (1990); S. 2071, 101st Cong., 2d Sess. (1990).

the tax preference to its revenue impact and the intended welfare benefits which may arise from investors holding their securities for a longer time. The required holding period for stock should ideally vary with the time horizon necessary to complete each corporation's particular project. However, this would be difficult to administer because the time required to complete the projects will vary significantly depending upon the industry and nature of the project.[198] These administrative problems necessitate the use of fixed holding periods with corresponding preferential tax rates which apply to all stocks regardless of the individual planning horizons of the different issuers. The result is that any *ex ante* attempt to correlate the size of the preference with the social benefit of lengthening the period for which an investor is willing to hold stock is largely an arbitrary process. It is noteworthy that since 1921, the holding periods for the capital gains preference have varied from six months to ten years.[199]

The other problem with providing a larger tax benefit for longer holding periods is that there is no guarantee that longer holding periods encourage stockholders to incur additional costs to monitor management and, therefore, provide any social benefit. As discussed earlier,[200] the larger the preferential tax treatment for capital gains, the greater the subsidy for the inefficient retention of earnings. Thus, the larger the preference, the less likely that stockholders will devote resources to monitoring management.[201] Without additional activism by stockholders, it is likely that management will seek to achieve its own objectives (including the maximization of short-term profits)[202] regardless of the holding period requirement.

2. Tax-Exempt Investors

Tax-exempt investors, such as pension funds and university endowments, comprise a large percentage of investors in the secu-

198 *See generally* Clint Larson, *Team Tactics Can Cut Product Development Costs,* J. BUS. STRATEGY, Sept.-Oct. 1988, at 22; Yutaka Kuwahara et al., *Planning Research and Development at Hitachi,* 22 LONG RANGE PLANNING, June 1989, at 54, 55; John Teresko, *Speeding the Product Development Cycle,* INDUS. WK., July 18, 1988, at 40, 40-42; Valentino & Christ, *supra* note 195, at 46.

199 *See* James R. Repetti, *The Use of Tax Law to Stabilize the Stock Market: The Efficacy of Holding Period Requirements,* 8 VA. TAX REV. 591, 596-601 (1989).

200 *See supra* text accompanying notes 174-184.

201 *Id.*

202 *See supra* text accompanying notes 137-173.

rities market. These investors cannot be influenced by the capital gains preference since they are usually not subject to any tax. Consequently, it has been suggested that a transfer tax be imposed on the gains of these institutions (as well as taxable investors) which arise from the sale or exchange of securities held for less than a specified period.[203]

The imposition of a tax on the short-term gains of taxable investors and otherwise tax-exempt investors should encourage investors to hold stock for the requisite holding period.[204] However, this does not necessarily mean that a stock transfer tax would encourage the investors to incur additional costs in monitoring management. As discussed earlier,[205] the transaction costs of stockholder activism are high, and the "free-rider" and legal problems associated with stockholder activism would still exist.[206] A large securities transfer tax that reduces the benefit of a sale might cause the incurrance of expenses to control management to appear relatively more attractive to an investor than selling the corporation's stock, but would not solve the "free-rider" problem and the other legal impediments to stockholder activism. Thus, the social benefit of a transfer tax is unclear. Moreover, in identifying the social benefit, the cost arising from the possibility that a large securities transfer tax could significantly impair market efficiency has to be considered.[207]

3. Efficiency Distortions of Holding Period Requirements

The imposition of holding period requirements as a prerequisite for favorable tax treatment could impair market efficiency by distorting securities prices. In a rationally efficient stock market, prices are determined in a manner which equates the marginal rates of return (adjusted for risk) of all producers and savers.[208] Scarce resources, therefore, are optimally allocated among produc-

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203 S. 1654, 101st Cong., 1st Sess. (1989).

204 *See supra* text accompanying notes 185-188 for a discussion of the impact of a holding period requirement for capital gains preferences.

205 *See supra* text accompanying notes 67-78.

206 *See* Lawrence H. Summers & Victoria P. Summers, *The Case for a Securities Transactions Excise Tax*, 48 TAX NOTES 879, 882 (1990) (noting that stock transfer tax would probably not encourage stockholder activism because of "free-rider" problem).

207 Kiefer, *supra* note 111, at 889; Repetti, *supra* note 41, at 88.

208 *See* WILLIAM J. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY vii (1965); COPELAND & WESTON, *supra* note 113, at 330.

tive investments.[209] Holding period requirements would distort this allocation process by affecting the prices of securities and, as a result, the rates of return of the securities. This distortion would occur because investors would be induced to hold a security when real economic factors, such as an increase in the amount of risk associated with the return of the security, might dictate that the investor sell.[210] The inducement to hold the security would cause the security price to be above the price which would be established in a nondistorted market by artificially decreasing the supply of securities.[211] Of course, once the holding period is satisfied, a taxpayer may be particularly eager to sell risky securities in order to lock in the gain.[212]

It is possible that this distortion would not be great because at any given time, although some investors would be holding securities to satisfy the requirement, the majority of investors would have satisfied the holding period requirement. However, evidence suggests that at times investors will act in tandem as they are attracted to a rising market.[213] Explanations of this phenomenon have been based on both rational stockholder behavior in the case of rational speculative bubbles,[214] and irrational stockholder behavior in the case of "fads".[215] Under either explanation, inves-

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209 COPELAND & WESTON, *supra* note 112.

210 KAPLAN, *supra* note 188.

211 Because stocks have a downward sloping demand curve, stock prices respond to changes in supply. Andrei Schleifer, *Do Demand Curves For Stocks Slope Down?*, 41 J. FIN. 579, 588-89 (1986).

212 *See* George M. Constantinides, *Optimal Stock Trading with Personal Taxes: Implications for Prices and the Abnormal January Returns*, 13 J. FIN. ECON. 65, 73 (1984).

