

CORPORATE GOVERNANCE IN THE TWENTY-FIRST CENTURY

A PRELIMINARY OUTLINE

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SUMMARY

This paper is an outline of corporate governance -- its scope, its history and suggestions for improving its effectiveness in the United States.

Section 1 describes the goal of governance as maximizing wealth creation to the extent it is compatible with the overall interests of society. In Section 2, we explain the American attempts to balance centralized power, public and private, with the interests of the individual citizen. In the early days of this country, the power of government was considered the biggest threat to individual liberty, but in this century corporate power is becoming the more pressing concern. On an international scale, competition for tax and other revenues triggers a "race to the bottom" for countries willing to externalize the costs of a system without accountability on the rest of the world.

The issues raised by this effort to find the right balance are discussed further in Section 3, which outlines lawmakers' and judges' reliance on the theoretical powers of owners to assure corporate responsibility. In Section 4, we discuss the limitations of the current system of shareholder and director oversight and of the proposals by scholars and practitioners to increase the number of "independent" directors as the key to effective corporate governance.

All over the world, businesses are being privatized with little, if any, analysis of how the ownership can best be structured or what improvements are hoped for or expected. We comment briefly on this phenomena in Section 5. In Section 6, we begin a discussion of institutional shareholders in the United States today and focus particularly on the pension system -- holder of 30 percent of the total equity capital -- as the new "permanent and universal" owner of the private enterprise

system. We find the beginnings of a new legal basis for corporate governance in the policies of the U.S. Department of Labor, which suggest the beginning of a "Federal Law of Ownership."

In a system that has many owners with relatively small percentage stakes, the most significant obstacles to effective monitoring are "collective action" or "free rider" problems and conflicts of interest. In Sections 6 and 7, we suggest how the new Federal Law of Ownership and enhanced communication among shareholders might begin to deal effectively with these threshold problems, so that institutional investors might organize themselves to be "rationally" informed and active with respect to their portfolio security holdings. In Section 8, we discuss improvements to the system for finding directors.

In Sections 9, 10 and 11 we make specific proposals to improve the effectiveness of an ownership-based governance system in the United States.

In Section 9, we suggest that equity holdings be divided between "ownership" and "trading" categories. This would accommodate the legitimate needs of certain classes of investor who place a premium on liquidity while permitting other classes of investor, the "permanent" owners, to exercise a rational level of oversight. We point out the limitations of the traditional languages of accountability in Section 10, and we recommend that the "ownership" shareholders devise an appropriate language of accountability objectives and hold management responsible for achieving those objectives. In Section 11, we suggest that the existence of fiduciary institutions -- who are by law "exclusively" committed to the interests of their beneficiaries -- will lead to the rise of new special purpose "fiduciary ownership" institutions. In order to meet the market test, they will have to avoid the inefficiencies of traditional bureaucracies by demonstrably adding value.

Finally, we conclude in Section 12 that no system of governance can be effective without all of the interested parties -- including government and corporate management -- being persuaded that it is not only in their interest, but essential for long-term productivity and competitiveness.

INTRODUCTION

One of the continuing themes of human existence is the tension between individual freedom and institutional power. In centuries past, this drama was played out in the Western world first with church and more recently with the civil state. In the century to come, the focus will be on making corporate power compatible with society in a democracy. The corporation gives the ultimate scope and expression to individual genius; this creative force has improved the living standard of billions of human beings. The challenge is to encourage the liberating energy without imposing unacceptable costs on individuals and society.

As the outreach of world wide communications, financial markets and industrial enterprises exponentially expand in ways we can only begin to imagine, we must acknowledge that the traditional concepts by which corporate power was to be held accountable simply do not work. Neither law nor practice has developed an acceptable system of accountability. The consequences are too important to allow us to rely on a dysfunctional mythology.

This paper is not the last word on American corporate governance. It is a beginning outline within the context of the United States of a comprehensive theory of governance based on empowered and motivated ownership. It is our effort to stretch existing dialogue to a framework of internally consistent concepts. We hope it will be the wire frame on which we and other sculptors will over time add the substance of a fully realized creation.

1. The Goal of Governance

The challenge of corporate governance is to find a way to maximize wealth creation over time, in a manner that does not impose inappropriate costs on third parties or on society as a whole. Wealth creation can be looked at from a macro perspective (including the wealth created for employees and the community as well as investors), although doing so requires rigorous and quantitative calculations to prevent vague "stakeholder" claims. Inappropriate costs can include agency costs imposed on investors as reflected, for example, in excessive CEO pay. They also include externalized costs imposed on society at large, like pollution and criminal behavior.

An effective corporate governance system requires a system of checks and balances, assuring that the right questions get asked ("Do we need to revise our corporate strategy? Our asset mix? Our organizational structure? Our allocation of resources? How is the CEO doing? How is the board doing?") of the right people (those with the best access to information, the fewest conflicts of interest, and the authority to make the decisions and see they get implemented). Since the one certainty in life, whether corporate or not, is change, the one goal we have for corporate governance is that it optimally enables corporations to respond to, affect, and even lead change. All governance systems should be evaluated on this basis.

In order to respond to change, you have to both be aware of it and be able to determine and implement the right response to it. Both require constant questioning, evaluation and re-evaluation. A corporate governance system that is not effective is one in which questions are raised too late, or not at all, or are decided by people who are unable to evaluate them properly. The result of an ineffective system of corporate governance is the use of power without a level of accountability sufficient to ensure that it is exercised to maximize wealth creation. As we examine the corporate failures of the past decades, we see failures of individual corporate behemoths as symbols of the failure of the corporate structure as a mechanism for tying together the use of power and the accountability for the consequences of its exercise.

In order to understand what needs to be done, we must first ask what we are trying to achieve, not just in the context of the corporate structure, but in the societal systems that create and surround it. Other systems place equality or stability or the good of the group as a whole as their most important priority, but the capitalist system prizes individual liberty above everything else. The basis of our system is the belief that the greatest benefit to the greatest number will come from a system in which each person profits according to his contribution.

It is not entirely Darwinian or libertarian, of course. We have social programs and legislatively imposed standards to ensure that those who are unable to achieve a certain level of contribution will nevertheless have food, shelter, education, and health care. But our system is designed to make Horatio Alger stories possible, and our heroes are those, from Andrew Carnegie to Walt Disney to Sam Walton to Bill Gates, who have exceeded even Alger's dreams of success. For that reason, we leave to the individual and to the structures they create a broad range of decisions and judgments, believing that the individual should have as much freedom as possible to pursue success as he defines it. When we do impose limits, they are designed to resolve problems of externalities and conflicts of interests. For example, we reduce occupational injuries by establishing health and safety standards, reasoning that the costs they impose on corporations and their investors are exceeded by the benefits to the individual employees and to society as a whole.

As we look at corporate governance, then, we evaluate the options by measuring them against the goals of protecting individual liberty, maximizing wealth, and managing change. This requires most of all, a balance of power between the distinct elements of the corporation. Even the smallest company, owned and operated by the same people, cannot operate by consensus. Some authority must be delegated. If too little is delegated, the enterprise will not be able to benefit from expertise and specialization. Decision-making will take so long that opportunities will

be missed. If too much authority is delegated, the result will be a lack of coordination and consistency that can be very expensive. The benefit of sharing expertise and experience will also be missed. The challenge is to find the right level of delegation, at all levels in the corporation. Which decisions should be made on the spot, and which should be reviewed before implementation? Which divisions (counsel's office, marketing, finance) within the company should be brought in, and at which stages? Which decisions must be left to the board? Which must be decided by shareholders?

Perhaps the most difficult task in designing and operating the corporation is achieving the optimal balance between power and accountability. We want all people in the corporation to have power to perform their tasks, so long as there is enough accountability to ensure that those tasks are performed for the benefit of the owners over the long term. While this applies to every individual who has any decision-making authority, we will discuss the issues in terms of categories of people, primarily owners (shareholders), managers (top executives), directors, and employees. Each of these categories has important connections to each of the others. There is in place, at least in theory, a system of checks and balances designed to permit the appropriate scope of authority (power) and limit the abuse of that authority (accountability).

The indispensable link between the corporate constituents is the creation of a credible structure (with incentives and disincentives) that enables people with overlapping but not entirely congruent interests to have a sufficient level of confidence in each other and the viability of the enterprise as a whole. That structure, of course, will vary with the relationships and the circumstances.

