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The SEPARATION OF OWNERSHIP AND CONTROL: INCREASING THE RESPONSIVENESS OF BOARDS OF DIRECTORS TO SHAREHOLDERS' INTERESTS?

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I. INTRODUCTION

That the declining competitiveness of many large U.S. corporations can be attributed to their failure to respond to market changes is axiomatic. In this article, we argue that one of the important causes of this failure to respond is rooted in the nature of the corporate governance structure. More specifically, we argue that the governance structure of many firms is not designed to effectively facilitate the motivation of the top management in a way that best represents shareholders' interests. Though they legally meet fiduciary responsibilities to equity holders, boards of directors are often either unwilling or unable to effectively control the firm in ways which preclude top management from placing their interests ahead of those of the shareholders or, for that matter, those of other important stakeholders. As we will demonstrate in this paper, the theoretical and research literature is quite clear regarding this issue; studies show that firms controlled by management are less effective than those in which equity holders control the firm.[1]

The public press, too, has taken note of this problem.[2] Some U.S. firms, such as General Motors (GM), have endured a long, steady

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1. The question of who controls the firm is old and an important one. The concept of ownership rights in the firm through equity holdings is made legitimate by the doctrine of private property. As a result, stockholders should control the firm. However with wide dispersion of stockholders and the laws governing the corporation, ultimately control rests with managers. But how dispersed must the stock be for the owners to lose control? In 1937, the SEC suggested that 10% stock ownership was sufficient to control the firm. Some research suggests that if a single equity holder controls as little as 5% of the voting stock, equity holders can have significant influence on the behavior of managers in the firm. The research divides firms into owner-controlled (OC) and management-controlled (MC) types. Those with at least one equity holder with a stockholding of at least 5% or more are called owner-controlled (OC). When there is no equity holder with holdings of at least 5%, the firm is called a management-controlled (MC) firm. In management-controlled firms, equity holdings are so diluted that the owners cannot exert sufficient control over the managers, giving managers broad discretion to act in their own, not the stockholders' interests. In an owner-controlled firm the stockholder has the power to align the incentive structure of management with the owners. For a discussion of the issues regarding the level of ownership concentration necessary for ownership influence to be exerted, see Herbert G. Hunt, *The Separation of Corporate Ownership and Control: Theory, Evidence, and Implications*, 5 J. ACCT. LITERATURE 85-124 (1986). *See also* Gerald Salancik & Jeffrey Pfeffer, *Effects of Ownership and Performance on Executive Tenure in U. S. Corporations*, 23 ACAD. MGMT. J. 653-64 (1980). Salancik and Pfeffer note that while "the exact amount of stock needed to control a firm effectively is unknown, as is the precise functional relationship between ownership concentration and control . . . [if] theory predicts differences depending on ownership classification, and a classification is found that is consistent with the theory, then there is reasonable assurance that the categorization has some validity." *Id.* at 658.

2. No legal citation is necessary to confirm the salience of this issue. President George Bush, accompanied by representatives of the largest U.S. automobile manufacturers, recently

decline in profitability, but failed to replace its Chief Executive Officer (CEO), Roger Smith. Even when GM started closing plants, the board of directors did not replace the CEO.[3] In 1990 Time Warner reported a $227 million loss, yet CEO Steve Ross collected a bonus of $2.075 million, his salary of $800,000, as well as another $400,000 in deferred compensation.[4]

Concurrently, shareholder activism has escalated. For example, several dissidents won minority representation at Cleveland-Cliffs Inc. and at Baltimore Bancorp. However, proxy fights may not be a viable long term solution. The confrontations are risky, time consuming, more expensive than tender offers and allow no immediate payoff for the dissenter. Also, "free riders"[5] receive the benefits won by the dissident without providing any financial support.[6]

Entrenched managements have also been assisted in some states by legislatures which have virtually removed the threat of hostile takeovers.[7] Essentially, this legislation prevents takeover entrepreneurs from entering capital markets with a tender offer, thus rendering useless one of the forces in the market for corporate control which can have a disciplining effect, curbing management's opportunistic behavior.[8]

This article describes the nature of the problem, both theoretically and empirically, and one of its fundamental causes, that is the nature of the corporate governance structure. The first section of the article examines the separation of ownership and control in the modern corporation from the perspective of the theory of managerial capitalism. The next section illustrates how owner- versus manager-controlled firms differ with respect to performance and board composition. Next, legislative and policy proposals are examined and their potential effects

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visited Japan to participate in discussions that he hoped would improve the U.S. automotive industry's international competitive position. The industry sustained considerable losses in the past decade and has been forced to lay off workers and close plants. Other U.S. industries, such as electronics and computing equipment have been similarly affected.

3. Peter Passell, *Those Big Executive Salaries May Mask a Bigger Problem*, N.Y. TIMES Apr. 20, 1992, at A1.

4. Graef S. Crystal, *The Prince of Pay*, FORTUNE, Sept. 30, 1991, at 95.

5. "Free riders" are shareholders other than the dissident in the firm.