213 KENNETH A. FROOT ET AL., HERD ON THE STREET: INFORMATIONAL INEFFICIENCIES IN A MARKET WITH SHORT-TERM SPECULATION (National Bureau of Economics Research Working Paper No. 3250, 1990); Gikas A. Hardouvelis, *Evidence on Stock Market Speculative Bubbles: Japan, the United States, and Great Britain*, 13 FEDERAL RES. BANK N.Y. Q. REV., Summer 1988, at 4, 8-15; Robert J. Shiller, *Fashion, Fads, and Bubbles in Financial Markets*, *in* KNIGHTS, RAIDERS AND TARGETS *supra* note 25, at 56, 59.

214 *See, e.g.*, Costas Azariadis, *Self-Fulfilling Prophesies*, 25 J. ECON. THEORY 380, 380-81, 395 (1981); Oliver J. Blanchard & Mark W. Watson, *Bubbles, Rational Expectations, and Financial Markets*, *in* CRISES IN THE ECONOMIC AND FINANCIAL STRUCTURE 295, 295-99 (Paul Wachtel ed., 1982); Richard A. Meese, *Testing for Bubbles in Exchange Markets: A Case of Sparkling Rates*, 94 J. POL. ECON. 345, 346 (1986); *see also* Jean Tirole, *On the Possibility of Speculation Under Rational Expectations*, 50 ECONOMETRICA 1163, 1178-97 (1982) (formulating a model using the rational expectations theory which allows for the formation of speculative bubbles); F. van der Ploeg, *Rational Expectations, Risk, and Chaos in Financial Markets*, 96 ECON. J. 151, 151-52 (Supp. 1986) (hypothesizing that rational speculative bubbles occur in the bond market). For an interesting account of many historical bubbles, see CHARLES P. KINDLEBERGER, MANIAS, PANICS, AND CRASHES (1978).

215 KEYNES, *supra* note 76, at 56, 59; Shiller, *supra* note 213, at 59.

tors contemporaneously buying into a rising market could result in a significant portion of investors being subject to holding period requirements at the same time.[216] The tax incentive to hold rather than sell could fuel the increase in stock prices above the value which would otherwise have been established in an efficient market by artificially restricting the supply of securities,[217] resulting in prices no longer appropriately reflecting their rates of return as adjusted for risk. Moreover, the artificial inflation of prices caused by holding period requirements could in certain scenarios contribute to stock market volatility by exacerbating the amount by which prices have to fall in order to reach their fundamental value when the bubble bursts or the fad dissipates after the holding period has been satisfied.[218]

V. USING THE TAX SYSTEM TO INFLUENCE MANAGERIAL BEHAVIOR

A. *Incentives to Motivate Behavior—Management Stock Ownership Incentives*

In addition to the questionable impact of holding periods and the capital gains preference on stockholder behavior, Congress has also adopted various tax provisions with the intention of influencing management behavior. As is the case with capital gains, the analyses of the provisions have failed to focus sufficiently on the effect of the separation of ownership from control. In particular, Congress has repeatedly failed to consider fully the fact that stockholder abdication generally enables management to avoid modifying its behavior in response to the tax incentives Congress has created while, at the same time, benefitting from the incentives.

This Section focuses on a provision which Congress has adopted with the hope of more closely aligning management objectives with stockholder objectives—incentive stock option plans.

1. History of Incentive Stock Options

In general, under I.R.C. §83, the receipt of a stock option as part of an executive compensation package is not a taxable

216 Repetti, *supra* note 199, at 616-17.

217 Since stocks have a downward sloping demand curve, an increase in demand without an accompanying increase in price will raise stock prices. Shleifer, *supra* note 211, at 588-89.

218 *See* Repetti, *supra* note 199, at 617.

event.[219] Rather, the option holder recognizes income at the time the option is exercised. The income equals the amount by which the fair market value of the stock received upon exercise exceeds the price paid for the stock pursuant to the option.[220]

Beginning with the Revenue Act of 1950,[221] however, Congress has provided certain preferential tax treatment for stock options granted to key employees. In the Revenue Act of 1950, Congress adopted §130A, later recodified as §420 in the Revenue Act of 1956, which, if certain conditions were satisfied, permitted the holder of a qualified option to defer the recognition of gain at the time the option was exercised. Gain would only be recognized upon the subsequent sale of the stock to the extent the sale price exceeded the amount paid for the stock upon exercise of the option.

Congress adopted the preferential treatment for stock options to encourage their use as management incentives. The assumption was that incentives which provided management with a stock interest in the corporation would be advantageous to the economy by more closely aligning management's interests with the stockholders' interest.[222] The early legislative history of stock options, however, indicates that Congress failed to consider fully the extent to which management's control of public corporations relatively unfettered by stockholders meant that management could obtain the benefits of the preferential tax treatment for options without modifying its behavior.

The original version of stock options adopted in 1950, referred to as "restricted stock options," reflected some legislative awareness that executives would use their power to obtain the favorable tax treatment provided by restricted stock options without aligning their objectives more closely with stockholders. Thus,

219 Treas Reg. § 1.83-7 (1978). Receipt of a stock option is not a taxable event unless the option is actively traded on an established market or meets the following conditions: (1) the option is transferable (2) the option is exercisable in full (3) the option or the stock receivable upon exercise is not subject to any restriction or condition which has a significant effect on fair market value and (4) the value can be measured with reasonable accuracy. *Id.* § 1.83-7(b).

220 *Id.* § 1.83-7(a).

221 Revenue Act of 1950, ch. 994, § 218(a), 64 Stat. 906, 942 (repealed 1976) (current version at I.R.C. § 422 (West Supp. 1992)).