2. The Century of Corporations

America's founding fathers were profoundly aware of the abuses of power and the importance of making sure that all power -- private as well as public -- drew its legitimacy from a system of checks and balances. The fight for independence, after all, stemmed not from the imposition of rules or taxes from England, but from the lack of representation to ensure that the actions of the legislature reflected the priorities of the community which they affected. The earliest documents of our country's history reflected these concerns and the commitment that all power, public and private, would be grounded in accountability. The solution would be a government "of, by, and for the people." Private power exercised by privately established entities was not explicitly considered as a part of this process. The word "corporation" is not mentioned in the Constitution.

In England, corporations developed as a structure for exercising power outside the monarchy and the church. In the new United States, democratic government was the source of power, and the founding fathers limited that power very carefully. Thomas Jefferson wrote in a letter of his concerns over corporate accountability: "Merchants have no country. The mere spot they stand on does not constitute so strong an attachment as that from which they draw their gains."^[i] Jefferson was concerned about what we now refer to as agency costs. He warned that we could not expect corporations and their officers to act in accordance with the best interests of the state, because their incentives were determined by commerce.

For this reason, in the early days of the United States, a corporate charter was granted only by a special act of the state legislatures. Applicants for corporate charters had to negotiate with legislators to arrive at specific charter provisions, notes Harvey H. Segal, including "the purpose of the enterprise, the location of its activities, the amount of capital to be raised by stock sales, and the power of its directory."^[ii] The theory was that the state should separately and specifically approve each new corporation, to guard against improper activity. But, as Segal noted, instead of oversight, this process "invited bribery and corruption." So, in 1811, New York enacted a general incorporation statute (though restricting it to manufacturing enterprises), and other states followed suit. The states, however, remained deeply involved.

One early controversy that arose in the early 1830s concerned the charter of the Bank of the United States. The Bank, as originally chartered, was a private corporation, though it had the power to issue notes of exchange. The Bank was not taxed, and Congress was not allowed to charter any similar institution. In return for these favors, the government was allowed to appoint five of the Bank's twenty-five directors. The Bank's powers shocked democrats. Roger B. Taney, Congressman and later Chief Justice of the Supreme Court, said: "It is this power concentrated in the hands of a few individuals -- exercised in secret and unseen although constantly felt -- irresponsible and above the control of the people or the government ... that is sufficient to awaken any man in the country if the danger is brought distinctly to his view." [iii]

It was the fear of centralized power that caused Americans in their Constitution and Bill of Rights to protect themselves against Government and established religion. Possibly the most eloquent statement of the threat of corporate power is in the dissenting opinion of Justice Louis D. Brandeis in *Liggett v. Lee*:

Although the value of this instrumentality in commerce and industry was fully recognized, incorporation for business was commonly denied long after it had been freely granted for religious, education, and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual, fear of the subjugation of labor to capital, fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain. There was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations. [iv]

After the Civil War, companies began to form "trusts." It was clear that if competitors in the same line of business worked together instead of separately, they could control prices. This was not illegal or even disapproved of at the time. Indeed, the directors of these new entities were called "trustees," a term that still lives on in the nonprofit, banking, and securities sectors to describe those with special obligations to protect the rights of others. Segal points out that "In wielding such broad discretionary power, the trustees established important precedents for the control of corporations by professional managers rather than dominant shareholders." [v] The first antitrust laws ended the trusts, but the professional managers were there to stay. As corporations grew bigger and more complex, and the connection between ownership and control stretched to the breaking point, professional managers took on more authority. Jefferson's analysis of the loyalties of the businessman was intended to justify government oversight. In earlier centuries, mankind created institutions -- the Church, the nation state -- that dominated human existence. As the twentieth century began, Henry Adams' famous chapter *The Virgin and the Dynamo* recounted how technology rather than piety had become the driving force of society. As we approach a new century, there can be little question but that large corporations have an increasing impact on the lives of individuals all over the world.

The world now boasts a total of 37,000 transnational companies that control about a third of all private sector assets, and enjoy worldwide sales of about \$5.5 trillion -- slightly less than America's GDP last year. [vi]

In just over two centuries, the American corporation has gone from an enterprise strictly limited by the state in both its scope and duration to a perpetual entity that has been held by the Supreme Court to be a "person" with Constitutionally protected powers of speech. Yet many observers remain concerned that the centralization of vast power inherently threatens the freedom of individuals. "The large private corporation fits oddly into Democratic theory. Indeed, it does not fit." [vii]

By making ordinary business decisions [corporate] managers now have more power than most sovereign governments to determine where people will live; what work they will do if any; what

they will eat, drink, and wear; and what sorts of knowledge they will encourage; and what kind of society their children will inherit.[viii]

Now, with multi-national corporations larger in assets and population than many countries, we have no clear answer to the question -- to whom are those who control these great enterprises accountable? In theory, the owners, the holders of equity securities and the government, representing the society as a whole, play that role. The basic framework is a matter of the law established by the legislature of the company's domicile. But the company's managers can choose virtually any place for domicile no matter where the corporation actually resides or operates. An international "race to the bottom" is the result of competition for fees and taxes associated with corporate domicile, so that any attempt at accountability through chartering restraints on corporate power will ultimately be diluted to meaninglessness.

3. Use and Abuse of Corporate Power

It is not the power of corporate managers itself that concerns us. To the extent that corporate managers determine many of the most important aspects of people's lives, including what they will buy and the conditions of their employment, they may be in a better position to make those determinations than the alternatives, like, for example, the government. If the market is working efficiently, those managers will be responding to the people themselves, their consumers and investors. After all, no corporate management in the world, no matter how powerful, can make consumers buy Edsels or switch to New Coke or invest in a company with poor prospects. In countries where the government makes the decisions about what corporations will sell, where they will be located, and what the conditions of employment will be, there are few choices left to consumers and employees. The premise of the capitalist system is that we will let any company that wants to make toothpaste try it. If that means that a dozen different brands are on the shelf, it is evidence that the market is providing a broad variety of consumers exactly what they need. This does not mean that everyone gets his first choice. Someone whose heart's desire is pizza flavored toothpaste is unlikely to find it under this system. But it beats a system where one person in the government gets to decide that pizza flavored toothpaste will be the only option available. Allowing the market (the consumers) to decide how many varieties of toothpaste will be available and giving the market (the investors) the ability to respond when corporate management does poorly is more likely to result in total wealth maximization than giving that authority to the government or any of the other alternatives.

This all supposes, however, that the market is indeed efficient, which has not always been the case, even under capitalist systems. What concerns us is the abuse of corporate power, which is made possible by impediments to market-based accountability.

Corporations exist because governments authorize their existence. The government has tried to assure that their citizens receive the benefits of corporate activity -- products, jobs, income -- while protecting them from its excesses. This has taken several forms in American history. As noted above, in the earliest days of the United States, government limited the purposes for which corporations could be formed, even requiring approval of each applicant's lines of business. It also limited their life span, and limited the amount of capital that could be invested in their stock.

But the federalist system, with each state permitted to make its own rules, resulted in competition between states for the taxes and service revenues associated with incorporation. In order to compete for incorporations in their state, legislators diluted the restraints on the "insidious menace" Brandeis referred to; apparently loss of revenues to the state was a menace that was even more insidious. By the end of the nineteenth century, government focused particularly on assuring the competitiveness of the corporate environment. The theory -- beginning with Adam Smith -- continues to be that a truly competitive marketplace will insure socially desirable results.

In the 20th century, United States government has focused on specific problems like product safety, the adverse impact of corporations on the environment, health hazards in the work place, and discrimination in employment. While the earliest regulatory agencies of the federal government focused on economic regulation, from the 1960's on, the focus shifted to health and safety. Transportation and telecommunications were increasingly deregulated to enable them to compete. To the extent that the federal government's involvement goes beyond health and safety issues, tax policy, and criminal standards, it tends toward disclosure requirements (in aid of consumer and investor knowledge and confidence, and therefore market efficiency), and works through independent private organizations -- the New York Stock Exchange, the National Association of Securities Dealers, the Financial Accounting Standards Board, among others -- to encourage self-regulation whenever possible.

This has left us with a system that may have gone too far in giving corporate managers power without proportionate responsibility. In addition to specific examples of abuses, the overall inability of the market to respond adequately to performance failures and of the government to respond adequately to violations of law force us to question whether the current structure provides enough of a balance to protect society against abuses of corporate power.