6. Judith H. Dobrzynski, *Cutting Loose from Shareholder Activists*, BUS. WK., July 8, 1991, at 34.

7. DEL. CODE ANN. tit. 8, § 203 (1983). The Delaware Statute prohibits a stockholder who purchases fifteen percent or more of a Delaware corporation from engaging in a business combination with that firm for three years unless board approval is obtained prior to the acquisition. *Id.*

8. *See supra* note 6, at 34.

assessed. Finally, a solution is proposed which requires a fundamental change in the structure of corporate governance. The proposal is, essentially, to return control of the firm to shareholders by ensuring that directors are independent of the CEO. This should result in boards which are more likely to act in the interests of the shareholders and which hold the executive more directly responsible for firm performance.

II. THE SEPARATION OF OWNERSHIP AND CONTROL

A. *Historical Development*

Adam Smith noted that corporations were established so that the risk of conducting business particularly, foreign commerce, could be shared by a group of individuals and also because no single individual possessed the funds needed to finance foreign trade.[9] This business arrangement, according to Smith, produced owners — shareholders — who knew relatively little about the operations of their company.[10] Rather, these owners, or shareholders, treated the company as an investment, focusing on the dividends paid out and relying on directors to oversee the daily operation of the firm.[11] Smith observed that these directors, or managers, who were charged with the responsibility of running the corporation, did not always do so in the best interests of the shareholders.[12] Shareholders sought to maximize their wealth through passive investment, but managers, having no personal stake in the firm, had no incentive to support shareholder objectives.

The pervasiveness and the effects of the separation of ownership and control in the modern corporation are articulated in the theory of managerial capitalism[13] and in the Berle-Means Hypothesis.[14] The

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9. ADAM SMITH, THE WEALTH OF NATIONS 690 (Cannan ed. 1937).

10. *Id.* at 699.

11. *Id.*

12. Smith notes that,

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

Id. at 700.

13. ROBIN MARRIS, THE ECONOMIC THEORY OF MANAGERIAL CAPITALISM 43 (1964).

14. ADOLPH BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 139 (1932).

Berle-Means Hypothesis is clearly illustrated in U.S. industry by the increasing incidence of a wider dispersion of ownership, leading to the separation of ownership and control and a reduction in the power of owners to direct the operation of the firm.[15] Managers may be motivated to pursue not only personal profit objectives, but also prestige and power.[16] Thus, goals of management may be quite different from those of the shareholders. Consequently, the best interests of the owners will most assuredly not be served when a personal profit-seeking group is in control.[17] This situation prevails even though the law requires that management must devote attention to business and to the interests of the corporation and must exhibit reasonable business prudence.[18] While the situation could be reversed if shareholders collaborate to become a majority interest,[19] typically that dissatisfied equity holders simply sell their shares.

One way that management's self-seeking interests are often served is through efforts to expand the size of the firm. In fact, one commentator has noted that "size rather than the industry as such is responsible for the observed industrial differences in compensation" between executives in firms controlled by managers and firms controlled by owners.[20] But this is not usually an unbridled search to maximize their

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15. *Id.* at 120. Berle and Means also note that,

> When the owner was also in control of his enterprises he could operate it in his own interest and the philosophy surrounding the institution of private property has assumed that he would do so. This assumption has been carried over to present conditions and it is still expected that enterprise will be operated in the interests of the owners. But have we any justification for assuming that those in control of a modern corporation will choose to operate it in the interests of the owners? The answer to this question will depend on the degree to which the self-interest of those in control may run parallel to the interests of ownership and, insofar as they differ, on the checks on the use of power which may be established by political, economic, or social conditions.

Id. at 121.

16. *Id.* at 139.

17. *Id.* at 122.

18. *Id.* at 235. Alan R. Parmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1353, 1351-1464. "It is a fundamental principle of corporate law that directors owe fiduciary duties of care and loyalty to their corporation and its body of shareholders." *See also* DEL. CODE ANN. Tit. 8, § 141 (b) (1983); MODEL BUSINESS CORP. ACT § 8.03 (1984). Officers of the corporation are appointed by the directors and oversee the daily operation of the company. *See e.g.*, DEL. CODE ANN. Tit. 8, § 142 (1983); REV. MODEL BUSINESS CORP. ACT §§ 8.40-8.41 (1984).