222 S. REP. NO. 2375, 81st Cong., 2d Sess., (1950), *reprinted in* 1950 U.S.C.C.A.N. 3053, 3194-15; H. REP. NO. 749, 88th Cong., 1st Sess. (1964), *reprinted in* 1964 U.S.C.C.A.N. 1313, 1372; S. REP. NO. 830, 88th Cong., 2d Sess. (1964), *reprinted in* 1964 U.S.C.C.A.N. 1673, 1761.

the statute required that stock acquired pursuant to the exercise of a "restricted stock option" not be sold less than two years subsequent to the date on which the option was granted, and that such stock also be held for at least six months after the exercise of the option.[223] Congress stated that the purpose for this requirement was to insure that the employee "remains in the employment of the company for a substantial period after the time when he acquires the option and actually invests in the stock of the company for a considerable period."[224]

In addition, "restricted stock options" could not be granted to any employee owning directly or indirectly more than 10 percent of the combined voting power of all classes of stock of the employer corporation.[225] The legislature imposed this requirement to "prevent the use of stock options by employers who seek merely to convert the earning of a corporation from ordinary income into a capital gain."[226] However, the provision also had the perhaps unintended beneficial result of confining the tax advantage to those employees whose alignment with stockholders would provide the greatest benefit to the corporation. Granting stock to employees who already own 10 percent of the stock of the corporation is unlikely to have provided significant benefits to the corporation.[227]

Despite legislative concern that management objectives should be more closely aligned with stockholder objectives, Congress failed to anticipate the ingenuity of management in obtaining the benefits of restricted stock options without actually adopting stock-

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223 § 218(a). *See generally* John H. Alexander, *Employee Stock Options And The 1950 Revenue Act*, 6 TAX L. REV. 165 (1950) (providing a detailed description of the features of restricted stock options); Jack D. Edwards, *Executive Compensation: The Taxation of Stock Options*, 13 VAND. L. REV. 475 (1960) (same).

224 S. REP. NO. 2375, *supra* note 222, at 3115.

225 Revenue Act of 1950, ch. 994, § 218(a), 64 Stat. 906, 942 (repealed 1976).

226 S. REP. NO. 2375, *supra* note 222, at 3115.

227 *See* Randall Morck et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 293, 294-95 (1988); which found that firm performance for corporations improved when the percentage of ownership in the corporation by directors increased from 0 to 5 percent, but then began to fall as ownership increased beyond 5%. *See generally*, Michael C. Jensen & Jerold B. Warner, *The Distribution of Power Among Corporate Managers, Shareholders, and Directors*, 20 J. FIN. ECON. 3, 12-15 (1988) (surveying the literature regarding the impact of executive stock ownership on corporate performance.) *But see* John J. McConnell & Henri Servaes, *Additional Evidence On Equity Ownership And Corporate Value* 27 J. FIN. ECON. 595, 603-09 (1990) (finding corporate performance increased as management's percentage of stock ownership increased from 0% to approximately 40% and then began to decline).

holder objectives. Thus, the 1964 Revenue Act replaced restricted stock options with a new form of option, the "qualified stock option,"[228] which would qualify for the same favorable tax benefit as restricted stock options if certain new requirements intended to correct management abuses were satisfied.[229] One of Congress' concerns was that executives were disposing of their stock shortly after satisfying the six month holding period and, as a result, not maintaining a significant stake in the employer corporation.[230] In response, the 1964 Act increased the period for which an employee was required to hold stock after the exercise of an option from six months to three years.[231] Critics of restricted stock options had also charged that executives could obtain substantial benefits from an option even if the market price of the corporation's stock fell by obtaining a new option with a lower exercise price.[232] The legislative response to prevent this required that a qualified stock option not be exercisable until previously granted options had been fully exercised or the period for their exercise had expired.[233]

Lastly, Congress was concerned that executives were granting themselves options without stockholder approval.[234] Thus, the legislature imposed a requirement that stockholders approve the plan pursuant to which the options were granted. The stock option plan would have to specify the number of shares of stock to be issued pursuant to the exercise of options and the employees or class of employees to receive options.[235]

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228 Revenue Act of 1964, P.L. No. 88-272, § 422(a), 78 Stat 19, 64 (1934) (repealed 1976).

229 H.R. REP. NO. 749, 88th Cong., 1st Sess. (1964), *reprinted in* 1964 U.S.C.C.A.N. 13722; S. REP. NO. 830, *supra* note 222; *see also* Edwin H. Baker, *Employee Stock Option Plans Under The Revenue Act of 1964*, 20 TAX L. REV. 77, 77-79 (1964-65).

230 *Id. See also* President's Message to the Congress on Tax Reduction and Reform, 1963 PUB. PAPERS 73 (Jan. 24, 1963) [hereinafter President's Message]; Revenue Act of 1964, P.L. No. 88-272, § 422(a), 78 Stat. 19, 64 (repealed 1976).

231 Revenue Act of 1964, P.L. No. 88-272, § 422(a), 78 Stat. 19, 64 (repealed 1976).

232 President's Message, *supra* note 230, at 484; Erwin N. Griswold, *The Mysterious Stock Option,* Committee on Ways and Means, Tax Revision Compendium, part 2, 1328 (1959); S. REP. NO. 830, *supra* note 222, at 1762.

233 I.R.C. §§ 422(b)(5), 422(c)(2) (West Supp. 1992). *See also,* S. REP. NO. 830, *supra* note 229, at 1762.

234 S. REP. NO. 830, *supra* note 222, at 1763.

235 I.R.C. § 422(b)(1) (West Supp. 1992). Congress also added the requirement that the exercise price at the time the option is granted be equal to the fair market value of the stock. Prior to the 1964 Act, the exercise price for the option only had to equal 85% of the fair market value of the stock at the time the option was granted. Internal Revenue Code of 1954, P.L. No. 591, § 421, 68A Stat. 3, 142 (repealed 1964). Congress

In 1976, Congress repealed the preferential tax treatment for stock options.[236] A depressed stock market had caused it to reexamine the value of stock options as an incentive.[237] The legislature determined that since the value of compensation in the form of stock options was subject to the uncertainties of the stock market, it seemed "doubtful" that a qualified option provided an incentive greater than other forms of compensation.[238] Moreover, it felt that even if qualified stock options were an effective incentive, the options nevertheless constituted compensation and should be taxed as such.[239]

However, Congress again reversed course in 1981 and adopted the present "incentive stock option" rules,[240] apparently hoping that reinstituting tax incentives for stock options would encourage management to improve the operations and profitability of their firms.[241] At the same time, provisions were included to thwart executive abuses that arose under prior law.[242] To insure that ex-

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increased the required exercise price in order "to decrease the compensatory returns of the existing stock option provision and to place greater emphasis on the employee's efforts to improve his company business and thereby raise the price level of the stock." S. REP. NO. 830, *supra* note 222, at 1762.

