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A Symposium on the ALI Corporate Governance Project

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Introduction: A Symposium on the ALI Corporate Governance Project

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I. BACKGROUND

Criticism of big business is not a recent phenomenon in the United States. A significant history of challenges to large-scale enterprises had developed prior to the industrial revolution.[1] Early business statutes reflected the public opposition to accumulations of power that could have an impact on commerce,[2] and the suspicion prevailed that the impact of big business would be negative. Yet businesses increased dramatically in size in this atmosphere of general public distrust.[3]

The critics of big business have advanced various reasons in

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1. A. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 497 (1977).

2. One example of the power of popular opinion directed against big business was the enactment of the 1811 New York General Incorporation Act. The Act limited the general incorporation of manufacturing ventures to firms with a maximum capitalization of $100,000. When the state of New York passed the Act, the factory system was already established, and textile concerns with capitalization of as much as $1,000,000 operated in other states. *See* Sowards & Mofsky, *Factors Affecting the Development of Corporation Law*, 23 U. MIAMI L. REV. 476, 489 (1969).

3. A. CHANDLER, *supra* note 1.

support of their positions. A new solution for curing the "problem" of big business followed each new expression of hostility. The corporation, the typical vehicle for organizing large-scale businesses, understandably became the target of the antibusiness sentiment.[4] The controversy over big business has now focused on its institutional form.

During the past twenty years, two primary and contradictory criticisms have predominated the discussion. The first of the two is that the modern corporation separates ownership from control. In 1932, Berle and Means brought that assertion to prominence in their seminal work *The Modern Corporation and Private Property.*[5] Separation of ownership from control occurs in businesses where no individual shareholder or group of related shareholders owns a controlling interest. Professional managers who have no controlling ownership stake exercise the responsibility for managing many such corporations. This arrangement led Berle and Means to conclude that, because corporation laws impose few institutional constraints on managerial behavior, managers operate firms in their own interests rather than for the welfare of shareholders.[6] Therefore, the critics argue, damage results to the shareholders.

The second criticism holds large corporations responsible for acts that have adversely affected many segments of society. For example, the critics claim that large corporations discriminate against minorities, engage in ecological abuses, bribe governmental officials, deal with undersirable countries, and otherwise engage in antisocial behavior.[7] The cure proposed for this behavior is corporate "social responsibility." The premise underlying this notion is that large corporations possess unlimited resources for withstanding the costs of social reform. The characterization of the corporation as a separate juridical entity is appropriate in most legal contexts, but the use of this fiction in analyzing the question of who bears the costs of social reform ignores reality. Corporations serve only as convenient devices for the facilitation of contractual

4. W. Meckling & M. Jensen, Reflections on the Corporation as a Social Invention 2 (International Institute for Economic Research Paper No. 18, 1983).

5. A. Berle & G. Means, The Modern Corporation and Private Property (1932). The general concept that ownership is separated from control has been around at least since Adam Smith criticized joint stock associations on those same grounds in 1776. A. Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 700 (E. Cannan ed. 1966).

6. A. Berle & G. Means, *supra* note 5; *see also* West, *The Role of the Market*, in Corporate Governance: Past & Future 46, 50 (H. Manne ed. 1982).

7. *See* R. Nader, M. Green & J. Seligman, Taming the Giant Corporation (1976).

arrangements among various individuals and groups. The costs and benefits of social reform must inevitably pass through the corporation and reach corporate shareholders or creditors, consumers of corporate products, or the firm's employees.[8] It is they who will bear the brunt of imposing social responsibility on the corporation.

The modern corporation is undeniably a social success, but success extracts a price. The corporation has attracted many critics, some of whom advocate reformation of the law to impose institutional arrangements for controlling the behavior of managers. Other critics seek rules that would result in transfers of wealth from one group, such as stockholders, to another group, such as the constituency that the particular advocate represents. Except for a theory that would eliminate the concept of private property, rarely do the critics advocate the abolition of the corporate form.