19. Berle & Means, *supra* note 14, at 277.

20. DAVID R. ROBERTS, EXECUTIVE COMPENSATION 45 (1959).

self-interests without some regard for shareholder wealth.[21] They seek to ensure that profits are high enough to placate stockholders, but are concerned with maximizing total revenue — not necessarily owner returns. This behavior is undeniably unexceptable from the point of view of the stockholder, and, worse, entrenches management since no dire cause for concern is apparent.[22] Another commentator similarly noted that "managers pursue organizational size and growth because of the power, salary, status, and security that come with attaining these objectives."[23]

Such growth strategies divert funds from competing projects including the issuance of dividends that may otherwise yield a greater return on investment. Continued diversion of funds from profitable ventures to growth objectives will eventually cause the rate of return to the firm to fall. When this happens, the firm's stock price will fall and the firm will be vulnerable to takeover. The threat of takeover — and the subsequent loss of a personal income stream — forces the manager to maintain a minimally acceptable level of return and to keep share prices in a "safe region."[24]

B. *The Empirical Evidence*

Empirical evidence supports the assertion that, given different objectives of owners and managers, the performance and practices of owner-controlled firms differ from those of manager-controlled firms. With the link between firm size and executive pay, managers have incentives to cause the firm to grow, often beyond the optimal size of the firm.[25] The growth permits managers to increase the resources under their control, increase their compensation, and increase their ability to reward middle managers through promotion.[26] However,

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21. WILLIAM J. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH 43 (1959). Baumol notes that,

> In recent years the managers of large firms have displayed signs of a desire for respectability and security. To avoid difficulties with the public regulatory authorities as well as with their own stockholders, managements have veered away from the rough and tumble. . . . In some cases I have seen the possibility of competitive countermoves considered as a sort of breach of etiquette. . . .

Id. at 30.

22. *Id.* at 50.

23. WILLIAM A. MCEACHERN, MANAGERIAL CONTROL AND PERFORMANCE 9 (1975).

24. *Id.* at 43.

25. Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323-29 (1988).

26. *Id.* at 323.

suboptimal size means suboptimal returns to owners. A study of 500 U.S. manufacturing firms revealed that, consistent with the predictions of "managerial models, owner-controlled firms' rate of return are higher and more variable than the returns on managerial-controlled firms . . . the industry membership effect on individual firm rates of return, risk, and size is significant . . . across all classifications, risk and return are systematically and positively related."[27] Other empirical evidence shows that owner-controlled firms are more profitable than manager-controlled firms.[28] This is likely due to the higher level of monitoring of management and greater alignment of managerial incentives with owners' interests in owner-controlled firms.[29] Higher levels of monitoring and compensation alignment should lead to higher firm performance.[30]

C. *The Principle-Agent Problem*

Principle-Agent Theory frames this issue of divergent interests in the anagement of large corporations. The shareholders of a firm are the residual claimants for its profits, hence it is in the best interest of the shareholder to maximize the profits of a firm. When a firm is not acting to maximize profits, the cause may be attributable to the separation of ownership and control.[31] In such a case, a principle-agent problem exists. Both the principle and the agent are assumed to be utility maximizers and will endeavor to pursue their own respective objectives.[32] The agent (the manager) takes certain unobservable action on behalf of a principle (the shareholders) that result in an observable outcome (profits). In the principle-agent context, there is a basic incentive problem: the agent's objectives are not aligned with those of the principle, resulting in residual losses to the agent. One solution is to reward the agent with a fixed percentage of the profits so that there is no longer an incentive to make suboptimal decisions.[33] Then, decisions that maximize the agent's personal profit similarly maximize

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27. Kenneth J. Boudreaux, *Managerialism and Risk-Return Performance*, 39 S. ECON. J. 368-69, 366-72 (1973).

28. *Id.* at 369.

29. Henry L. Tosi & Luis R. Gomez-Mejia, *The Decoupling of CEO Pay and Performance: An Agency Theory Perspective*, 34 ADMIN. SCI. Q. 179, 169-89 (1989).

30. *Id.* at 169.

31. JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 35 (1988).

32. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 308, 305-60 (1976).

33. *Id.*

the principle's profit.[34] A second solution is that the principle incur monitoring costs to ensure, within limits, that the agent is indeed making decisions in the best interest of the principle.[35] Similarly, the agent may post a bond to guarantee that he will not pursue actions that will be harmful to the principle.[36]

Monitoring expenditures by the principle, the bonding expenditures by the agent, and the residual loss that results from the failure to perfectly align principle and agent interests are defined as agency costs.[37] However, even if the principle is willing to incur agency costs of monitoring, it may still be difficult to effectively control agents. For example, a characteristic of many managerial situations is the executive team. In team production, it is difficult to ascertain if an agent is shirking since his effort may not be separable from the efforts of others.[38] In such an instance, monitoring may be difficult or impossible.[39] Additionally, "[t]here may be uncertainty about the tasks (or the value of the tasks) that any member of the organization will be undertaking, about his(her) ability to undertake these tasks, and about the way in which he(she) will or has undertaken these tasks."[40]

Monitoring is also problematic when the agent's action does not completely determine the outcome.[41] What action is optimal for a given set of circumstances is unclear. Furthermore, several actions may yield the same optimal result. As such, no standard against which to measure the appropriateness of an agent's actions exists.

The problems of moral hazard (hidden action) and adverse selection (hidden information) further complicates the monitoring process.[42] Moral hazard refers to the actions (or inactions) carried out by the

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34. This explanation of the agency relationship assumes that both the agent and the principle are risk-neutral. When one or both parties are risk averse, a more involved incentive structure is required. *See* TIROLE, *supra* note 31, at 36 for a technical discussion.