236 Tax Reform Act of 1976, P.L. No. 94-455, §§ 603(a),(b), 1906(b)(13)(A), 90 Stat. 1520, 1574, 1834.

237 *See* STAFF OF JOINT COMM. ON INTERNAL REVENUE TAX'N, 94TH CONG., 1ST SESS., RETIREMENT INCOME CREDIT, CHILD CARE DEDUCTION, QUALIFIED STOCK OPTIONS, AND SICK PAY EXCLUSION 10-11 (Comm. Print 1975), which stated in part:

> Qualified stock options have become less attractive as a compensation technique in recent years because of the generally declining stock market in recent years. The market price of stocks of many publicly held companies has dropped substantially in the recent recession. As a result, many qualified stock options granted in previous years at purchase prices which seemed attractive on an assumption that the price of the company's stock would rise became unattractive as the price of the outstanding stock fell. Many executives thus had no incentive to exercise their options which were "under water", i.e. options whose exercise price was higher than the current level of the company's stock in the open market. Because of this loss-of-incentive feature (and the prohibition against resulting the option price downward), many companies have turned to other techniques and plans as a way to compensate their executives.

238 S. REP. NO. 938, 94th Cong., 2d Sess., *reprinted in* 1976-3 C.B. 49, 199.

239 *Id.*

240 Economic Recovery Tax Act of 1981, P.L. No. 97-34, 95 Stat. 172, 256 (1981) (current version at I.R.C. § 422 (West Supp. 1992)).

241 S. REP. NO. 144, 97th Cong., 2d Sess. 98 (1981).

242 *Id. See also* STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 159, (Comm. Print 1981).

ecutives would have a commitment to the corporation's long-term success, the incentive stock option rules require the employee to hold the stock during a two year period from the date the option was granted and for one year after the stock was received.[243] In addition, the option holder is required to be an employee of the corporation granting the option[244] for the entire period from the date of granting the option[245] up to three months prior to the date of exercise of the option.

2. Analysis of Incentive Stock Options

Whether increased stock ownership by management through stock options will reconcile the clashing objectives of management and stockholders is unresolved.[246] One study that illustrates the ambiguous benefit of increased stock ownership for management and directors found that corporate performance improved when directors' ownership increased from 0 to 5 percent, but then decreased as the directors' ownership exceeded 5 percent.[247] The study demonstrates the complex relationship between compensation packages and management motivation. The study's findings could be interpreted as indicating that at a sufficiently high level of stock ownership, management will use its power to expropriate immediately for its benefit the resources of the firm rather than wait for some future payout that might accompany the sale of their stock. As long as management owns less than 100 percent of the corporation, it will normally benefit more from expropriating wealth than from stock ownership. Thus, the theoretical grounding of stock options in resolving the agency conflict between management and outside investors is not clear.

Even given the questionable premise on which tax preferences for stock options are based, the incentive stock option provisions are no better at accomplishing their legislative purpose of encour-

243 I.R.C. § 422(a)(1) (West Supp. 1992).

244 I.R.C. § 422(a)(2) requires that the option recipient be an "employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation . . . ." *Id.* § 422(a)(2).

245 *Id.* Incentive stocks options, as was the case with qualified stock options, must also be granted pursuant to a plan approved by stockholders.

246 *See* Jensen & Warner, *supra* note 227, at 12-15 (surveying the literature regarding the impact of executive stock ownership on corporate performance).

247 Morck et al., *supra* note 227, at 294-95. *Cf.* McConnell & Servaes, *supra* note 227, at 603-09 (finding corporate performance increased as management's percentage of stock ownership increased from 0% to approximately 40% and then began to decline).

aging long-term investment by management than the rules which apply to restricted stock options and qualified stock options. Congress has failed to consider fully the interaction of the incentive stock option rules with the current tax treatment for options not qualifying as incentive stock options ("nonqualified options") under I.R.C. section 83.[248] The fact that the maximum corporate income tax rate is now higher than the maximum individual rate causes nonqualified options to be more attractive for compensating management than incentive stock options, with the result that incentive stock options are rarely utilized.[249] To understand why incentive stock options are rarely used, consider the following example.[250]

Suppose that X Corp. is contemplating issuing an option to an employee with an exercise price of $100 for one share of stock. First, consider the tax treatment if the option is nonqualified. The employee's receipt of the option is not taxable as long as the option does not have a "readily ascertainable fair market value" as described in Treasury Regulation § 1.83-7.[251] If the stock value increases to $200 and the employee exercises the option, the employee will have $100 of ordinary income,[252] and the corporation that granted the option will have a deduction of $100.[253] Assuming that the employee immediately sells the stock and pays tax at a 31 percent marginal rate and the corporation pays tax at a 34 percent marginal rate, the employee will have a net after tax return of $69 and the corporation will have obtained the benefit of a $100 deduction from income which increased its after-tax cash flow by $34.

Next, consider the tax treatment if the option is an incentive stock option. Again, receipt of the option is not a taxable event so long as Treasury Regulation § 1.83-7 is satisfied. When the incentive stock option is exercised, the corporation will not have a de-

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248 *See supra* text accompanying notes 222-228.

249 *See* Mayer Siegal et al., *Executive Compensation: Stock and Phantoms, in* 47 NEW YORK UNIVERSITY INSTITUTE ON FEDERAL TAXATION § 6.02, at 6-5 to 6-6 (Annual Conference on Employee Benefits and Executive Compensation 1989).

250 This example is based on an example from BITTKER &. LOKKEN, *supra* note 4, ¶ 60.6.1.

251 *See supra* note 219 and accompanying text.

252 I.R.C. § 83(a) (West Supp. 1992).

253 The corporation's deduction of the $100 depends, of course, upon satisfying the requirements of § 162. Treas. Reg. § 1.83-6(a)(1). Thus the expense must be an "ordinary and necessary" business expense which constitutes reasonable compensation and which is not a capital expenditure. BITTKER & LOKKEN, *supra* note 4, ¶ 60.4.5.

duction[254] and, the employee will not recognize income.[255] Assuming that the employee satisfies the requisite holding periods and then sells the stock for $200, the employee would have a capital gain of $100. After paying a tax of 28 percent for the capital gain, the employee would have $72.