The corporation did not achieve its success overnight.[9] Indeed, the modern corporation is the product of centuries of development. The corporation evolved to its present form through years of fashioning and refashioning different methods of contracting to achieve different sets of objectives.[10] The dominant status of corporations resulted from the freedom of individuals to contract in their self-interest rather than from special privileges conferred by the state. During the special charter period of American corporation law, when the corporate form was not the primary structure for business, the states extended monopoly benefits and special privileges to corporations.[11] Industrialization prompted the enactment of the general incorporation laws in the early part of the nineteenth century. Those laws effectively eliminated the monopoly benefits and privileges afforded by special charters. Even limited liability, which the general incorporation laws conferred on the corporation, was not a unique privilege otherwise unavailable to the corporation. Liability could be limited by contract long before statutes provided for it.[12] Thus, the success of the corporation was predicated on the

8. Jensen & Meckling, *Can the Corporation Survive?*, FIN. ANALYSTS J., Jan.-Feb. 1983, at 31.

9. In capital-intensive industries such as manufacturing, the corporate form of organization dominates, while not-for-profit firms, proprietorships, professional partnerships, and other partnerships and mutual organizations coexist with the corporation in certain other industries. For a discussion of the concept of the "separation of ownership from control" in both corporate and noncorporate organizations, see Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

10. Sowards & Mofsky, *supra* note 2, at 481-85.

11. *Id.* at 480.

12. Meiners, Mofsky & Tollison, *Piercing the Veil of Limited Liability*, 4 DEL. J. CORP. L. 351, 360-61 (1979).

ability of participants in the marketplace to contract freely.

The importance to the corporate enterprise of the freedom of individuals to contract did not go unnoticed by state legislatures. By attracting firms to incorporate in their states, legislatures could generate increased tax revenues for their states' coffers. Because of the revenues resulting from such taxation, states began competing for incorporations by liberalizing corporate codes. The codes thus reflected a relaxation of contract restrictions and an increase in management flexibility.[13] Accordingly, over the years the states have amended their general incorporation laws to eliminate many restrictions on the corporation. For instance, these laws now place few restrictions on the kind of business in which the corporation may engage, the amount of capital it may amass, the duration of its life, the kind of stock that may be sold to raise capital, the nature and manner by which shareholders' meetings are called, and how organic changes are made in the corporation.

Relaxation of statutory regulation of the corporation has its supporters and opponents. Some regard the liberalization as a necessary and logical consequence of the need for the contractual freedom that the corporation requires to evolve in a manner that maximizes its use and productiveness.[14] Others have characterized the abandonment of restrictions as beneficial to corporate management and costly to shareholders. For example, Professor Cary characterized Delaware's lead in the process of liberalization as the "race for the bottom."[15]

State law has also attracted criticism for its failure to provide for institutional arrangements that would require corporate management to account to shareholders. Advocates of this position believe that market forces alone are insufficient to accomplish the goal of accountability. Thus, they argue that the inability of the market to check the power of management demands a reformation of the corporation laws.

In the mid- and late 1970's, disenchantment with state regulation of the corporation led to the proposal of a federal statute regulating large corporations.[16] The statute was not passed, however,

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13. Sowards & Mofsky, *supra* note 2, at 491-92.

14. W. MECKLING & M. JENSEN, *supra* note 4, at 8.

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

16. Protection of Shareholders' Rights Act of 1980, S. 2567, 96th Cong., 2d Sess., 126 CONG. REC. S3754 (daily ed. Apr. 16, 1980) (introducted by Senator Metzenbaum); *see also* Corporate Democracy Act of 1980, H.R. 7010, 96th Cong., 2d Sess., *reprinted in Protection of Shareholders' Rights Act of 1980: Hearings on S. 2567 Before the Subcomm. on Securi-*

and some of its leading proponents are pessimistic in their assessment of the potential for enactment of a similar statute.[17] Notwithstanding that defeat, those advocating reform in corporate governance express more optimism for the achievement of changes in state law, especially changes bearing the prestigious imprimatur of the American Law Institute ("ALI").

II. THE ALI CORPORATE GOVERNANCE PROJECT

The ALI has undertaken a project with the purpose of achieving corporate reform. The project has two objectives: a) restatement of the law where there is judicial authority deemed satisfactory under modern standards, and b) recommendations "[w]here there is no judicial authority, or where the cases are unsatisfactory by modern standards — either because of their antiquity, or the absence of compelling analysis, or because today they just seem wrong."[18] The ALI's project grew out of four conferences held during 1977 and 1978.[19] In April 1982, the ALI published Tentative Draft No. 1 ("Draft") of the project, entitled *Principles of Corporate Governance and Structure: Restatement and Recommendations*.[20] Immediately upon dissemination, the debate over this controversial document began.