In theory, the self-interest of owners is supposed to insure that enterprises promote the general good.

The conventional view assigned the stockholder two roles in legitimating corporate power. His interest in a share of the corporation's earnings defined a primary goal of the enterprise; satisfaction of that interest was -- in law as it was assumed to be in fact -- the key measure of management's performance. Stockholders were also to play an active role -- and in some respects the superior role -- in the internal governance of the corporation; their votes elected the board of directors. In both respects, the shareholders' involvement would insure that those immediately in charge of the enterprise would be held to a profit-seeking performance, which under market discipline would make the firm an acceptable productive contributor to the economy.[ix]

But it has become increasingly clear that corporations exercise great power in the election of government officials, the debates leading to adoption of laws and the development of regulations for their implementation and enforcement.

This culture gives enormous advantages to long-term big players. Even if a corporation hasn't contributed to the member of Congress it most needs to see, other members and other corporate officials can provide introductions and testimonials. The member knows that the corporation is a major player, has been around for a long time, and has the resources to deliver. The corporation will be able to give a PAC contribution every election for as long as the member is in Congress and do so without straining corporate resources. Moreover, the corporation will be able to draw on reserve power if need be. It is this sort of reputation that both individuals and corporations work for years to achieve. With such a reputation, very little needs to be made explicit. A wink and a nod communicate everything; even the wink and nod may be superfluous. Without such a reputation, people looking for favors are a much greater risk - that they will put the issue as an explicit exchange, thereby compromising the member (and potentially forcing a rejection of the request); that they will be more likely to double-cross a member because they don't have a reputation to safeguard; or that if asked for extra help they won't have the necessary networks to deliver.

Therefore individuals, labor unions, small businesses, or nonprofit organizations are in a different structural position than major corporations, even if they are willing and able to contribute the same amount of PAC money. A corporation is also able to draw on and promise access to resources not connected to campaign money. It can deliver not only a campaign contribution but perhaps also a free trip or a lecture fee or even line up campaign contributions from other corporate PACs. If a member needs information on an issue, the company has experts who can

provide it. If the company has a facility in the member's district, it can provide the member with entree to its employees, it will have leverage with both its customers and suppliers, and its managers will have personal networks with other key figures in the community.

Moreover, most of the time most major corporations have a high degree of legitimacy. Even if a member of Congress is helping them to pollute the environment or evade taxes, the special benefit is still likely to be widely regarded as at least defensible and perhaps honorable. A news story, if there were one, would be a "balanced" presentation of "both sides." In part this is simply because business occupies a special place in our society. But it is also because businesses with major PACs are large operations. A tax break need not stand out; rather it will be seen as a complicated provision applying to special circumstances faced by this corporation and intended only to create fair conditions for this unusual situation.[x]

Corporations in the United States enjoy many of the rights constitutionally guaranteed to individuals, among them "freedom of speech" which permits financial involvement in elections and referenda.

Corporations, by their nature, do not function as democratic organizations, yet it is they who have seized the political ground left vacant by citizens, the political parties and other mediating institutions. Business and finance stepped into the vacuum created by failed political institutions and took up the daily work of politics. Their tremendous financial resources, the diversity of their interests, the squads of talented professionals -- all these assets and some others are now relentlessly focused on the politics of governing.

This new institutional reality is the centerpiece in the breakdown of contemporary democracy. Corporations exist to pursue their own profit maximization, not the collective aspirations of the society. They are commanded by a hierarchy of managers, not by democratic deliberation. Yet the modern corporation presumes to act like a mediating institution -- speaking on behalf of others and for the larger public good. It is corporations that have taken the place of political parties, to the extent anyone has.

With varying degrees of sophistication and intensity, hundreds of these large corporate political organizations are now astride the democratic landscape, organizing the ideas and agendas, financing electoral politics and overwhelming the competing voices of other, less well-endowed organizations and citizens. They portray themselves as "good citizens," doing their part for public affairs.

For obvious reasons, this institutional arrangement is bound to disappoint democratic expectations. The contest of politics becomes mainly an indistinct competition among rival behemoths. The political space that once belonged to parties and other mediating institutions is usurped by narrow-minded economic interests. Citizens at large vaguely perceive that government is being steered by these forces and they naturally resent it.

The transformation occurred partly by default and partly by design. Corporate political organizations set out to seize the high ground, but they also simply learned how to do politics in the modern setting more inventively than anyone else. By necessity, they have adapted effectively to the new conditions of mass-media politics and the diffusion of government authority, while citizens and rival organizations have not.

Corporations, however, enjoy an anomalous status not available to anyone else: In the lawless government, corporate "citizens" are the leading outlaws. They may regularly violate the law without surrendering their political rights -- committing felonious acts that would send people to prison and strip them of their citizenship. This contradiction is crucial to what has deformed democracy; the power relationships of politics cannot be brought into a more equitable balance until citizens confront the privileged legal status accorded to these political organizations.[xi]

The most important task for the corporate governance system is ensuring a balance between the freedom to maximize wealth (power) and the limits of doing so without imposing disproportionate costs on others (accountability). In this sense, corporate governance must both protect corporations from society and society from corporations. Consider the classic externality of environmental pollution. We would not want environmental rules that effectively prohibit manufacturing any more than we would want environmental rules (or absence of rules) that permit corporate managers to emit effluents into the air and water without regard to the cost to the community. We try to design environmental rules (and, we hope, all rules), based on the most reliable cost-benefit analysis. We recognize that combustion engines are responsible for much of the damage to the air, but we do not consider for a moment the possibility of prohibiting cars and trucks, because we recognize the value they add to our society. So, we negotiate at the margin, requiring fuel and auto manufacturers to eliminate the use of especially harmful substances, like lead, and reduce other kinds of emissions to carefully calibrated levels, and we create incentives for development of alternatives. In a few areas, like the Food and Drug Act's notorious Delany clause, we do not have the luxury of a cost-benefit analysis, and we end up banning one substance (like cyclamates), only to find a decade later that the substance that replaced it was even more hazardous.

But our laws have failed in one important regard, and that has prevented us from being able to calibrate the optimal balance between power and accountability. Our commitment to freedom of speech and spirited public discourse has made us uncomfortable about limiting the involvement of the corporation in politics. The result has been too many occasions when the cost-benefit analyses used to underlie legislative and regulatory standards has been based more on political costs than economic costs. The record of the automobile companies with regard to emissions and airbags is just one example.

"An institution which wields practical power -- which compels men's wills or behavior -- must be accountable for its purposes and its performance by criteria not wholly in the control of the institution itself."^[xii] As we will discuss later (sections 5 and 9), there are countries in which corporate power appears to dominate the state and there is a continuing problem in this country with the power of corporations over the electoral and legislative process. Our effort is to suggest a system of governance that originates from within the corporation itself and that includes the participation of an informed and effectively manifested broad class of "owners."

4. The "Conventional Wisdom"

Governance should focus on performance and competitiveness. Its objective must therefore be to minimize the "agency costs" inherent in any system where the people who provide the capital hire someone else to manage their property. Owner and manager will always have different interests, and at least some of the time those interests will conflict. A well governed corporation is one in which the interests are aligned to as great a degree as possible, providing optimal efficiency and profitability.

The conventional wisdom is that this is accomplished by giving the owners the right to elect the directors, who in turn select and monitor the Chief Executive Officer and the rest of management. And if the shareholders don't like it, they can sell their shares and invest in something else. In the Anglo-American (and, to a lesser extent in the balance of the OECD) world, this theoretical constraint of accountability differs sharply from reality. Our statutes use the language of democratic politics -- election, vote, ballot, confidentiality -- while the reality is that the system is inbred and self-perpetuating, the other end of the scale from meaningful accountability. Edward J. Epstein says that shareholder elections "are procedurally much more akin to the elections held by the Communist party of North Korea than those held in Western democracies."^[xiii]

Professor Melvin Aron Eisenberg writes of the "limits of shareholder consent,"^[xiv] noting that "under current law and practice, shareholder consent to rules proposed by top managers in publicly held corporations may be either nominal, tainted by a conflict of interest, coerced, or impoverished."^[xv] In Eisenberg's view, shareholder consent is "nominal" when (as permitted under proxy rules) the shareholder does not vote at all and management votes on his behalf, or shares held by the broker or broker's depository are voted with no direction from the beneficial owner. Shareholder consent is "tainted" by a conflict of interest when an institutional investor votes in favor of a management proposal it would otherwise oppose, due to commercial ties to the company management.