35. *See supra* note 32, at 308.

36. *See supra* note 32, at 308.

37. *See supra* note 32, at 308-09.

38. Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 779, 777-95 (1972).

39. *Id.* at 779. "Two men jointly lift heavy cargo into trucks. Solely by observing the total loaded per day, it is impossible to determine each person's marginal productivity. With team production it is difficult, solely by observing total output, to either define or determine each individual's contribution to this output of the cooperating inputs." *Id.*

40. James A. Mirrlees, *The Optimal Structure of Incentives and Authority Within an Organization*, 7 BELL J. ECON. 107, 105-31 (1976).

41. Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPLES AND AGENTS: THE STRUCTURE OF BUSINESS 37, 37-51 (Pratt & Zechhauser, eds., 1985).

42. *Id.* at 38.

agent which are unobservable by the principle. Adverse selection addresses the problems of information asymmetry. In this situation, the agent has more information with respect to the optimal choice of action than does the principle. Hence, the principle is unable to evaluate the agent's action since the proper action is unknown.

These agency problems, however, are eventually resolved by market forces. Inefficient firms and managers will be disciplined, and agency costs will be reduced in the long run. But, in the short run, which may extend over a long number of years, inefficiencies and losses arising from management control and intransigence are unnecessary. For example, many believe that the U.S. automobile industry has begun to be more competitive with foreign manufacturers after years of difficulty. The industry lost its world leadership and led to disastrous effects in the manufacturing sector of the economy. The market did, indeed, work. Nevertheless, we contend that the response of the industry should have — and would have — been quicker had the top management of those firms been less entrenched. If their employment and income had been more contingent on firm performance, we believe the current situation would have been very different.

III. Some Proposed Solutions

A. *Suggested Regulation*

There is no doubt that costs of such management failures to respond to market forces are borne by equity holders and other stakeholders while the top management of the firm appears to be insulated from negative effects. For this reason management faces growing pressure to be more accountable and less free to extract high compensation from firms when performance is low. One suggested approach to accomplish this is through legislation of CEO compensation. Congress and the Securities and Exchange Commission have introduced proposals to limit compensation levels and to promote shareholder participation in executive pay decisions. One proposal limits the amount of executive compensation that firms may deduct as a business expense to twenty-five times the amount of the lowest paid employee. Another approach directly prohibits the deduction of executive compensation in excess of $1 million.[43]

Our thesis is that the matter is better resolved through modifications in the corporate governance process, an area of much current

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43. Janet Fuersich & Barry Cosloy, Executive Compensation Practices Under Fire, Benefits Briefing (Coopers & Lybrand, eds. 1992).

controversy.[44] It is doubtful that legislation of the type proposed is likely to increase managerial accountability and may serve only to limit that form of compensation which it covers. Outcomes not envisaged by some of the legislative proposals could be equally problematic. Consider the instance of Michael Eisner, the CEO of The Walt Disney Company: since many Disney employees earn the current minimum wage ($4.25 per hour), his annual income, based on a forty hour work week, would be approximately $221,000 if legislation limited CEO pay to that twenty-five times the amount of the lowest paid employee. Under Eisner's direction, Disney's reported earnings increased from $98 million in 1984 to $824 million in 1990 while Eisner's income for those six years totaled over $100 million.[45] Without debating the merits of either salary level, most would agree that given the lower salary, there would be very limited alignment of managerial and owners' interests. Similarly, legislation regarding information disclosure may not be practical. Since management is responsible for the information disclosure, they can exercise discretion in the compilation and presentation of such information, effectively exploiting information asymmetries.

While there is no current evidence regarding the precise unintended and undesirable consequences of the proposed compensation legislation, the results of research on the effects of state legislation restricting takeovers is illustrative. This legislation appears to have exacerbated the problem it was trying to remedy. The wave of "so-called second generation antitakeover statutes [permitted] managers to stage takeover defenses not envisaged in the original corporate charter, thereby helping to preserve their income streams at the expense of shareholder wealth."[46] Thus, these laws actually harm stockholders.[47]

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44. Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV., 1732, 1671-1734 (1985) notes that,

> State corporation law is in a state of flux, partly caused by, and partly a cause of, a crisis of nerve. In the central sector of shareholder governance rights, traditional enabling-law philosophy, excessively aggressive efficiency rationales, and powerfully focused managerialist strategy have combined to weaken an already inarticulate faith in the primacy of owner over manager.

See also Richard M. Buxbaum, *Corporate Legitimacy, Economic Theory, and Legal Doctrine*, 45 OHIO ST. L.J., 515, 517, 541-42 (1984).