Because the ALI Reporters have made significant changes to the Draft since its initial publication, any attempt to analyze the project at this point may be analogized, as suggested by the President of the ALI, to shooting at "a moving target."[21] Tentative

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ties of the Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess. 360 (1980) (introduced by Congressman Rosenthal); R. NADER, M. GREEN & J. SELIGMAN, *supra* note 7; Cary, *supra* note 15 (suggesting minimum federal standards for large publicly held corporations).

17. *See* Schwartz, Federalism and Corporate Governance (paper delivered at Ohio State University Symposium on Corporate Governance, Oct. 20, 1983) (to be published in volume 45 of *Ohio State Law Journal*).

18. PRINCIPLES OF CORP. GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS foreword at viii (Tent. Draft No. 1, 1982) [hereinafter cited as RESTATEMENT].

19. For a transcript of these conferences, see COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE: THE ALI-ABA SYMPOSIUMS 1977-1978 (D. Schwartz ed. 1979).

20. RESTATEMENT, *supra* note 18. For a critical discussion of the Draft, see Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983); see also Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of* Zapata *and the ALI Project*, 1982 DUKE L.J. 959; Comment, *Corporate Ethics and Corporate Governance: A Critique of the ALI Statement on Corporate Governance Section 2.01(b)*, 71 CALIF. L. REV. 994 (1983).

21. R. Perkins, Background and Status of ALI Corporate Governance Project and Commentary on Papers of Professors Andrews, Demsetz, and MacAvoy (Exhibits A, B and C to Feb. 1983 Statement of the Business Roundtable) 9 (remarks at forum at the Association of

Draft No. 1 contains only some of the parts (parts I, II, III, IV and VII) that will ultimately constitute the entire project. The Draft includes neither parts V and VI nor certain proposed additions expected to be included.[22] Part I contains definitions of terms used elsewhere in the Draft;[23] part II contains a statement regarding the objective and conduct of the corporation;[24] part III contains provisions relating to the composition, structure, functions, and powers of the board of directors and its committees;[25] part IV deals with the duty of care of corporate officers and directors and the business judgment rule;[26] and finally, the portions of part VII (remedies) included in the Draft deal with derivative actions.[27]

A. *The Debate*

The proponents of the ALI's corporate governance project do not appear to attack the modern corporation on the basis of corporate social responsibility. On its face, the Draft recognizes shareholders as the legitimate "owners" of the corporation. The proponents state their concern that the perceived separation of ownership from control has placed professional managers in a position of control that enables them to act in their own interests and not always in a manner consistent with the maximization of shareholder wealth.[28] Consequently, the ALI Reporters have proposed arrangements designed to require, or to recognize as "good corporate practice," certain institutional reforms intended to achieve a balance between the interests of shareholders and the perceived incentives of management. The apparent goal of creating these institutional arrangements is to protect shareholder wealth from managers expected to behave in ways inimical to shareholders.

Tentative Draft No. 1 incorporates a variety of changes from the prevailing law—for example, a requirement that the boards of large corporations consist of a majority of outside directors and of independent audit and nominating committees.[29] The Draft also

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the Bar of the City of New York, Mar. 14, 1983).

22. RESTATEMENT, *supra* note 18, table of contents at xiii-xvi.

23. *Id.* pt. I, at 1-16.

24. Basically, that statement recognizes the profit-maximization objective of the corporation and the goal of enhancing shareholder gain. *See id.* pt. II, at 17-43.

25. *Id.* pt. III, at 45-125.

26. *Id.* pt. IV, at 127-216.

27. *Id.* pt. VII, at 217-426.

28. *See, e.g., id.* § 3.03 comments c-e, at 74-77.