Shareholder consent is "coerced" when, for example, management ties an action that is attractive to shareholders, like a special dividend, to passage of a provision that may be contrary to their interests. For instance, in 1989, shareholders of Ramada Inc. were asked to approve a package of antitakeover measures, bundled with a generous cash payment.^[xvi] And shareholder consent is "impoverished" when "for example, shareholders may vote for a rule proposed by management even though they would prefer a different rule, because the proposed rule is better than the rule it replaces and management's control over the agenda effectively limits the shareholders' choice to the existing rule or the proposed rule."^[xvii] This is a reflection of management's vastly superior access to the proxy, both procedurally (in terms of resources) and substantively (in terms of appropriate subject matter). Eisenberg has described shareholders as "disenfranchised."^[xviii]

In almost every case, CEOs select the "outside" directors, as described in this recent article:

Still, the Digital Equipment Company's Board hasn't gone far enough. Take the new directors, Phillips [an incumbent] says he proposed Feldstein and Staley, then 'Bob Palmer [the CEO] interviewed them and he made the decision to invite them'. That's hardly a way to establish a new director's independence.^[xix]

It requires extraordinary independence and commitment to overcome the inherent structural obstacles to meaningful monitoring, in this context. That simply cannot be achieved as long as, in almost every case, the directors are selected by the CEO. As one potential director candidate told me after an (unsuccessful) interview with the CEO, "I could tell it was a job interview. What I didn't know was who was interviewing whom. I guess each of us thought he was doing the interviewing." Unless the directors understand that they owe their appointment to the shareholders, they will find it all but impossible to escape the "dance with the one who brought you" syndrome.

The other problem with directors is that they are busy and successful people. Many serve on six or more boards. A few, like Vernon Jordan and Frank Carlucci, serve on many more than that. It takes a great deal of time and attention to master the elements of the corporation's businesses and to understand enough about the company to be able to overcome the inherent disadvantage of having the substance and timing of all information controlled by management.

It also takes a willingness to confront management when necessary and to drop everything and turn to a corporate crisis like a CEO succession or a hostile takeover when necessary. While there may be people who are willing and able to undertake this responsibility, very few of them will do so for the limited amount that directors get paid, especially since it is rarely, if ever, related to performance. There are dozens, maybe even hundreds of examples of boards made up of distinguished, capable, honest people who just did not give the job the attention and independent judgment it requires. America's greatest and strongest companies fell, one by one, as the boards watched. The value of General Motors, IBM, Sears, Westinghouse, and Kodak plummeted before the boards responded. At other companies, boards approved executive pay levels that would have brought a blush to Marie Antoinette, without regard to performance. Still other companies violated laws resulting in fines, debarment, and other penalties, and the boards paid the legal fees and kept the management team in place. All of these are the result of classic agency cost problems. Investors' interest in long-term performance was outweighed by corporate managers'

interest in shorter-term security and stability and board members' interest in collegiality and lack of confrontation. Directors must take responsibility for developing a long-term strategy, and not just nodding sagely at the CEO's flip-charts.

Because the failure of corporate boards has been well documented, a considerable literature has developed to describe how they can better discharge their directorial responsibilities. Recommendations have included a limit on the number of boards that an individual should serve (Lipton & Lorsch suggest three^[xx]; requiring directors to have a meaningful personal financial commitment in their corporations (Buffett); selecting directors by nominating committees comprised of "independent" directors; limiting the number of "insiders" allowed on the board (former SEC Chairman Harold Williams suggested that only the CEO should be allowed on the board); designating a "lead director" when CEO and Chairman are the same person (Lipton); holding a regularly scheduled board evaluation.

Unfortunately, salutary as all of these proposals are, they are addressing the symptoms rather than the illness. "Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years, it is futile to blame men. It is the institution that malfunctions."^[xxi] At the margin, these proposals will all help, especially the proposals about substantial board member investment in the company (nothing makes a director think like a shareholder more than being a shareholder) and board evaluation. But the unavoidable truth is that at the end of the day, all of the proposals fail to address the essence of the problem, the self-perpetuating aspect of an organization whose members are selected by themselves. Encouraging developments of the past few years do show an increased responsiveness to the priorities of the owners. Recent directoral activism, epitomized by the General Motors' board taking back control of the failing enterprise from the full time managers, may be proof that the present equilibrium between owners and managers in the United States can improve. And yet, the question remains, "What took them so long?" How could a survey of corporate directors in the late 1980s show that the most admired boards in the country were GM and IBM? How could IBM have a board on which not one director used a personal computer? The key element of monitoring, essential for establishing and maintaining focus, was missing. An entity which is self-perpetuating can not meaningfully evaluate itself. All of the focus on "independent directors" from the exchanges to the government to shareholders, ignores the essential fact that, they are still selected by the people they are supposed to oversee, and that system is as riddled with conflicts as asking a student to determine his own grade. As long as that continues, corporate managers will not be reminded often enough that their priorities are performance, performance, and performance.

As the size and complexity of corporations continues to increase, the problems with abuse of corporate power will be unignorable. As citizens in the future grapple with these problems, we can no longer afford the gap between the myth of an accountable structure and the reality of a structure that does not respond until too late. A governance system must be based on concepts and structure that are clear, understandable and straightforward, and that acknowledge and deal explicitly with real and apparent conflicts of interest. The current system falls far short.

5. Corporation and State

The failed experiments with Communism in the post World War II era reflect the conclusion that state ownership and control over business does not best serve the public interest or promote corporate vitality. With all of the capitalist system's failures, its commitment to competition enabled it to outperform Communism. Any number of former Soviet republics and Czechoslovakia have distributed "ownership vouchers" to their citizens as a means of transition to private ownership. Countries that have been capitalist have become even more so with privatization of formerly public enterprises. France, Italy and the United Kingdom have distributed the state's equity in various enterprises through underwriters to private investors. In Germany, the

bellwether company Daimler Benz has broken out of the fifty year Government/Hausbank control structure by listing its shares on the New York Stock Exchange in an effort to get access to the most cost effective world capital markets. Japan retains its government sanctioned kereitsu arrangement, but top business leaders there say that the need for change is urgent.[xxii] Surprisingly, in Britain, no attention was given to the governance issues raised by the Thatcher-era privatization.[xxiii]

The shift was more a move away from government control than a move to a private, ownership-based corporate system. There may not have been a universal conclusion that private ownership was good, but there was a universal conviction that any alternative was better than ownership by the state. In Eastern Europe and especially in the former Soviet Union, the inefficiencies of the bureaucratic state permeated the production and service sector. Twenty years ago, I waited alongside my colleague Simon Chilowich, who exported farm implements to the Soviet Union, in the Moscow Industry Park for an inspection visit by Brezhnev. I looked over the various combines, bailers, plows and other implements and noted that there was a plastic envelope containing a wheel attached to each piece of equipment. The wheel did not accord in size to any of the other wheels, so it did not seem suitable as a spare. Finally, I asked Simon what the extra wheel was for. He roared with the laughter of a Pole whose family had done business with Russia for over two hundred years and said: "Finally, my friend, you have learned something about Russian business. Those wheels are for the Russian tractors. Their tractor plant does not make a front wheel, so they buy our attachments to make the whole thing work." I asked, "Why doesn't somebody do something about it? Why don't you tell Brezhnev yourself when he comes by?" Simon placed the index finger of his right hand to his right temple in the universal sign of a pistol and compressed the middle finger indicating that he would be shot. The importation of the spare wheel without which Soviet tractors could not be operated exemplified the system of control in which information could not be circulated at the risk of death.

There is also a close to universal conviction that it is not much better to have the state "owned" by corporations. In some countries, like Italy and Japan, the interconnection between government and large corporations has been so pervasive that it raises questions about the legitimacy of both. Are the corporations really profitable and competitive, or are they being subsidized by the taxpayers? Is the government simply an agent for maintaining a corporation/business oligarchy in wealth and power?

Even France, with its great pride in its education and technology, seems to be evolving away from dirigisme. Its enormous unemployment levels cast doubt on the efficacy of even the most intelligent centrally-directed economic systems; nor is its government/business relationship immune from the corruption more usually associated with Italy.