45. Rita Koselka, *Mickey's Midlife Crisis*, FORBES, May 13, 1991, at 42.

46. Richard N. Langlois, *Contract, Competition, and Efficiency*, 55 BROOK. L. REV., 831, 831-52 (1989).

47. Stephen Mahle, *Proxy Contests, Agency Costs, and Third Generation State Antitakeover Statutes*, J. CORP. L., 760, 721-61 (1990) states that,

This legislation effectively quelled one of the disciplining forces of the market on management, and, more specifically, on the boards of directors.[48]

However, neither do we believe that it is most efficacious to leave the resolution to markets, given the current state of corporate governance laws in the United States. In the ideal world of theoretical economic models, most would agree that competition in markets generally leads to efficient outcomes, but that the breakdown of that competition results in inefficient bargains between management and shareholders.[49] Typically, such bargains do not optimally utilize shareholder assets and stock prices decline as shareholders divest the stock in favor of a more lucrative portfolio. As the stock becomes undervalued, share prices drop and equity holders may be forced to take lower prices when selling the stock. Takeover attempts will result with an increase in the rise in the stock price of the acquired firm. Such a response is taken to mean that investors believe that a new management team will improve the firm performance over the old management team.[50] Evidence exists that shows substantial increases in productivity after both leveraged buyouts and management buyouts.[51] Thus, markets forces eventually compel inefficient firms toward efficiency, but at what we believe to be at very high costs, which, we contend, can be reduced substantially with changes in corporate governance as we propose below.

Economic analysis of state antitakeover laws indicates that the recent proliferation of Just-Say-No laws harm stockholders of corporations that are chartered in Just-Say-No states. These statutes prohibit hostile tender offers and force would-be tender offerors to attempt to gain control of corporations by using proxy fights. Proxy fights are difficult to win, and even when proxy dissidents are successful, the resulting management team has the propensity to subject stockholders to higher post-control-change agency costs than do successful tender offerors.

48. *See supra* note 5, at 34.

49. *See supra* note 63, at 832; *see also* Henry N. Butler & Larry E. Reibstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767 (1989); Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1180-82, 1203 n.122 (1981).

50. KENNETH M. DAVIDSON, MEGAMERGERS: CORPORATE AMERICA'S BILLION-DOLLAR TAKEOVERS 283 (1985); *see also* Michael Jensen & Richard Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 11-13, 5-50 (1983).

51. Frank R. Lichtenberg & Donald Siegle, The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behavior, Discussion Paper, U.S. Department of Commerce, Bureau of the Census, 1989.

B. *Alternative Policy Proposals*

Many believe that more legislation of corporate governance is not necessary, that these problems can be resolved by more responsible actions within the firm. Such advocates have proposed policy recommendations which utilize existing, internal processes to control managers.[52] Three such proposals are discussed below.

Proposal 1. Link Managerial Compensation and Performance

Research shows that the pay of chief executives is related to firm performance, but the relationship is not a strong one.[53] Further, the link between pay and performance may be even weaker when managers, not owners, control firms. CEO base pay in management-controlled firms tends to be more strongly related to organization size, but when owners control the firm, performance has significant effects on base pay.[54] CEO bonuses and long term income, however, are both related to performance in management-controlled firms as well as owner-controlled firms. Evidence indicates that management-controlled firms have a greater propensity than do owner-controlled firms to merge and acquire.[55] Thus, one can infer that the design of incentive structures of management-controlled firms motivates managerial behavior to maximize firm size rather than profitability, which promotes the managements' own interests.[56] Therefore, CEO's in management-controlled firms have less performance risk than CEO's in owner-controlled firms. In management-controlled firms, the policies which govern bonus and long term income of CEO's are structured to reduce

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52. Murray Weidenbaum & Stephen Vogt, *The Pot Versus the Kettle*, 30 CHALLENGE 59-60, 56-60 (1987).

53. John Deckop, Twenty-five Years of Executive Compensation: A Look Back and Suggestions for the Future, Paper presented at the Southern Academy of Management, New Orleans, LA, 1987.

54. Luis R. Gomez-Mejia, Henry L. Tosi & Timothy Hinkin, *Managerial Control, Performance and Executive Compensation*, 30 ACAD. MGMT. J. 62, 51-70 (1987).

55. Roger Blair & David Kaserman, *Ownership and Control in Modern Organizations*, 11 J. BUS. RES. 337, 333-44 (1983).

56. There are other reasons that the "size/pay" relationship which enhance management interests as a result of growth and acquisition. Acquisitions help managers diversify their employment risk. An investor may diversify risk by investing in several firms. A manager, like other employees, cannot easily diversify his or her human capital which may be invested in the single firm of employment. *See* Yakov Ahimud & Baruch Lev, *Risk Reduction as a managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605-17 (1981). Acquisition and merger might lead to less variable income and, with the further effects of income smoothing discussed in the next section, decrease the risk associated with losing the job.

pay variability and downside risk, and to have a shorter term orientation than in owner-controlled firms. Thus, managers in manager-controlled firms appear able to pursue their own objectives.[57]

> Management-controlled firms clearly designed compensation systems to avoid the vagaries of fluctuating performance . . . . [E]xecutives in management controlled firms appear to have the best of both worlds. Their basic salaries were a function of firms' size, a relatively stable factor, their long term incomes were greater when performance was good and the scale of their organizations provided a downside hedge against poor performance.[58]