29. *Id.* §§ 3.03, 3.05-.06. Subsequent to the publication of Tentative Draft No. 1, the Council of the ALI voted to delete the language of § 3.03 that would have *mandated* that at

proposes, as a matter of "good corporate practice," an independent compensation committee.[30] Current law embodies none of these proposals. Critics of the project perceive the Reporters' treatment of the directors' duty of care and the business judgment rule as an attempt to expand the liability of directors.[31] Similarly, the Reporters' proposals concerning derivative litigation appear to make derivative suits easier to bring and harder to dismiss.[32]

Debate within the legal and business communities over the Draft is heated; it extends to the substantive proposals, the format of the project, and the title of the first tentative draft. Critics have described the first draft as a "hybrid document" having a format never before used by the ALI.[33] Objections to the substance of the draft focus upon the notion that Tentative Draft No. 1 fails to distinguish between provisions that actually restate the law and materials that reflect only the Reporters' perceptions of "good corporate practice." Thus, opponents of the draft argue that these deficiencies may lead courts and others to the false belief that all provisions are restatements of the law. Moreover, questions arise about the legal status of recommendations made by the ALI regarding "good corporate practice." Some of the critics suggest that the courts may treat deviation from such rules of "good corporate practice" as "bad corporate practice" that is actionable by the corporation or its shareholders. Responding to these criticisms, the President of the ALI has stated that the Council of the ALI is actively considering renaming the project; the Council has also requested that the Reporters sharpen the distinctions between actual restatement provisions and recommendations or suggestions.[34]

Resolution of problems relating to title and format will not extinguish the debate over the Draft's substantive provisions—a debate pitting powerful organizations and institutions against each other.[35] Furthermore, the nature of the substantive issues in dis-

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least a majority of the directors of large publicly held corporations be outsiders. The Council asked that this be put on a "good corporate practice basis." R. Perkins, *supra* note 21, at 11. A memorandum attached to Mr. Perkins' remarks reflects that Advisory Group Draft No. 3 of the project does not mandate the establishment of an independent nominating committee, but recommends it as "good corporate practice." R. Perkins, *supra* note 21, app. at 2.

30. *See* RESTATEMENT, *supra* note 18, at § 3.07.

31. *See* THE BUSINESS ROUNDTABLE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" 41 (1983).

32. *Id.* at 14.

33. *Id.* at 8.

34. Perkins, *supra* note 21, at 12-13.

35. See, e.g., the debate between the Business Roundtable, THE BUSINESS ROUNDTABLE,

pute does not suggest any simple compromise. Supporters of the ALI project believe that the Draft contains relatively modest proposals that do not depart significantly from generally accepted or clearly emerging corporate norms. Those in favor of the project assume that management accountability is a prerequisite for the corporation's attainment of legitimacy.[36] They argue that the ALI proposals based on director accountability to shareholders are not radical.[37] In short, the supporters argue, the uproar is much ado about nothing.[38]

Critics of the Draft disagree. They assert that many current corporate practices—such as practices relating to the composition of boards of directors and the appointment of independent committees of the board—are part of an evolutionary process that will be stifled by the inclusion of these practices in a document purporting to be a restatement of the law.[39] Another objection to the Draft is that it reflects only one of several models of the modern board of directors. This argument suggests that some of the Draft's provisions are inconsistent with current realities of corporate governance.[40] A more general objection is that current corporation law works well and needs no adjustment.[41] Still others emphasize the deficiency of the scholarship underlying the Draft, which omits any discussion of the management and economics literature regarding corporate governance.[42] Finally, those satisfied with the status quo believe that the market is a more efficient method of disciplining managers, directors, and others than are formal rules such as those incorporated in the Draft.[43] Obviously, the Draft has engendered substantial objections.

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supra note 31, *passim*, and the American Law Institute, R. Perkins, *supra* note 21, at 14-27.

36. *E.g.*, Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223, 232 (1983).

37. *See, e.g., id.* at 225-27.

38. *E.g.*, Steinberg, *The American Law Institute's Draft Restatement on Corporate Governance: The Business Judgment Rule, Related Principles, and Some General Observations*, 37 U. MIAMI L. REV. 295, 299 (1983).

39. *E.g.*, Andrews, *Rigid Rules Will Not Make Good Boards*, HARV. BUS. REV., Nov.-Dec. 1982, at 34.

40. *Id.* at 39.

41. *See* Ruder, *Protections for Corporate Shareholders: Are Major Revisions Needed?*, 37 U. MIAMI L. REV. 243 (1983).

42. *See, e.g.*, Andrews, *supra* note 39, at 37.