From the employer's perspective, nonqualified options are preferable because the employer gets a $100 deduction when the option is exercised. In contrast, the employee may at first glance seem to prefer incentive stock options because no gain is recognized upon the exercise of the option but instead is deferred until the stock is ultimately sold, and because of the preferential capital gain treatment. However, the incentive stock option has significant disadvantages.[256] In order to obtain the preferential treatment, the executive must hold the stock for the required one year holding period. All other factors being equal, stockholders generally prefer liquidity, i.e., the ability to convert stock to cash whenever they wish.[257] Moreover, executives generally prefer as much compensation as quickly as possible, rather than deferred compensation, because they prefer to maximize the present value of their return on the investment of their human capital.[258] Additionally, incentive stock option plans have to be approved by stockholders,[259] while no such requirement exists for nonqualified options.[260]

"Fortunately" for management, there is a tax "excuse" that justifies using nonqualified options and that leaves both the corporation and employee better off. Recall that with respect to the incentive stock option the executive had $72 after holding the stock for one year and paying tax on the gain, and the corporation had no deduction. With respect to the nonqualified option,

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254 I.R.C. §§ 421(a)(2), 422(a) (West Supp. 1992).

255 *Id.*

256 *See* BITTKER & LOKKEN, *supra* note 4, at ¶ 60.6.

257 *See supra* text accompanying note 195.

258 *See generally* Fama & Jensen, *supra* note 6, at 303. The executive might prefer to hold the stock, however, if he or she is advanced in age and wishes to take advantage of the step-up in basis at death under § 1014(a). The step-up in basis would enable his or her estate to avoid paying income tax on the difference between the amount paid for the stock and the fair market value of the stock at the time of death. *See* BITTKER & LOKKEN, *supra* note 4 ¶ 60.6.1.

259 I.R.C. § 422(b)(1) (West Supp. 1992).

260 An additional benefit to management which arises from stock options (both incentive and nonqualified) is that the corporation is not required to report an expense on its income statement when an option is granted and when the option is exercised. Accounting Principles Board Opinion No. 25 (Oct. 1972).

the executive had $69 after tax and the corporation had a $100 deduction. The $100 deduction increased the corporation's cash flow by $34 since the $100 deduction was not attributable to a cash payment to the employee, but instead the issuance of stock.[261] The corporation can give the executive the economic benefit of the incentive stock option by giving him or her the nonqualified option and paying him or her $4.35 cash upon exercise of the nonqualified option.[262] Upon exercise of the option, the executive will recognize $100 of ordinary income from the exercise and $4.35 of ordinary income from the cash payment. If the executive immediately sells the stock received upon exercise of the option, he or she will have $72 after paying tax on the recognized income, the same amount the executive would have with the incentive stock option. Moreover, the corporation gets a deduction of $100 for the transfer of stock and a deduction of $4.35 for the payment of cash. The net affect on the corporation's cash flow of deducting $104.35 and paying $4.35 cash to the employee is that it increases its net cash flow by $31.13.[263]

A corporation is most likely to prefer incentive stock options over nonqualified options when it does not need additional deductions, or when it cannot expend the cash to reimburse the employee for the tax liability arising from the exercise of a nonqualified option. These situations are most likely to arise when the corporation is in the start-up phase or when it is not profitable.[264] When a corporation is in the start-up phase, however, tax incentives such as incentive stock options are not needed to more closely align management with stockholders because the stockholders (frequently venture capital firms or members of the management team of the company) are usually already carefully monitoring the activities of management. Venture capitalists will generally not invest in a corporation unless they are given tight control over management. Similarly, if the corporation is not profitable, it is unlikely that incentive stock options will be used. The poor profitability would likely mean that stock prices are low and

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261 The corporation's issuance of stock upon exercise of the nonqualified option was not costless, however. It did dilute current stockholder ownership by a value of $100.

262 *See* BITTKER & LOKKEN, *supra* note 4, at ¶ 60.6.

263 This is calculated by subtracting the cash outlay of $4.35 from the income sheltered from the deduction ((.34 x 100) + (.34 x 4.35)).

264 *See* Alisa Baker, *Incentive Stock Options Continue to Be a Viable Choice Despite TRA '86*, 68 J. TAX'N 164, 164 (1988) (stating benefits of incentive stock options for start-up companies).

there is no guarantee that the prices will rebound quickly. Management would prefer to use other mechanisms that provide greater assurance of compensation as quickly as possible.[265]

The net result is that the attempt to use incentive stock options as a mechanism for aligning management objectives with stockholder objectives is a failure.[266] Management avoids using them because the holding period defers compensation and restrains liquidity. Even if Congress reduced the holding period requirement, it is unlikely that incentive stock options would be utilized. Management would avoid them because they require stockholder approval and because the corporation can obtain more favorable tax treatment through the use of nonqualified options.

B. *Disincentives for Certain Management Activities—Golden Parachute and Greenmail Provisions*

In addition to encouraging management activity to be more consonant with stockholder objectives by providing incentives for management to become stockholders, Congress has also promulgated Code provisions to *discourage* certain management activities. In particular, Congress has adopted sections 280G and 4999 to discourage the use of golden parachute contracts, which usually pay management large sums in the event control of the corporation changes. Similarly, section 5881 was adopted in order to discourage "greenmail" payments, which are generally payments made by a corporation to repurchase stock at a premium from a person who has made a tender offer or threatened a tender offer for stock of the corporation.

Under section 280G, payments made to an officer, shareholder, or "highly compensated"[267] individual are generally not deductible by the corporation if (1) the payments are contingent on a change in ownership or effective control of the corporation or in the ownership of a substantial portion of the corporation's

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265 *See supra* text accompanying notes 52-55.

266 For an interesting critique of other tax policy problems with incentive stock options, see Michael W. Melton, *The Alchemy of Incentive Stock Options—Turning Employee Income Into Gold*, 68 CORNELL L. REV. 488, 500-12 (1983).