Proposal 2. Improve Financial Reporting to Facilitate Shareholder Influence

The SEC has issued directives that require firms to publish shareholder proposals regarding executive compensation and to directly disclose executive compensation in proxy statements. An additional directive requires the Financial Accounting Standards Board to investigate valuation procedures for stock options included in executive compensation plans.[59] More accurate and timely financial reporting would allow the equity holder to better monitor investment decisions and understand more about top management compensation. However, the evidence shows that the financial reporting practices of management-controlled firms and owner-controlled firms differ in ways which create an information disadvantage for the equity holders in manager-controlled firms. Management-controlled firms are more likely than owner-controlled firms (1) to report financial data in the best possible light,[60] (2) to use inventory methods and other accounting practices which overstate earnings, and (3) utilize income smoothing strategies which will minimize the appearance of earnings variability.[61] In one study of market reactions to tender offers, researchers found that equity holders in management-controlled firms realized merger anticipation premiums in the market prices of their holdings much later than equity holders in owner-controlled firms.[62] Managers of manage-

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57. *See supra* note 71, at 62.

58. *Id.* at 65.

59. *See supra* note 43.

60. Herbert G. Hunt, *The Separation of Corporate Ownership and Control: Theory, Evidence, and Implications*, 5 J. ACCT. LITERATURE 114-15, 85-124 (1986).

61. *Id.* at 117-18.

62. In-Mu Haw, Steven Lilien, & Victor Pastena, Market Reactions to Tender Offers for Owner-Controlled Versus Manager-Controlled Firms, Unpublished Paper, Baruch College, CUNY, 1987.

ment-controlled firms appear to be motivated to restrict the leakage of information about tender offers to protect their position by, perhaps, discouraging the tender and potential future tenders.

Proposal 3. Demand More Responsible Actions by Boards

The standard demand is that boards meet their fiduciary responsibility. However, this demand fails to consider that management-controlled firms and owner-controlled firms exhibit different patterns of board influence. The board of directors functions as the monitor of a firm's top executives.[63] They are charged by the shareholders to ensure that shareholder interests are represented and that managerial opportunism is curtailed.[64] The board hires and fires the CEO and the board's compensation committee determines the CEO's pay package. Yet in management controlled firms, boards of directors seem to either lack the power or the incentive to structure the compensation process in ways to discipline the management to act more strongly in shareholders' interests. Researchers have shown that in manager-controlled firms, the CEO was the most influential participant in the CEO pay setting process but that in owner-controlled firms, there was more influence over CEO pay by major stockholders and by the boards of directors.[65] Other research shows that firms that provided golden parachutes[66] for their CEO's tended to have a relatively higher dispersion of stock ownership, a higher tenure of the CEO relative to the board, and a higher proportion of external directors on their boards.[67] Whenever there is a high dispersion of stock ownership and high CEO tenure, CEO's are likely to significantly influence board-management relationships.[68]

In part, the lack of board influence in management controlled firms may stem from the fact that there are social, not economic, consider-

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63. Eugene F. Fama & Michael Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 311, 301-25 (1983).

64. *Id.* at 311.

65. *See supra* note 29, at 179-80.

66. Golden parachutes are incentive packages for incumbent managers as insurance against the possibility of takeover. Given a manager's interest in retaining his position, a golden parachute provides (usually) a lucrative incentive for the CEO should an attractive takeover proposal emerge. In this way, the manager can act in the shareholders' best interest since the value of the parachute offsets the value of his current position. However, some believe that a golden parachute is nothing more than insurance against incompetence. *See* A. M. Morrison, *Those Executive Bailout Deals*, FORTUNE, Dec. 13, 1982, at 82-87.

67. Harbir Singh & Farid Harianto, *Management-Board Relationships, Takeover Risk, and the Adoption of Golden Parachutes*, 32 ACAD. MGMT. J. 20, 7-24 (1989).

68. *Id.* at 24.

ations which play an important role in board deliberations.[69] One study found CEO's were more likely to receive a golden parachute when they had longer tenure in the firm relative to the tenure of members of the board.[70] Researchers concluded that the CEO is more likely to have appointed board members who perceive the golden parachutes as a reciprocal obligation.[71] Thus, CEO's may enhance or solidify power by influencing the board selection process.[72] This leads to the inevitable conclusion that, at least in manager-controlled firms, the process of setting the terms of CEO compensation is circular and one in which the locus of control is quite clear. "[I]n most cases board members are handpicked by management. In many practical respects, then, management is, therefore, in control of the board."[73] So,

> In practice, contrary to the basic tenets of the [compensation] model procedure, the chief executive often has his hand in the pay setting process almost from the first step. He generally approves, or at least knows about, the recommendation of his personnel executive before it goes to the compensation committee, and may take a pre-game pass at the consultant's recommendation, too. Both (personnel executives and consultants) rely upon the good graces of the chief executive for their livelihood. The consultant in particular — who is typically hired by management — would like to be invited for a return engagement. The board's compensation committee doesn't operate independently of the chief executive either.[74]

Thus, the research shows that boards of directors act in ways consistent with the power distribution of the firm. When there is a powerful stockholder, the board is more likely to behave in ways to further owners' interests; when there is not a powerful stockholder, the board seems to act in the managers' interests. This predisposition implies that management-controlled firms, unchecked by boards, do not operate in the best interests of the shareholders.