43. *See, e.g.*, Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1283-84 (1982); *see also* West, *supra* note 6.

B. *The Views of the Symposium Participants*

The participants in this symposium have varying substantive viewpoints. Professor Eisenberg, one of the Reporters for the Draft, believes that the separation of ownership from control results in a lack of protection for shareholders. For Professor Eisenberg, the ALI project is a modernization of corporate law, which attempts, among other things, to recognize the need for institutional arrangements that facilitate the accountability of managers to shareholders. Because the Draft's provisions provide for monitoring of the performance of managers, he views the entire project as helping to legitimize the modern corporation.

Professor Andrews expresses a different opinion of the Draft. He contends that the provisions of the Draft are unrealistic and fail to take into account the complexities of the large corporation. Noting that the Draft ignores the recent evolution of the large corporation as the dominant institution in our society, Professor Andrews argues against freezing the evolving corporate norms into the rigidity of a restatement. Moreover, he criticizes the failure of the Reporters to understand the problems of corporate governance and suggests that unless the Reporters take a more realistic view of the modern corporation, the ALI project will not achieve its objectives.

Professor Brudney characterizes the Draft as a reflection of current corporate practice that contains no significant surprises for the business community. In fact, he states, the Draft merely establishes minimum standards of performance that are not so strict as to inhibit positive performance or achievement of efficient results. Professor Brudney comments that the Draft's critics, many of whom are seeking to block the ALI project, are attempting to dilute the directors' traditional obligations to shareholders.

Dean Ruder perceives the Reporters' objectives as unnecessarily increasing the protections for shareholders beyond existing law. He examines the existing federal and state laws and concludes that the present regulation of corporate affairs strikes a proper balance between facilitating corporate business decisions without undue interference and protecting shareholders against injury by officers, directors, and controlling shareholders. Thus he finds no need for a restatement of the law.

Mr. Smith speaks from his experience as a director of several large corporations. He characterizes the project as more the Reporters' own statement of the prevailing corporate practices than as a restatement of existing legal principles. In noting that no two corporate boards are alike, Mr. Smith urges that the key to an effective board is the flexibility to meet the needs of an everchanging business environment. He believes that the Draft would operate as a straitjacket on the effective operation of the board.

Professor Steinberg views the Reporters' deviations from existing law as a positive change. He advocates the exposure of corporate fiduciaries to liability for ordinary negligence in ordinary business transactions. He also finds that the standards imposed on directors desiring to dismiss bothersome derivative suits do not impose an undue burden on corporate fiduciaries. Professor Steinberg concludes that the Draft represents a substantial increase in protections for shareholders at the expense of corporate fiduciaries and that this result is desirable.

III. Additional Perspectives

Although the papers included in this symposium contain interesting and diverse views, their authors do not address at least two important points that we should mention to complete this introduction. First, there is a relative paucity of empirical evidence on many of the important issues with which the Draft deals. Second, there is a market for corporate control that provides significant protections for shareholders.

A. *Empirical Evidence*

At this symposium the commentators agreed that no empirical study convincingly answers the questions of whether new law dealing with corporate governance would improve shareholder or community welfare and whether the benefits of the ALI project would outweigh the costs of compliance. In fact, no such empirical study exists. Nevertheless, the proponents of the Draft persist in their assertion, based primarily on their personal experiences and impressions, that such law is desirable. Some commentators argue, however, that personal and shared experiences do not justify the promulgation of a restatement on corporate governance.[44] One may argue that the logic of a particular proposition—such as a rule requiring a majority of independent directors or an independent audit committee—is overwhelmingly clear. But when one attempts to analyze these proposed rules, no such overwhelming logic emerges.

44. *See, e.g.*, Wolfson, *SEC Thinking and Lessons in Bureaucratizing the Corporation*, in CORPORATE GOVERNANCE: PAST & FUTURE 1, 8-21 (H. Manne ed. 1982).