267 The term "highly compensated" individual is defined in I.R.C. § 280G(c) as a member of a group which consists of the highest paid one percent of the corporation's employees or highest paid 250 employees, whichever group is smaller. I.R.C. § 280G(c) (West Supp. 1992).

assets, and (2) the present value of the payments are at least three times the individual's average annual compensation from the company over the past five years.[268] If the payment is not deductible by the corporation, the recipient of the payment must pay an excise tax equal to 20 percent of the amount of the payment which the corporation can not deduct.[269] The recipient may not deduct the excise tax.[270]

Under section 5881, a nondeductible tax of 50 percent is imposed on gain that a person realizes upon the receipt of a "greenmail" payment.[271] The term "greenmail payment" is defined to include any payment made to a stockholder who has held stock for less than two years and has threatened or actually made a public tender offer for the company's stock, if the payment has not also been offered to all other stockholders of the company.[272]

Interestingly, the golden parachute provisions and greenmail provisions were enacted by Congress for conflicting purposes. Congress adopted the golden parachute provisions in 1984 in order to discourage management from shielding itself from hostile takeovers.[273] Congress was concerned that the large payments triggered by a takeover would discourage takeovers and thereby enable management in effect to entrench itself.[274] Congress also wanted to insure that golden parachutes would not bias management in favor of a hostile takeover that was not in the best interest of stockholders.[275] Thus, Congress seemed interested in insuring that the takeover market would operate efficiently without managerial bias in order to enable the takeover market to police corporate efficiency.[276]

However, three years later, Congress adopted the greenmail provisions with the stated purpose of discouraging hostile takeovers.[277] Congress had apparently concluded by 1987 that

268 *Id.* § 280G(a).

269 I.R.C. § 4999 (West 1988).

270 I.R.C. § 275(a)(6) (West Supp. 1992).

271 *Id.* § 5881(a).

272 *Id.* § 5881(b).

273 STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, AT 199 (Comm. Print 1984).

274 *Id.*

275 *Id.*

276 *See id.* at 199-200.

277 *See* H.R. REP. NO. 391, 100th Cong., 1st Sess., pt. 2, at 1086 (1987).

the beneficial role that a takeover played in policing efficiency was outweighed by the social harm in terms of unemployment and disruption.[278] Although greenmail provisions also have the effect of preventing management from entrenching itself by in effect "buying off" the bidder, the committee reports did not express that as another objective of the greenmail legislation.[279]

1. Problems with the Golden Parachute Rules

Greenmail and golden parachute provisions reflect an incomplete understanding of the separation of ownership from control issues.[280] The golden parachute provisions that are aimed at preventing management of the target corporation from polluting the takeover process by exacting a large fee assumes a pristine take-over market which is not affected by management of the *bidder* companies seeking to achieve its own objectives. By ignoring the fact that management of the bidding corporation may be seeking to achieve its own objectives rather than impose efficiency on the target, the rule seriously misjudges the utility of golden parachute agreements.

Although, on average, corporations subject to hostile takeovers are less efficient than other companies,[281] not all takeover targets are inefficiently managed.[282] Management of bidding companies may attempt acquisitions of very well managed companies in order to achieve their own objectives.[283] The objectives of the bidding company's management might include increased job security or an increase in the size of the company in order to justify increased compensation.[284] In an analysis of 326 acquisitions involving pub-

278 *See id.*

279 *Id.*

280 The provisions have many other problems from a tax policy perspective which are insightfully analyzed in Edward A. Zelinsky, *Greenmail, Golden Parachutes and the Internal Revenue Code: A Tax Policy Critique of Section 2806, 4999 and 5881*, 35 VILL. L. REV. 131 (1990).

281 Andrei Shleifer & Robert W. Vishny, *Value Maximization and the Acquisition Process*, 2 J. ECON. PERSPECTIVES 7 (1988). The study found that the average Tobin's "q" for a sample of 371 firms in the Fortune 500 was .848 while the average Tobin's "q" for firms from that sample, which were subsequently subject to a hostile takeover, was only 0.524. The "q" represents the ratio of the market value of a firm to the replacement cost of the firm's physical assets. Firms with a low "q", therefore, tend to be less efficient. Thus, the study suggests that on average less efficient firms are subject to takeovers. *Id.*

282 Morck et al., *supra* note 32, at 31-32.

283 *Id.*

284 *Id. See also* Richard Roll, *The Hubres Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986).

licly held companies, one study found that 25 percent of the acquisitions not only had a negative economic impact on the stockholders of the bidding company as exhibited by a decline in the price of the bidding company's stock price, but that the combined value of the target and bidder dropped.[285] The study suggests that at least 25 percent of acquisitions involving public companies do not make any economic sense.

The problem with the golden parachute rules is that they fail to recognize the fact that although golden parachutes may help entrench inefficient management, in certain instances they may help protect efficient management from inefficient bidders.[286] Congress seemed partially aware that golden parachute payments might benefit stockholders because it exempted payments by "small business corporations"[287] and corporations whose stock is not publicly traded and whose stockholders have approved the golden parachute payment from the general rule that such payments are not deductible and are subject to an excise tax.[288] However, by their very nature such corporations are not likely to be subject to hostile takeovers since their stock is not publicly traded. Thus, the corporations most likely to benefit from providing security to its management—efficiently managed public corporations—do not have the ability to avoid the disadvantageous tax treatment of golden parachute rules through a stockholder vote which approves the parachute.

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285 Morck et al., *supra* note 32, at 32.

286 Many commentators have noted that golden parachute payments may benefit stockholders. *See, e.g.*, John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 75-76 (1986); Jonathan R. Macey, *Externalities, Firm—Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes* 1989 DUKE L.J. 173, 186 (1989); Richard A. Posner, *Law and the Theory of Finance: Some Intersections*, 54 GEO. WASH. L. REV. 159, 166 (1986). However, this view is not shared by all commentators. *See, e.g.*, Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 285 n.114 (1984); David W. Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153, 183 n.105 (1986); Martin Riger, *On Golden Parachutes—Ripcords or Ripoffs? Some Comments on Special Termination Agreements*, 3 PACE L. REV. 15, 39 (1982); Michael Rosenzweig, *Target Litigation*, 85 MICH. L. REV. 110, 149 n.192 (1986).