By and large, a marketplace economy obtains the service of needed personnel in a competitive market place. It has been felt that government is unable to be competitive at the top level and that private sector salaries simply dominate the educational and job seeking priorities of youth. Harvard's former President Derek Bok has written a heartfelt lament on the personal and societal consequences of this dominion by the private sector.[xxiv] The presumption is that higher salaries attract and motivate abler people and that private ownership will not be limited by the lower compensation available for government employees.

While marketplace capitalism struggles for theoretic and practical roots, socialism is plainly an experiment that has failed. Implicit in this victory over socialism is the conviction that "ownership" by individuals adds elements of value, both objective and subjective, to the existing enterprises. Surprisingly little attention has been paid as to how the new private owners are to play their role and what results can reasonably be expected from their involvement in the governance of private entities.

As the number of institutional investors increased, some prophets said that these investors, moved by their stakes and informed by their expertise, would begin to play in earnest the

legendary roles of the supervisory stockholder. But through the 1970s the record showed little to bear out the prophecies. The size of their assets commanded respect when institutional investors sought information; by their probing they introduced some fresh surveillance into corporate affairs. They became a bit more effective in the late 1980s, objecting to some of the abuses of the takeover era and later to CEO pay that was unrelated to performance. Nonetheless, the institutional investors generally behaved as individuals did; like individuals, they expressed dissatisfaction with the government of a corporation by selling out rather than by voting their shares for new men or different decisions. On rare occasions institutional investors cast their weight for a change in top management; rarer was evidence of their influence brought to bear on particular issues of corporation policy.[xxv]

While accountability based on shareholder discipline is an inveterate element of corporate theory, the conflicts and collective choice problems that have prevented effective shareholder involvement have resulted in a role for shareholders that is vestigial at best. The well known publications of A.A. Berle pointed out seventy-five years ago that corporate power was in fact exercised by a self-perpetuating cadre of professional managers, because ownership had become too diffuse to be susceptible of effective mobilization. But Berle could not have imagined that a class of shareholders, small in number but enormous in size, would transform the equation. In 1994, institutions owned more than 50 percent of the total outstanding equity of American corporations, and there is a real class of corporate owners with the opportunity to turn governance theory into reality. Furthermore, while the institutional shareholders are very different in many ways, they have one important thing in common. They are all fiduciaries, obligated to meet the highest standards imposed by our legal system. As such, if becoming effective monitors will add value to their portfolios, as all evidence shows that it will, they must do it.

6. Pension Plan Capitalism Based on a Federal Law of Ownership

Within the category of institutional investors, the largest group, public and private pension funds, are the best suited to playing the "legendary" supervisory role. For reasons discussed extensively elsewhere,[xxvi] other institutions have a short-term perspective (money market funds) or conflicts of interest (banks and other entities who rely on corporations for business). Pension funds have a perspective so long-term it is almost perpetual, with an average of 30 years from the date an employee puts the first dollar in to the date he takes the first dollar out. By that time, a whole new generation of employees is paying in. Pension funds and the professionals who manage them have conflicts of interest, too. But the strict fiduciary standards that apply to them should ensure that all aspects of the portfolio, including shareholder rights, are exercised, in the words of ERISA[xxvii], "for the exclusive benefit of (pension) plan participants," so that all conflicts are resolved in favor of the beneficial holders.

The funded pension systems in the United States, both public and private, have created a class of long term owners whose interests are congruent with those of society. The pension plan participants want not only retirement income security but also the security of living their retirement years in a country that is economically strong and socially safe, comfortable, and just.[xxviii] We will therefore focus on how these "new owners" can function as the core of an international system of governance.[xxix]

The United States government has encouraged both companies and individuals to create a voluntary prefunded defined benefit pension system through very large tax incentives over the last fifty years. The result is an aggregate of approximately \$3 trillion of investment capital having a particular character. These trusts really are collateral for the payment of promises years in the future, so pension funds have very little need for liquidity in their holdings. They are the quintessential long term owner. Because pension funds hold shares in literally every public

company and every industry, they also constitute a new class of "universal owners." But they are also absentee owners.

To a certain extent, the competition between companies and industries has created a collective choice problem in dealing with issues that are of value to the group as a whole, but uneconomic as an individual choice. Fields such as vocational education, energy conservation, occupational health and safety, and environmental sensitivity fit in this category. This is an agenda that can be addressed only by government in conjunction with a "universal shareholder." There are approximately one hundred million Americans who have interests in public and private pension systems. This means that 40 percent of the entire population has an interest in enjoying their retirement years in a society that is clean, safe, internationally confident and stable.

Pension funds have emerged because of government subsidy. The "tax cost" of pensions is in excess of \$50 billion per year and is, after defense, the largest item on the United States budget. Because, pension funds are "paid for" in substantial part by public funds, it is appropriate for government to retain residual authority to define broadly how pension fund trustees should function in their capacity as owners of the country's industrial establishment. While pension funds (with some 30 percent of the total - 20 percent private, 10 percent public) are the largest single institutional investor, other trustee funds subject to federal government oversight -- mutual funds (SEC) and bank trusts (FDIC, Comptroller, Federal Reserve) -- are so substantial that today a majority of the equity capital in the country is held by trustees, the scope of whose functioning is defined by federal authority.

The Pension and Welfare Benefits Administration of the U.S. Department of Labor (referred to hereinafter usually as PWBA and DOL, respectively) issued on July 29, 1994 the most comprehensive guidelines yet available as to the "responsibility of ownership:"

The Department believes that, where proxy voting decisions may have an effect on the economic value of the plan's underlying investment, plan fiduciaries should make proxy voting decisions with a view to enhancing the value of the shares of stock, taking into account the period over which the plan expects to hold such shares. Similarly in certain situations it may be appropriate for a fiduciary to engage in activities intended to monitor or influence corporate management if the fiduciary expects that such activities are likely to enhance the value of the plan's investment.

Although, within the corporate structure, the primary responsibility to oversee corporate management falls on the corporation's board of directors, the Department believes that active monitoring and communication with corporate management is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such activities by the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved. Such a reasonable expectation may exist in various circumstances, for example, where plan investments in corporate stock are held as long-term investments or where a plan may not be able easily to dispose of such an investment.

Active monitoring and communication activities may concern a variety of issues, such as the independence and expertise of candidates for the corporation's board of directors or assuring that the board has sufficient information to carry out its responsibility to monitor management. Other issues might include consideration of the appropriateness of executive compensation, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalization, the nature of long-term business plans, the corporation's investment in training to develop its work force, other workplace practices and financial and non-financial measure of corporate performance. Active monitoring and communication may be carried out through a variety of methods including by means of correspondence and meetings with corporate management as well as by exercising the legal rights of a shareholder.[xxx]

The development of a governance system based on increasingly active shareholders does not require any changes in law. The Securities & Exchange Commission (SEC) in the fall of 1992 modified the proxy rules to lessen the restrictions on institutional investors who want to communicate with each other about proxy issues. The Department of Justice has ruled that institutional shareholders can collaborate with respect to their ownership rights in portfolio companies, without violating antitrust standards.[xxxii] What is required is the energizing of the institutions -- particularly the private pensions subject to ERISA -- out of a conviction that activism is in their long-term best interest.

The failure of state law to provide a satisfactory structure for the governance of corporate power due to the inevitable consequences of the "race to the bottom" has been extensively documented.[xxxiii] Having the responsibilities of legal (trustee) ownership of 55.8 percent[xxxiii] of the 1000 largest United States corporations susceptible of definition by the DOL, the SEC and the various bank regulators gives rise to the prospect of a Federal Law of Ownership. Coordinated action by the relevant agencies, probably following the lead of the DOL, can reinstate the long missing legal basis for our system of governance.

Pension funds are institutions. They have their own limitations. They are as susceptible of bureaucratic failings as the companies in which they invest. It would be folly simply to substitute one bureaucracy for another. Public pension plans have the further liability of having a "political" agenda, whereby they might use their ownership power to advance non commercial objectives. The trustees of private pension plans are appointed by managements. The "fundamental contradiction" of ERISA, permitting corporations to oversee trusts for their employees' benefit, has contributed to the situation in which private trustees have been virtually silent in their responsibility as owners. On one hand, as a corporate manager, the pension fiduciary would tend to favor provisions that, on the other hand, as a shareholder, he might find unduly protective of management. And this could be so as a general matter or more specifically; he could even be a board member of the company whose equity securities are being held by the pension fund.