There is a popular assumption that independent directors can monitor and assure successful management better than management itself can. Commentators who disagree with this contention suggest that senior managers have an incentive to monitor their colleagues of equal rank; even junior managers have an incentive to monitor their superiors. Behind the manager-as-monitor model is the notion that the success of a manager's peers and superiors will benefit the manager's own reputation and future compensation.[45] Independent directors, however, occupy a less strategic position for monitoring the performance of the firm than do managers. As part-timers, independent directors have less time to devote to monitoring activities. And because their compensation is not a function of the success of the firm, independent directors, unlike managers, have no financial incentive prompting them to act quickly and decisively in correcting management's inefficiencies. Indeed, one may expect that independent directors—when compared with managers—are less entrepreneurial, more receptive to the demands of public interest groups than to the interests of shareholders, and less efficient in disciplining inefficient employees.[46]

This reasoning does not emphatically lead to the conclusion that inside directors are more desirable as monitors than are independent directors. Rather, because there are many reasonable arguments that support both sides of the question, the answer should depend on empirical research. Also, arguably, it is inadvisable to impose a requirement for an independent board when a rule and practice already exist that permit the selection of a balance of independent and outside directors according to the needs of the particular firm.

The preceding analysis is equally applicable to independent audit, compensation, and nominating committees, and to other Draft proposals. Each of these issues leads to the same conclusion, i.e., that we are dealing with empirical propositions for which there are rational arguments on both sides. The proponents of corporate reform have not yet sustained the burden of proving the need for the proposals they advocate.

Although there is no conclusive empirical evidence that the Draft proposals are correct, researchers have begun to test the Reporters' hypotheses. The Business Roundtable, as part of its re-

45. *See* Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); *see also* Wolfson, *supra* note 44, at 9.

46. Wolfson, *supra* note 44, at 9-10.

sponse to Tentative Draft No. 1, commissioned Professor MacAvoy to test various hypotheses underlying the Draft. Examining his data, MacAvoy found no empirical basis for the conclusion that the Reporters' proposed structural models of the corporation would achieve their objectives.[47] In particular, he found that "[t]he most important and statistically significant result is that there is no indication here that the board structure has any impact on the relative profitability performance of corporations."[48] Professor MacAvoy similarly found, with respect to the ALI Reporters' recommendations on "socially responsible behavior" and corporate compliance with the law, that his data showed no significant differences between firms having board characteristics like those advocated by the ALI Reporters and those with different characteristics.[49]

The Berle and Means theory noted earlier, that ownership is separate from control, underlies the ALI's project on corporate governance. In a recent issue of *The Journal of Law and Economics* devoted entirely to the subject of corporate governance, Professors Stigler and Friedland empirically tested the basic tenets of the Berle and Means theory.[50] Using data assembled in the 1920's and 1930's, Stigler and Friedland examined the question of whether separation of ownership and control has any significance with respect to the effective operation of business.[51] Their data revealed no significant relationship between the profitability of the corporation and the exercise of control by either management or the owners of the corporation.[52] In addition, analyzing another body of data, they found no significant relationship between executive compensation and the type of control.[53] Stigler and Friedland thus concluded that there is no merit to the claim that separation of ownership and control injures shareholders.

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47. *See* MacAvoy, Cantor, Dana & Peck, *ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis, reprinted in* THE BUSINESS ROUNDTABLE, *supra* note 31, exhibit C.

48. *Id.* at C-34.

49. *See id.* at C-38, C-42.

50. Stigler & Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J.L. & ECON. 237 (1983).

51. Statistical regressions of corporate profits or corporate assets and type of control were presented for five periods from 1928 to 1938. *Id.* at 256.

52. *Id.* at 254, 259.

53. The data used in the study was collected by the Federal Trade Commission for 1928 to 1932, the Securities and Exchange Commission for 1934 to 1935, and the Temporary National Economic Committee and the Securities and Exchange Commission for 1937 to 1938. *Id.* at 249-54.

In another empirical study, Professors Dodd and Leftwich tested the effects on shareholder wealth of 140 changes in the state of incorporation during the period from 1928 to 1967.[54] They designed the study to test whether corporate management, in order to exploit stockholders, deliberately chose Delaware as the state of incorporation. In the twenty-five months prior to and including the month that the firm switched the state of incorporation to Delaware, stockholders of the firm earned a positive abnormal return exceeding thirty percent. For a period of up to five years after the change, there were basically no abnormal returns.

The evidence from the Dodd and Leftwich study is consistent with the hypothesis that management switches the state of incorporation for the benefit of shareholders. As news of the intended change in the state of incorporation becomes known to members of the investment community, investors revise in an upward direction their evaluations of the corporation's prospects, even before the consummation of the switch. That reevaluation increases stock prices, which in turn produces abnormally high returns for shareholders.