287 I.R.C. § 1361(b) (West Supp. 1992) generally defines a "small business corporation" as a corporation which does not have more than 35 shareholders, does not have as a shareholder a person (other than estates and certain trusts) who is not an individual, does not have a nonresident alien as a shareholder, and does not have more than one class of stock.

288 *Id.* § 280G(b)(5).

As noted by Professor Zelinsky, the failure of Congress to permit stockholders of public corporations to approve parachute payments may "reflect skepticism about the genuineness of shareholder self governance."[289] However, by denying the deductibility of the payments, Congress has created a tax incentive for stockholders to monitor the utilization of parachute payments because the nondeductibility of the payments will adversely affect the value of the corporation's stock. It seems nonsensical to create an incentive for stockholder monitoring and then preclude stockholder action which results from the incentive.[290] Instead, it is preferable that the tax treatment of golden parachutes be based on neutral income tax principles.[291]

2. Problems with the Greenmail Rules

Analysis of the greenmail provisions also leads to the conclusion that Congress has failed to consider fully the effect of the separation of ownership from control on management behavior. The House Committee Report which accompanied the enactment of section 5881 stated that the greenmail provision was adopted for the following reasons:

> The committee believes that corporate acquisitions that lack the consent of the acquired corporation are detrimental to the general economy as well as to the welfare of the acquired corporation's employees and community. The committee therefore believes it is appropriate to create tax disincentives for such acquisitions. In addition, the committee believes that taxpayers should be discouraged from realizing short-term profits by acquiring stock in a public tender offer and later being redeemed by the corporation in an effort by the corporation to avert the hostile takeover.[292]

Thus, the committee thought that adoption of the greenmail tax would discourage hostile takeover attempts and would also discourage a bidder from bluffing a takeover attempt in order to receive

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289 Zelinsky, *supra* note 280, at 143.

290 Moreover, there is a serious issue as to whether the tax system is an appropriate mechanism for policing golden parachute payments. *See id.* at 187-92.

291 *See id.* at 163-64. The issue with respect to golden parachute payments under normal tax principles is whether the payment constitutes unreasonable compensation which would be nondeductible under Treas. Reg. § 1.162-7(a) (1958). *See* Edwin T. Hood & John J. Benge, *Tax Cost of Protecting Executives When Corporate Ownership Changes Has Increased,* 36 TAX'N FOR ACCT. 92, 92-93 (1986).

292 H.R. REP. NO. 3545, 100th Cong., 2d Sess. 1086 (1987).

a quick profit from selling the shares it had already acquired to the target corporation.[293]

The greenmail tax reduces the benefit associated with an aborted takeover attempt.[294] Thus, in theory, a potential bidder, in weighing the costs associated with a takeover attempt against the benefits of either a successful takeover or a greenmail payment, will reduce the amount of the benefit associated with the greenmail payments as a result of the tax. All other factors remaining unchanged, this reduced benefit is likely to discourage some takeover attempts which would otherwise have occurred.[295]

There is, arguably, a social benefit in deterring hostile takeovers. While the threat of hostile takeovers marginally restricts management in achieving its objectives, it is unlikely that the

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293 As is the case with golden parachutes, commentators generally disagree about the propriety of greenmail payments. Some have argued that greenmail payments may be an appropriate "award" to the people receiving them for identifying inefficient companies. *See, e.g.*, Roger J. Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281, 284 (1985); Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 17 (1985). Others argue that the potential for abuse and the harmful effects of greenmail are too great and, therefore, that it should be prohibited or curtailed. *See, e.g.*, Jeffrey N. Gordon & Lewis A. Kornhauser, *Takeover Defense Tactics: A Comment on Two Models*, 96 YALE L.J. 295, 297 (1986); Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 NW. U.L. REV. 1473, 1502 n.126 (1986).

294 *See* Zelinsky, *supra* note 280, at 174-75.

295 A bidder, in analyzing whether to proceed with a hostile takeover will weigh the expense of the takeover with the expected benefit. If the present value of the expected benefit exceeds the present value of the cost, the takeover will be a worthwhile endeavor from the bidder's perspective. The expected value of the takeover will be the sums of the values of each possible outcome multiplied by the probability of each outcome. For example, in a hostile takeover contest there are at least four probable scenarios: (1) a successful takeover, (2) an aborted takeover with no greenmail and no other takeover bid, (3) an aborted takeover with greenmail, or (4) an aborted takeover followed by another bidder making a tender offer. A bidder would assign an expected value (Ev) to each scenario by multiplying the present value of each outcome (P_{v1}, P_{v2}, P_{v3}, P_{v4}) by the probability (P_1, P_2, P_3, P_4) of each outcome occurring. In other words the expected value of each scenario, i.e., scenarios 1 through 4, is calculated as:

$$Ev_n = Pv_n\ (Pn)$$

where n equals the particular scenario.

The bidder will engage in the takeover if the cost of the takeover C_t is less than the sum of the expected values of the takeover. Thus in our examples the bidder will engage in the takeover if

$$C_t < \Sigma\ Ev_n$$

Obviously, by reducing the value of Ev_3, the expected value of an aborted takeover with a greenmail payment, the overall expected value of the takeover is reduced. Thus, where the bidder maximizes its profits, a tax on greenmail has the effect of rendering hostile takeovers marginally less attractive by reducing the potential gain associated with the takeover.

threat represents a major deterrent to management excesses.[296] Although, on average, corporations subject to hostile takeovers are less efficient than other companies,[297] the inefficiencies of the target must be severe before a profit-maximizing bidder will attempt a takeover.[298] Only then will an opportunity for sufficient gain to offset the expenses of a takeover exist. In situations where the target is severely mismanaged, a hostile takeover is an extremely drastic remedy. It involves a major redeployment of corporate assets and personnel which often severely impacts the corporation's employees and their community.[299] A far better remedy would be one in which the corporation's inefficiencies are ferreted out at an earlier stage as the result of stockholders effectively monitoring management.