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69. James Wade, Charles A. O'Reilly, III & Ike Chandratat, *Golden Parachutes: CEO's and the Exercise of Social Influence*, 35 ADMIN. SCI. Q. 601, 587-603 (1990).

70. *Id.*

71. *Id.*

72. *Id.*

73. Jeffrey Pfeffer, *Size and Composition of Corporate Boards of Directors*, 17 ADMIN. SCI. Q. 220, 218-28 (1972).

74. Monci Jo Williams, *Why Chief Executives' Pay Keeps Rising*, FORTUNE, Apr. 1, 1985, at 66-76.

C. *An Alternative Solution*

These proposals are, indeed, a reasoned call for ethical and legal behavior by both boards and managers of firms. But the evidence is clear that they are likely to fail because they do not address a crucial dimension of the problem: the organizational control structure.[75] If shareholders are disenfranchised, management has an opportunity to act in a self-interested manner.[76] Effectively, the argument is, owners lose control in very large organizations when equity holdings are so broadly dispersed that they cannot easily form coalitions and exert control over managers.[77] Thus, managers insulated from stockholder constraints and market pressures will have broad discretion.[78] If managers' objectives differ from owners' objectives, managers' actions are likely to deviate from profit-maximization behaviors toward those consistent with their own self-interest.

Given the close link between the power distribution in the firm and the propensity of boards to support either shareholder or management interests, managerial influence on the board should be minimized. Managers often influence board selection through modification of the rules on terms of office, the nomination of candidates, and voting procedures. These policies can make it difficult for owners of companies with widely distributed equity holdings to exert much influence on boards and managements.[79]

In the current governance context, equity holders cannot exert influence. Currently, dissatisfied investors have limited choices. If they disapprove of their firm's management, but are unable to form an effective coalition with others, their alternatives are to (1) wait until management improves profitability, (2) hope for a serious takeover attempt, or (3) dispose of their stocks. These may be perfectly acceptable alternatives for some, but those investors who may want to exercise ownership rights should not be forced into this passive mode by an entrenched management by virtue of ownership diffusion and corporate bylaws. We reject the convenient theoretical argument that shareholders prefer to be passive investors who spread their risk through personal portfolio diversification rather than through the in-

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75. The organizational control structure refers to the extent to which equity holders are able to influence organizational policies.

76. *See supra* note 12, at 139.

77. *See supra* note 12, at 139.

78. WILLIAM A. MCEACHERN, MANAGERIAL CONTROL AND PERFORMANCE 41 (1975).

79. *Id.*

fluence of firm policy and strategy. Although some investors choose to assume a passive role, an increasing number wish to exercise ownership rights, as shown in the Delaware Supreme Court decision in the Time/Warner/Paramount case.[80]

Some believe that the Time/Warner/Paramount decision places much more power in the hands of directors, at the expense of investors, even in light of the nature of board fiduciary responsibility. State corporate statutes entrust the management of a corporation's business activity and affairs to the board of directors[81] defining the fiduciary responsibility to the corporation and its shareholders.[82] The Supreme Court of Delaware, in *Mills Acquisition Co. v. Macmillan, Inc.*,[83] defined the scope of directors' duties in an auction to be more than simply obtaining the highest price. The court held the Macmillan Board of Directors liable for failing to oversee the entire auction process and prevent self-interested management from unfairly influencing the auction.[84] Even in light of this ruling, boards can remain within the boundaries of legal interpretation while still placing managerial interest over those of equity holders, for all the reasons noted earlier in this paper.

We believe there is a solution which is superior to the proposed legislation and policy recommendations. Owners must be given more control over board selection reduce managerial control, which would make boards more responsive to owners' interests. Removing management from the process of selecting board members would accomplish this. The creation of independent offices or agents to manage the election of directors for publicly traded firms frees equity holders from the influence of management. These independent offices could make relevant performance information available to equity holders, could facilitate coalitions of stockholders, and could generally enhance owner involvement. Equity holding managers would have rights similar to those afforded other stockholders in terms of proposing and advocating candidates for board membership.

This alternative would require federal legislation mandating that publicly traded firms establish independent offices or agents outside

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80. Bill Saporito, *The Inside Story of Time Warner*," FORTUNE, Nov. 20, 1989, at 164-210.

81. WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 2.01, at 37 (4th ed. 1988). For relevant state statutes, see DEL. CODE ANN. tit. 8, § 141(a) (1983); CAL. CORP. CODE § 300 (West 1990).

82. See Harry G. Henn, LAWS OF CORPORATIONS § 234, at 621 (3rd ed. 1983).

83. 559 A.2d 1261 (Del. 1989).

84. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1279-80 (Del. 1989).

the firm to conduct director elections. The independent agent could be, for example, a public accounting firm, a law firm, or another organization specifically created for the purpose of protecting shareholder ownership rights. The board of directors for a given firm could choose an outside agent, subject to the constraint that the agent not have other business or professional relationships with that firm. The independent office would solicit slates for board election from stockholders. To minimize the number of slates, but still provide opportunities for choice, some minimum percentage of stock (e.g., one percent) must be held by individuals or coalitions nominating candidates for the board.

The management group could also nominate a single slate, to ensure that the current managerial competence and knowledge be represented in the election. Beyond that, the management of the firm would be permitted to participate in the election to the extent that they meet the same holdings requirements as other equity holders. Information about the proposals and programs of each nominated candidate or slate could be distributed in much the same fashion as under current practice, perhaps even in a more simplified form. The equity holders will then select board members who advocate positions congruent with their own interests. The independent office will also disseminate other information to equity holders. Newsletters, for example, could contain proposals which might have utility to the larger population of stockholders, or could serve as an informal forum through which equity holders may communicate.

This alternative should also include provisions for arbitration or mediation in the event that equity holders who do not control the legal minimum for slate nomination have grievances, thereby limiting the need for expensive legal action as equity holders seek to take advantage of ownership rights.

IV. Other Considerations

A. *The Further Intrusion of Non-Market Forces into the Private Sector*

Our proposal represents a departure from the current, general practice of board selection in the United States. Although this approach strengthens boards and seeks to align firm decisions with shareholder interests, there are still problems that must be resolved in the development and implementation of legislation. Even though there is already substantial regulation of business, this proposal may minimize the need for more complex regulation.

The question is not, "Should there be regulation?" Rather it is, "What kind of legislation makes the best sense?" We believe that our

proposal, implemented, is (1) far less intrusive in capital markets, (2) is a positive, rather than a negative approach to the separation of ownership and control dilemma, and (3) will provide stronger internal pressures for more efficiency and increased productivity. If boards begin to hold management more accountable, then forces within the firm would drive it toward efficiency. This would reduce the severe and costly adjustment "shocks" often associated with restructuring in order to achieve increased productivity.

B. *The Specific Form of Regulation*

In this paper we have outlined only the general boundaries of the proposal. There are many other specific matters to be resolved. For instance, should the requirement of independent election be applied to presently regulated firms, such as public utilities? What should the minimum holding requirement be in order for shareholders to nominate candidates for board membership?

C. *Resistance by Current Management*

The current management of firms will, no doubt, oppose our proposal. It would reduce their control over the board and increase their dependence upon it. Managers will most likely contend that they are best informed about problems of the firm and are therefore best equipped to solve those problems and to do so in the best interest of equity holders, hence they should continue to play a strong hand in selection of the board.

While it is true that management, generally, is well informed about problems, it does not necessarily follow that it is best suited to solve those problems or that solutions would be in the best interests of the owners. If, indeed, that were the case, there would be far fewer takeover attempts since assets would be more efficiently managed and less concern about the current levels of CEO pay. We would add that, there would be for managements that do work in the owners' interest, our proposal should have only minimal effects. Boards are not likely to replace executives who have managed effectively.

D. *Additional, Unnecessary Costs Are Unlikely*

The costs of independent elections must be paid by the firm. However, it is possible that the aggregate increased costs would be far less than those which would be incurred with more complex regulatory legislation or those agency costs currently incurred. Further, since independent elections will shift the distribution of power in the firm to owners, one can expect a reduction in monitoring and in the agency costs incurred by the separation of ownership and control.

The magnitude of costs associated with this proposal is not expected to be excessive, especially since firms already incur costs to meet current requirements of director selection. The difference is that these costs will be paid to external agents. More likely, incremental costs associated with the independent office will be offset by the increases in profitability and productivity that accompany greater accountability. There may be some increased regulatory costs, though even that is not certain.

E. *The Determination of Suitable Independent Agents*

We have suggested that public accounting firms, or law firms, could be designated as executors of the independent selection of board members. Other alternatives, such as an ombudsman-like office, could be considered. In this approach, a mission-specific office is created that is directly responsible to the board and has access to adequate resources to execute the election, disseminate information, and facilitate shareholder interests. Disputes between this office and management, or stockholders, could be subject to arbitration or mediation.

V. SUMMARY

There is evidence and theory which supports the argument that the current state of compensation of the highest levels of management in U. S. corporations can be accounted for, in part, by the fact that equity holders are not influential in the control of the firm. This permits managers to act in ways to further their own self-interest at the expense of equity holders. In the current legal environment, equity holders are often powerless in the firm and their main option is to dispose of their equity. A change in corporate governance practice is proposed which would increase owner influence. This change is to remove the firm's management from control of the process of board selection, assigning that role to independent agents. The effect, it is argued, would be to increase the dependence of the management on the owners, leading to a stronger profit maximization strategy.