The "Federal Law of Ownership" will never work unless the crippling problems of "collective action" and conflict of interest are effectively addressed. The first is gradually being ameliorated as ownership becomes defined essentially (in the PWBA release) as a responsibility in addition to being a right. Trustees can not fail to act "prudently" in discharging responsibilities. Fiduciaries under ERISA (as well as the Securities & Banking Regulations) have many conflicting interests, as is inevitable in a pluralist economy. The question is how are these conflicts resolved in the context of exercising ownership responsibility for portfolio companies. At present, there can be little doubt but that the "ownership" responsibilities to trust beneficiaries are being subordinated to the commercial concerns of the trustees.

Plan sponsors, in addition to the DOL, need to be more active to ensure the integrity of pension funds. In some cases, achieving this goal may require plan sponsors to retain voting responsibility for the shares in the plan's portfolio. Plan sponsors who delegate such decisions to outside managers should monitor closely how voting decisions are made to ensure that they are not tainted by conflicts of interest.

Investment managers, too, need to play a greater role in the debate on the fiduciary duty under ERISA. While investment managers and other institutional investors were among the first to question the effect of antitakeover measures on the value of the shareholders' investment, it is equally clear that money managers, as a group, have been reluctant to confront publicly the problem of conflicts of interest.[xxxiv]

The government will need to set the standard for interpreting and enforcing the "exclusive benefit" rule of ERISA to provide guidance for private sector fiduciaries.

ERISA trustees operate today in a climate of seriously conflicted interest. Our own involvement with Chase Bank as trustee for the Employee Benefit Plans of Stone & Webster is a case in point.

The trustee "owns" thirty-seven percent of the total outstanding stock, for the purposes of exercising ownership rights. So far, this means the trustee has stood passively by, without question or protest, as the company's performance spiraled down. Unless a holder of this size begins to act like an owner, management is effectively insulated from being held accountable by other shareholders. And the ESOP beneficiaries are losing value, with no end in sight.

Chase, like other large fiduciaries has other important business relationships with Stone & Webster. All depend on the good grace of Stone & Webster management. Chase understandably does not want to cause either Stone & Webster or the business community anxiety with an aggressive interpretation of its fiduciary requirements. It will only act if it has to. Who will show it that it has to? The management who hires it? The employees, for whom it acts as fiduciary but who have no information about its performance on their behalf as shareholder?

At some point, the DOL will have to be explicit in requiring ERISA trustees to act for the "exclusive benefit of" and "solely" in the interest of plan participants for the purposes of this kind of monitoring. Institutions like Chase will not necessarily be foreclosed from acting as ERISA fiduciaries, they will simply have to bear the burden of proving that they are acting free of conflict of interest. This may spur the creation of special purpose fiduciary institutions in the future.

Even trustees without commercial conflicts face the obstacle of the "free rider" and collective choice problems. A trustee holding as much as one percent of a large company has a very large money investment, but the unattractive prospect of expending all of the resources in activism in exchange for only a pro rata share of the benefits. The DOL Interpretive Bulletin cited above, and the SEC's 1992 amendments to the rules governing communication between shareholders help to make collective action legitimate, and economic. This mitigates but does not solve this problem. Further indications of appropriateness from state and federal agencies are probably necessary. But some options already available to shareholders have not yet been taken advantage of. The EXXON by-law described below is one example.

7. Structure for an Ownership Based System of Governance

Once we understand that the existence of a class of long term -- essentially permanent -- shareholders, provides a stable financial infrastructure, we can create a system that benefits from their stability and uses them as a foundation. Knowing that the largest group of investors will be permanent "citizens" of the corporation makes it possible for one or more "owners" to undertake primary responsibility for monitoring a particular corporation. It must be clear to all parties that monitoring is an essential but strictly limited endeavor. Just as there are agency costs in having directors or managers make decisions best left to the shareholders, there are agency costs in having shareholders make decisions that are best left to managers or directors. Shareholders should monitor the director nomination and evaluation process, the executive and director compensation plans, and overall performance and structure. They should not monitor ordinary business decisions. Even if they had the right to do so, and even if they had the information to do so, the very fact of their diversified holdings would make it impossible. They cannot give Ford business advice when they are equally interested in the productivity of all of its competitors and suppliers.

In the context of these limitations, there are several possible models for organizing monitoring structures. The large institutional investors already have a number of associations, including the Council of Institutional Investors (CII), and the Committee on Investment of Employee Benefits Assets (CIEBA) of the Financial Executives Institute. CII has already shown that its members can combine forces to develop lists of poorly performing companies that can benefit from some shareholder feedback. Its impact has been so effective that an investment strategy based solely on CII-listed companies placed third in a national competition. Some of the CII members have set

up group meetings with CEOs and directors. They could take this one step further by developing a systematic approach to "assign" problem companies to one or two member institutions, which would take the lead and report back to the group.

Another model was proposed in a recent law review article. "The proxy system is the key to management control; giving shareholders control of the proxy system, therefore, is both a necessary and a sufficient condition for uniting ownership and control. However, collective action problems prevent coordination among all the shareholders, so control must vest in some subset of shareholders. Hence the law should grant exclusive access to the corporate treasury for proxy solicitation to a committee of the ten or twenty largest shareholders of the firm. The largest shareholders should comprise this committee because they are the most knowledgeable, have the greatest stake in the firm and therefore should be the most diligent in improving corporate performance." [xxxv]

The ESOP structure could well be used as the basis for effective ownership involvement.

Employees with stock in an ESOP have the right to vote on major issues and, in some cases, even for the board of directors. This is more voting rights than they have when they own stock through any other pension or benefit plan or through a mutual fund. In a normal pension or benefit plan, the trustees buy and sell stock and vote the shares without ever consulting the employees who are the beneficial owners of those shares. With an ESOP, the employees also have the benefit of a trustee who is bound to provide them with unbiased information, information that may be at odds with the information provided by the company's managers. The employees also have a representative at the annual meeting who is bound by law to look out only for their best financial interests.

Of course, the proper role of the ESOP trustee must be explained to the employees, along with the employees' role in voting their shares and receiving information from the trustee. If this process is properly explained, everyone should feel confident that their interests are being looked out for and that they are better off than they would be without the ESOP trustee. [xxxvi]

Still another possibility is suggested by Allen Sykes:

Each of the [most prominent] investment institutions would become "relationship investors" in say 8 of the top 100 companies. Each such company would then have 5 relationship investors whose combined shareholding be say 15% to 20% (8%-10% in the biggest companies), i.e. enough for influence but not dominance. Each institution would appoint a capable businessman (not an institutional manager) as a non-executive or as I shall call them henceforth, a "shareholder director". These directors, on behalf of all shareholders to whom they would be responsible at shareholder meetings, would discharge the monitoring and remuneration functions, i.e. hold executive directors (senior managers) fully accountable. [xxxvii]

I made a formal proposal at the 1992 EXXON Annual Meeting for the creation of a mechanism for shareholder involvement that was directed at the "free rider" problem and the difficulty and expense of communicating with other shareholders. The EXXON proposal makes it possible for any shareholder (or group of shareholders) having a threshold economic interest to submit a competitive proposal to be elected the shareholder representative. The elected shareholder is entitled to (i) compensation for costs up to a limit; (ii) compensation for time expended; and (iii) liberal access to the company's proxy statement thus enabling economical communication with the shareholders. This proposal enables suitable shareholder groups to make competitive proposals based on their qualifications and records. If they are "elected" by the shareholders, they can be paid an amount sufficient to compensate for their effort. This will remove some of the "free rider" inhibitions that account for the dearth of shareholder activism by those seemingly most qualified. It should engender the growth of an "ownership" profession alongside of the various other specialties found useful in managing money.

The agenda for these "shareholder committees" should stay away from "ordinary business" and focus on an explicit "mission statement" for the board of directors, with specific governance and performance goals for the enterprise and benchmarks by which to measure their accomplishment (See Section 8 below). "Those who can best decide what directors should do are those who will be most affected by their actions; that is, the shareholders. They now have little reason to ponder the question because they play no role in the selection of directors. Only when shareholders control the board will they start to figure out how much time outside directors should devote to their positions, how actively they should participate in corporate planning, how to handle executive compensation, takeover defenses, and all the other problems that have long plagued corporate governance." [xxxviii] The statutory definitions of directoral duties imply a static responsibility. Directing a corporation is, in fact, a dynamic process. What a board should do at a particular time is different from what it should do at another; what is appropriate for one corporation is not for others. The principal utility of organizing a group of responsible shareholders is in their undertaking on a continuing basis to inform themselves and accordingly proscribe an appropriate program for the board. Included in this responsibility is an on-going determination of the kind of people needed for the board to achieve the desired objectives.