The difficulty with the greenmail rule's attempt to discourage takeovers, however, is that not all takeover targets are inefficiently managed corporations. Hostile takeovers may be launched against very well managed companies. As discussed earlier,[300] the management of the bidding companies may desire to acquire well managed companies in order to achieve their own personal objectives. For example, the bidding company's management may be seeking to achieve personal objectives such as increased job security or an increase in the size of the company in order to justify increased compensation. In those situations, hostile takeovers would

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296 Shleifer & Vishny, *supra* note 281, at 12.

297 *Id.* at 11. The foregoing study found that the average Tobin's "q" for a simple of 371 firms in the Fortune 500 was .848 while the average Tobin's; "q" for firms from that sample which were subsequently subject to a hostile takeover was only .524. Because "q" represents the ratio of the market value of a firm to the replacement cost of the firm's physical assets, the study indicates that on average, the poorly managed firms, that is the firms with a low "q" value, were the firms subject to hostile takeovers. *Id.*

298 *Id. See also* DERTOUZOS ET AL., *supra* note 41, at 39 ("Only an extraordinary optimist could believe . . . that the current wave of takeover activity is an efficient way to deal with the organizational deficiencies of American industries."); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1242-43 (1984); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1497-99 (1989) (while threat of hostile takeovers may cause some managers to be more efficient, the "takeover market neither adequately aligns the interests of managers and shareholders, nor adequately addresses the problem of managerial inefficiency."); Lipton & Rosenblum, *supra* note 101, at 202 ("Some hostile takeovers may replace bad managers with new ones . . . . But the threat of a hostile takeover is unlikely to improve the performance of bad managers.").

299 *See, e.g.*, Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 145-46 (1989); Andrei Shleifer & Lawrence H. Summers, *Breach of Trust In Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 47-53 (Alan J. Auerbach ed., 1988).

300 *See supra* text accompanying note 283-84.

harm social welfare if an otherwise well managed company falls under the control of a less well managed company.[301]

In the situation where the target company is well managed and subject to a hostile bid, it would usually benefit social welfare to permit target's management to in effect bribe the poor management of the bidding corporation to discontinue the hostile bid since the greenmail payment would prevent well managed assets from falling into the wrong hands.[302] However, because of the greenmail tax, it is less likely that the bidding company would be amenable to the greenmail payment in exchange for calling off the bid. Thus, the greenmail tax has the effect of discouraging profit-maximizing bidders from making hostile bids for inefficient companies and, at the same time, the tax prevents efficient firms from thwarting takeover attempts by inefficient firms.[303] The better method, if hostile takeovers are viewed as inflicting too high a social cost, is to avoid the situation in which a corporation becomes so inefficient that it is subject to a hostile bid. In any event, the tax laws should not bias the process one way or the other.

VI. CONCLUSION

The preceding sections have shown that tax provisions which Congress intended to promote a long-term stockholder view or to motivate management to adopt stockholder objectives are not successful because management, not the stockholders, control public corporations. The failure to appreciate the relative powerlessness of stockholders in affecting managerial behavior has resulted in a failure to analyze the potentially harmful impact of a capital gains preference, and of the golden parachute and greenmail excise taxes. Similarly, in the case of incentive stock options, the failure to consider fully the availability of alternative

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301 There is some evidence that bidding companies which make poor selections of target companies are themselves subject to takeovers more frequently than other companies. Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets*, 98 J. POL. ECON. 372, 375-76 (1990). However, it is unlikely that such takeovers provide a major deterrent because of the expense and infrequency of a hostile takeover. Morck et al., *supra* note 32, at 32.

302 *See* Richard A. Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635, 1662 (1988); Richard A. Booth, *Management Buyouts, Shareholder Welfare and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630, 662-63 (1985).

303 *See generally* Eric A. Lustig, *The Emerging Role of the Federal Tax Law In Regulating Hostile Corporate Takeover Defenses: The New Section 5881 Excise Tax on Greenmail*, 40 U. FLA. L. REV. 789, 825-27 (1988) (arguing that the greenmail provisions are overinclusive).

tax incentives for nonqualified options has resulted in management obtaining tax "subsidized" stock ownership without complying with the incentive stock option requirements.

This Article strongly recommends that policymakers fully consider the interaction of the separation of ownership from control in public corporations with tax provisions intended to increase productivity or otherwise promote desired stockholder or management behavior. For example, this analysis should be incorporated in determining the best method to alleviate corporate distributions from a double income tax under some form of corporate tax integration. It has been noted that a model of full integration, pursuant to which corporate income would be taxed directly to stockholders, would provide a strong incentive for stockholders to inquire about the profitability of projects for which the corporation's income is retained since stockholders would have to pay tax on their share of the corporation's income even though the income was not distributed.[304] However, as has been discussed by many authors, full integration may not be practical for a number of reasons.[305] Consideration of the various forms of partial integration which would relieve corporate dividends from a double tax without causing stockholders to be taxed on undistributed corporate income should include an analysis of each form's impact on stockholder abdication.

Similarly, consideration of stockholder abdication may be helpful in understanding why entrepreneurs frequently prefer the corporate form of business despite the tax bias which favors the use of a partnership whose income is only subject to a single tax. A recent study has concluded that the disparate tax treatment of corporations and partnerships play only a minor role in the selection of a form of entity for conducting a business.[306] The ability of the management team which started the corporation to control the corporation even after its percentage of stock own-

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304 MCCLURE, *supra* note 141, at 148. Indeed, management opposed full integration of corporate taxes during the 1970's for this very reason. *See, e.g.*, John K. McNulty, *Reform of the Individual Income Tax By Integration of the Corporate Income Tax*, 46 TAX NOTES 1445, 1446 (1990); Lee A. Sheppard, *Corporate Tax Integration, The Proper Way to Eliminate the Corporate Tax*, 27 TAX NOTES 637, 648-39 (1985).

305 *See, e.g.*, MCCLURE, *supra* note 141, at 146-84; Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719, 740 (1981); Zolt, *supra* note 174, at 847 n.41.

306 JEFFRIE K. MACKIE-MASON & ROGER H. GORDON, TAXES AND THE CHOICE OF ORGANIZATIONAL FORM (National Bureau of Economic Research Working Paper No. 3781, 1991).

ership is reduced as a result of the corporation going public may provide insight into management's motivation in selecting the corporate form despite the unfavorable tax treatment of corporations.