A recent unpublished study tested the hypothesis of the existence of a universally appropriate form of corporation law.[55] The study revealed that the choice of incorporating in a strict or liberal corporate legal environment was contingent upon the concentration of the power of the shareholdings. States with strict corporation laws use more political and legal methods to regulate the performance of management. Liberal states rely on the forces of the market to control management's performance. The study found that the more concentrated the shareholdings, the more the corporations tended to migrate to a state with strict corporation laws. In strict versus liberal states, there was no significant difference, however, in the financial performance of corporations. Based upon these findings, it follows that uniform corporation laws, such as those proposed in the Draft, are inappropriate.

B. *The Market for Corporate Control*

As indicated earlier, this symposium would be incomplete un-

54. Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulations*, 53 J. Bus. 259 (1980).

55. B. Baysinger & H. Butler, Corporate Law and Corporate Governance: A Contingency Theoretic Approach to the Control of Hired Managers (1984) (unpublished manuscript, Department of Management, College of Business Administration, Texas A & M University).

less it included some discussion of the "market for corporate control."[56] Under this theory, share prices work to discipline the behavior of corporate management. Inefficient management of a firm, or management behavior that is inconsistent with profit maximization, will cause the price of the firm's shares to fall to a level that is consistent with the degree of mismanagement. Lower stock prices make it easier (i.e., less costly) for outsiders to gain control of the corporation and to generate profits for themselves through the increase in share values that results from efficient management. After gaining control, the former outsiders generally replace the inefficient managers. Corporate managers thus have a strong incentive to be attentive to the price of their firms' shares.

In contests for corporate control, insurgents seek potential profits in the form of compensation for successful management, from capital gains realized through an increase in share values, or from both. It is this market for the profits derived from successful management that constrains management behavior. If corporate managers are inattentive to prevailing competition for the firm's goods or services, the market will quickly reflect their behavior in prices.[57] Therefore, the market for corporate control exerts a constant pressure on managers to monitor continually the firm's internal affairs and to behave in a manner that is consistent with the maximization of shareholder wealth. This pressure does not, however, completely insulate efficient management against a takeover. If an insurgent group determines that it can manage the corporation more efficiently than the incumbents can, the insurgents will attempt to gain control of the corporation. Nevertheless, efficient management decreases the risk of a successful takeover.

Critics of the market for corporate control theory have questioned its effectiveness as a protective device for shareholders.[58] According to these critics, if there is little or no market competi-

56. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1430 (1964).

57. J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 70-96 (1973); Manne, *Economic Aspects of Required Disclosure under Federal Securities Laws*, in WALL STREET IN TRANSITION: THE EMERGING SYSTEM AND ITS IMPACT ON THE ECONOMY 32 (1974) (The Charles C. Moskowitz Lectures); Jensen, *Problems in Selection of Security Portfolios: The Performance of Mutual Funds in the Period 1945-1964*, 23 J. FIN. 389 (1968); Jensen, *Risk, The Pricing of Capital Assets, and the Evaluation of Investment Portfolios*, 42 J. BUS. 167 (1969); Samuelson, *Proof That Properly Anticipated Prices Fluctuate Randomly*, IND. MGMT. REV., Spring 1965, at 41; Williamson, *Measurement and Forecasting of Mutual Fund Performance: Choosing an Investment Strategy*, FIN. ANALYSTS J., Nov.-Dec. 1972, at 78.

58. *E.g.*, R. NADER, M. GREEN & J. SELIGMAN, *supra* note 7.

tion for a firm's products or services, market forces lack the power to restrain corporate management and are therefore inadequate to protect shareholders. Critics point to regulated industries as examples of markets that lack competition.[59]

But even in regulated industries there is evidence that the market for corporate control provides a mechanism for ensuring efficient management behavior.[60] Professor De Alessi hypothesized that the tenure of managers of government-owned firms would be longer than the tenure of managers in privately owned firms.[61] Measuring the statistical differences in tenure patterns in government and privately owned electric utilities, he concluded from the empirical evidence that the profit constraint has more effect on privately held than on publicly held utilities. In addition, Professors Tollison and Crain found that regulated private utilities do not exhibit a significantly different tenure pattern for top management than do unregulated private firms.[62] These findings support the theory that the market for corporate control works effectively in all privately owned firms.