CII has also considered the possibility of establishing a clearinghouse for director candidates, like the United Kingdom's Pro-NED. This would address a key failure of the current system, the self-perpetuating nature of the board selection system.

Because of the free rider and collective choice problems, there must also be a way to compensate those shareholders who act on behalf of shareholders as a group.

8. How to Find Directors

As discussed above, boards are a successful myth. They approximate just enough of the appearance of their statutory and publicly advertised duties to blunt societal concerns about the concentration of power in corporate managements, without actually providing enough independent oversight to become a nuisance to those managements. If shareholders want to reap the benefits of diversified investment, they must turn the independent, monitoring board with a strong fiduciary duty to shareholders from myth into reality.

Boards are charged with enormous responsibilities. Their proper discharge will require the allocation of substantial resources, both in personnel and in money. The primary characteristic of an effective board is its flexibility -- its capacity to understand when involvement is desirable and when passivity is the best course; its ability to engage the energies of the appropriate members for the corporation's needs ("horses for courses" as the English would have it); and its capacity to prioritize its myriad responsibilities and to focus on the most important. All of this requires leadership, and more particularly a leader.

It is possible for a single individual to combine the characteristics necessary for being chief executive officer of a corporation at the same time as being responsible for directing its board of directors, but it is not probable. The primary task, therefore, for effectively monitoring shareholders is to identify suitable chairpersons for their portfolio companies. The position of chairperson will command a large salary; the very best candidates should be findable through professional search firms. The costs of the search should appropriately be borne by the company (possibly, after limits have been established), but the effort should be staffed and the employing contract consummated by the lead shareholders.

The chairperson, once selected, bears primary responsibility for defining the board's priorities and assuring that suitable persons are available for election to the board. A charmingly understated

account of the challenges confronting the chair is Hugh Parker's Letter to a New Chairman (published for the Institute of Directors).

Finally, where should you start to look for candidates? It is an ironic fact of life that there are literally thousands of people who would dearly love to be non-executive directors on your board, but very few who can meet the criteria....[xxxix]

Some measure of subjectivity is probably inherent in such board appointments. By its very nature, the process is as unlikely ever to be as systematic and objective as, for example, the approach used by professional headhunters in searching for line managers. We remember well the exasperation of Kay Whitmore, when as CEO of Eastman Kodak, he was forced to defend his board's competency to us. He said, in effect, "I wish you reformers would get your act together. You ask us to include women and minorities and community representatives on our board. We comply. Now you complain that we don't have a satisfactory board from the perspective of assuring that Kodak is a world-wide competitive enterprise. That's not what you asked for; it is incompatible with what you asked for; if you had asked for it, we could have produced it." The lead shareholders and chairpersons will need to articulate clearly what they expect of a board and the according characteristics of desirable candidates.

If the decision is made that boards are genuinely important and that board membership is a "real" in contrast to a "nominal" job, some categories of people can be excluded. Preeminent among them are persons who do not have the time and available energy to devote to the job. The job of being chief executive of a major corporation is one of the most challenging in the world today. Only extraordinary people are capable of performing adequately; a small portion of these will appropriately be able to commit some energy to directorship of another enterprise.

On how many boards can any one individual serve? We have elsewhere mentioned numerical limits suggested by experts in the field. We remember that Supreme Court Justice William O. Douglas was able fully to discharge his responsibilities in an amount of time utterly incomprehensible to his colleagues and successors, but we doubt whether there are many people who can simultaneously serve on more than three corporate boards. That someone of the eminence of Frank Carlucci can be of assistance to everyone of the more than twenty companies on whose boards he serves is not in dispute; whether that assistance is best funneled through membership on the board is the question.

The single characteristic of directors that correlates with improved return to shareholders is the fact of their being meaningfully invested in the stock of their company.[xi] Directors serve as individuals, so the investment must be personal. But the Nominating Committee should also look for director candidates among the lead shareholders of the company. There is an unresolved theoretical question as to the propriety of an officer of a large investing corporation also serving as a director of a portfolio company. Harvard Business School's William Taylor wrote that Pierre DuPont represented the ideal shareholder of General Motors at the same time as he was CEO and principal shareholder of DuPont.[xli] This relationship was ultimately found to be in "restraint of trade" by the United States Supreme Court, despite the fact that no one found that DuPont had a crippling conflict of interest. Nor has there been concern with Warren Buffett's service on the boards of Salomon Brothers, USAir and other Berkshire Hathaway investments at the same time as being its principal shareholder and CEO. Somehow, this acquiescence stops with modern pension funds -- particularly public funds.

There is no need here to resolve this inconsistency; it suffices to place the burden of identifying suitable directors on to the shareholders; whether they emanate from the fiduciary itself or elsewhere is not critical. There is much to recommend the thesis of Professors Gilson and Kraakman: "The agenda we proffer to institutional investors is simple: Elect to the boards of portfolio companies a core of professional directors who have the skills, time and incentive to monitor management performance on behalf of shareholders. This could be accomplished by placing a talented individual of [sic] six boards such that the director's total compensation from all

boards exceeded \$200,000. The desirability of such a position - together with the capacity of institutional investors to remove a director would be sufficient to create the market for outside directors...."[xlii]

What is critical is that directors owe their job to the shareholder -- no matter how large their personal investment, it is of almost equal importance that their job security, their reputation and their professional advancement will be at risk in their performance of the directoral responsibility. There must be someone to whom a director is meaningfully accountable for his stewardship, and there is no better choice for that role than those to whom he is accountable as a fiduciary.

9. Ownership Stock and Trading Stock

There is another possible approach to giving ownership interests the optimal structure for effective monitoring, and that is an equity structure that reflects the different needs and abilities of the different classes of investor. This would give institutional shareholders who want it the interest and the ability to monitor corporate performance.

United States shareholders currently enjoy an enviable amalgam of rights: the right to enjoy the residual benefits of the enterprise; liability limited to the amount of their investment; efficient trading markets permitting immediate and inexpensive transferability; and, among all the constituents having to do with the corporation, the exclusive right to the franchise of control. All corporate owners do not have the same need and do not attach the same value to each of these "rights." Individuals, for instance, value liquidity and the capacity to exchange their holdings for cash at any time. Some institutions, like mutual funds, also have a strong need for liquidity. These "shareholders" are analogous to the holders of betting slips on a horse race. They have no interest in the underlying venture and view share ownership merely as an efficient means of gambling. The house take is small and performance seems relatively free of being rigged. The risk/reward ratio of each class of shareholder is different.

The private pension plans and "index funds" are "permanent owners"[xliii] and, therefore, have no alternative but to become involved in the governance of portfolio companies; for individuals and mutual funds acting as owner could involve unacceptable costs and constraints. We can recognize this fact by offering a variety of instruments to today's owners, rather than continuing to treat demonstrably different interests as if they were the same. For example, we could have "ownership shares," which give up some liquidity in return for greater ownership rights, and "trading shares" which give up some ownership rights in favor of liquidity. Another approach, suggested once by Dean LeBaron, is to let ownership rights trade separately. But that creates another set of agency costs, and one that is more difficult to solve.

As participants in the heated exchange over the proposed amendments to the NYSE's long-time "one share, one vote" rule, we have testified that the problem is not in different classes of stock but in making sure that all classes are presented to the market on an equal basis, and not through coercive exchange offers.[xliv] The history of abuse and coercion requires careful planning to make sure that: (1) all holders should be free to choose whether they want to be "ownership" or "trading" shareholders; (2) the constraints on each should be publicly disclosed; (3) shareholders should determine any restrictions -- like the number of holders, or percentage of total equity -- that might apply to the new "ownership class;" and (4) the holders of the "ownership" shares must recognize their fiduciary obligation to the other shareholders.