There is a second challenge to the theory of the effectiveness of the market for corporate control. Some persons suggest that the high costs of takeover campaigns may actually shield management from accounting to shareholders.[63] High takeover costs, however, simply may indicate that the firm's management is very efficient, which is good for stockholders. Whether the takeover is in the form of a cash tender offer, proxy fight, or some other device, the cost of the takeover is in fact directly related to stock prices: The more efficiently managed the firm is, the higher are its stock prices; efficiently managed firms thus have higher takeover costs than inefficiently run firms. In sum, it is the low takeover costs resulting from the lower stock prices of poorly run firms that pose a threat to management and hold them accountable to shareholders.[64]

Nevertheless, government regulation has created takeover costs in addition to the costs reflected in stock prices. Because of the increased costs, the regulations impede the efficient function-

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59. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 266 (1977).

60. De Alessi, *Managerial Tenure under Private and Government Ownership in the Electric Power Industry*, 82 J. POL. ECON. 645 (1974).

61. *Id.*

62. Crain & Tollison, *On the Sufficient Conditions for Wealth-Maximizing Conduct*, 31 KYKLOS 500, 502 (1978).

63. *E.g.*, Winter, *supra* note 59, at 268.

64. *Id.* at 269.

ing of the market for corporate control.[65] Elimination of these regulations would lower the expenses of a takeover, a desirable goal for creating a more efficient market for corporate control.

Finally, the results of another study suggest that the rigid rules in the Draft for monitoring management behavior are inappropriate, especially in light of the beneficial consequences of strong market forces that discipline managers. The study, which focused on a firm's measurement of input productivity and rewards for the purpose of equating rewards with outputs, found that elimination of management discretion would be damaging to shareholders.[66] In a particular firm, the marginal productivity of each employee is difficult and costly to determine. Furthermore, aggregating the separate outputs of each employee will not provide an accurate measure of individual productivity. An employee has an incentive to shirk his responsibilities if his reward (salary, for example) is relatively unrelated to his productivity. Thus, it is essential that someone monitor the various inputs of employees to meter marginal productivity and to eliminate shirking. The monitor must gather information on productivity and on shirking.

The monitor and the persons he meters are, of course, members of the same team. This necessitates a device to reduce the monitor's incentive to shirk. That device, suggest Professors Alchian and Demsetz, is the allocation to the monitor of residual income after payment of other inputs.[67] This arrangement provides the monitor with an incentive to channel others' inputs in an efficient way, because his returns will be dependent on his ability to monitor effectively. For corporations, managers are monitors. Most shareholders are not interested in performing this task. But even if shareholders were interested, dispersion of share ownership makes monitoring impractical.

The notion that the residual income of a firm belongs only to the shareholders is incorrect. In fact, management has a residual share directly related to the cost of a takeover. Management can maintain the prohibitive cost of a takeover by increasing the yield to shareholders. The corporation is, therefore, the vehicle through

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65. An example of government regulation in the corporate community is the Securities and Exchange Commission's regulations governing tender offers. Manne, *Cash Tender Offers for Shares—A Reply to Chairman Cohen*, 1967 DUKE L.J. 231; Smiley, *The Effect of the Williams Amendment and Other Factors on Transactions Costs in Tender Offers*, 3 INDUS. ORG. REV. 3 (1975).

66. Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

67. *Id.* at 782.

which a substantial number of investors may aggregate capital while an efficient metering mechanism monitors the various inputs and rewards of management. These results flow almost entirely from strong market forces and are independent of complex rules of law intended to constrain the behavior of corporate managers. Indeed, these results may be achieved with only a few basic rules,[68] none of which is as complex as the suggestions of the Reporters in Tentative Draft No. 1.

IV. Conclusion

As the foregoing analysis and the views of the authors at this symposium demonstrate, it is not surprising that the American Law Institute project on corporate governance is laced with controversy. It is equally clear that there is no simple method for resolution of such differing views. Accordingly, one is safe in predicting a long and heated debate as the project takes it course. These papers, we hope, will serve as a focal point in that process.

68. Winter, *supra* note 59, at 290.