I believe it will be difficult, though probably not impossible, for fiduciaries, especially pension fiduciaries, to hold any other class of common stock than "ownership." Index funds and defined benefit plans have no need for liquidity and a fiduciary obligation to function in some way as owner. "In such funds, the investments are often held on a long-term basis and the prudent

exercise of proxy voting rights or other forms of corporate monitoring or communication may be the only method available for attempting to enhance the value of the portfolio"[xlv]. But there are other species of investors, with other time horizons, who will find the "trading" shares have attractive risk/reward alternatives for equity participation. The DOL's rulings suggest that ERISA plans will presumptively hold "ownership shares." [xlvi] Bank regulators might conclude the same about conventional trusts; the SEC probably would permit mutual funds to include either class in accordance with the representations in the prospectus.

A category of common stock that rewards investors' willingness to make a long term commitment makes sense. Consider the analogous situation of Warren Buffett who has been successful in persuading company managements to create new classes of security for his investment, usually convertible preferred stock assuring him a current return superior to that available to the common shareholder together with participation in equity growth at American Express, Champion Paper, USAir, Solomon Brothers, and others.

Harvard Professor Michael Porter wrote the synthesis paper for the Council on Competitiveness project analyzing the national system of capital allocation. One of his conclusions was that the United States should enable a new ownership structure with interests aligned closely to those of the corporation itself. "These long-term owners would commit to maintaining ownership for an extended period, and to becoming fully informed about the company. In return for a long term ownership commitment, however, must come a restructuring of the role of owners in governance. Long-term owners must have insider status, full access to information, influence with management, and seats on the board." [xlvii] For pension funds, this represents a long deserved recognition of the unique value of their capital investment. Having virtually no need for liquidity, their investments in common stock nonetheless have been reduced in value by the costs of maintaining a market place.

In recent times, capital structure determinations have been dominated by the need of many shareholders for liquidity of their holdings. The need for such a class does not, however, necessarily lead to the answer of recent history -- namely that this should be the only class of common stock. Presumably, trading markets would be maintained in both classes of equity security with appropriate arrangements to arrange the continuity of the commitments of "long term" holders.

10. Language of Accountability

In addition to the structural impediments to shareholder monitoring, another obstacle to accountability for corporate managements is the limits of the available vocabulary. Corporate managements can only be effectively held accountable to the extent that their performance can be quantitatively described in a language which is accessible and comprehensible to all parties. Generally Accepted Accounting Principles (GAPP) have been thought of as a workable language of accountability because they are seemingly precise and secondarily because they are intended to measure the business or commercial aspects of an enterprise. In fact, GAAP has failed to provide an informative and reliable measure of the economic performance and condition of a business. The principal attraction of GAAP is not that it contains an appropriate -- or even the most appropriate -- measure of performance but that it has the weight of history, precision and wide acceptance and the illusion of precision. The best it can offer is consistency. Even that is hard to hold on to, however, as shown by the pattern over the last half dozen years of "restructuring charges," which remove any semblance of consistency in valuation. This is "big bath accounting." A new management will evaluate all the sins of its predecessors, anticipate a few that will become apparent in the future, throw in reserves for safety and wrap the whole thing into a "restructuring charge." This will require restatement of prior years' operations, but, because the period that is being measured has passed, this has little practical consequence. For the

future, however, the implications are immense, as any sensible management would take advantage of the opportunity to write down the past and thus to "hard wire" profits for as long as possible in the future. "IBM's earnings plunged in 1989, Akers gave up on the year in early December, announcing he was going to cut ten thousand jobs and taking a big write-off. He made sure that write-off was big enough to give him a cushion going into 1990 -- some securities analysts estimated that the write-off let him take in 1989 above \$1 billion of expenses that he otherwise would have had to account for in 1990."^[xlvi] Even bringing in an outside accounting firm does not solve the problem. The decade of the 80s demonstrated that professionals of the highest repute would deliver outrageous "fairness" opinions in take over situations.^[xlix]

GAAP have value, but they are not up to the task we set for them. Once it is understood that GAAP -- even according to their own standards of "business reality" -- are an unhelpful measurement language, one can better proceed to consider the ingredients for a necessary new language of corporate accountability.

One of the basic problems is that management has no way to judge by what criteria outside shareholders value and appraise performance -- the stock market is surely the least reliable judge or, at best, only one judge and one that is subject to so many other influences that it is practically impossible to disentangle what, of the stock market appraisal, reflects the company's performance and what reflects caprice, affects the whims of securities analysts, short-term fashions and the general level of the economy and of the market rather than the performance of the company itself.^[i]

Former New York State Controller Ned Regan suggested that companies be judged periodically by a special audit process. But that does not solve the agency cost problem; it just adds another layer.

The inherently limited significance of government definition of corporate values can be seen in the area of corporate crime. By classifying an activity as criminal, society is giving the plainest possible signal as to the unacceptability of a particular activity. In other words, it is the apotheosis of "social accounting" -- this activity is so bad that we simply won't countenance it. Companies incur vast legal expenses, they are exposed to public ridicule and criticism and yet the market place apparently doesn't diminish its valuation of the enterprise as a whole. General Electric Company, periodically enjoying the highest market value of an industrial enterprise in the world, has had in recent decades such a pervasive involvement with criminal activity -- the infamous electric appliance conspiracy of the late 1950s involved a GE Vice President serving time in prison, continuing defense contracting scandals, the Kidder problems, etc. -- as almost to invite the characterization that its "culture" breeds such elements. "When you put the Kidder scandal together with other transgressions that have sullied GE's reputation over the past decade, you begin to get a sense that somewhere in the highly successful and celebrated GE culture something is not right".^[ii] This has not hurt the valuation of GE shares in the market.

David Engel argues persuasively that non-value driven corporate activity be limited to four areas: (i) compliance with law, whether or not so doing is cost effective; (ii) disclosure of information about the impact of corporate functioning on society beyond the extent required by law; (iii) restraint in participating in elections and law making process; and (iv) acting, when failure to do so would permit the continuance of indisputably damaging conduct.^[iii] Engel's closely reasoned argument persuades that corporate managements are really accorded a limited charter by society and their owners. They are entrusted with great power, but only because it is limited to areas of activity plausibly connected to value optimization. Consider in this regard the Annual Request by Berkshire Hathaway for its shareholders' suggestions as to how the corporation should make charitable contributions of "their" money. As Milton Friedman has said, the obligation of a corporation is to maximize profits within the constraint imposed by law. Corporations, therefore, should be structured so as to maximize their long term value as designed from time to time by the law of a governing jurisdiction having effective independent authority.

So long as the management has the one overriding duty of administering the resources under its control as trustees for the shareholders and for their benefit, its hands are tied; and it will have no arbitrary power to benefit this or that particular interest. But once the management of a big enterprise is regarded as not only entitled but even obliged to consider in its decisions whatever is regarded as the public or social interest or to support good causes and generally to act for the public benefit, it gains indeed an uncontrollable power -- a power which could not long be left in the hands of private managers but would inevitably be made the subject of increasing public control.[liii]

The only entities capable of providing appropriate normative direction for a corporate enterprise are long-term owners. Informed and involved owners can require the board to create an incentive and accountability system within the enterprise that rewards compliance with law, and with whatever less clearly defined social norms may appear appropriate. Owners are uniquely empowered to make the determination as to whether particular conduct will optimize the value of the enterprise in the long run (and to decide on sub-optimal behavior if that appears to be in their interest from time to time).

The government can create business opportunities, it can create incentives, but it has been totally ineffective in creating norms for corporate behavior as exemplified by the lack of inverse correlation between "criminality" and market value. The government's characterization of certain conduct as being unacceptable (by making it criminal) does not appear to have the power to affect the market's perception of value. The market is fickle; expert appraisals are too apt to reflect the hirer's wishes. It is probable that corporations should depart from a value maximization (or optimization) objective only in very limited situations. Corporations should adopt internal controls so as to inhibit activity that will undermine their own legitimacy. At the end of the day, values are necessarily subjective. The only "legitimate" creator of performance criteria is the owner.

11. Watching the Watchers -- Preventing a New Bureaucracy

"Moreover, in delegating investment management authority to an investment manager, a named fiduciary may also reserve to another named fiduciary the right to direct the trustee regarding the voting of proxies, if the plan document provides for procedures for allocating fiduciary responsibilities among fiduciaries."[liv]

I remember speaking to one of the principal authors of ERISA, Senator Jacob Javits, and asking him what he had in mind when he placed "control" of corporate America in the hands of ERISA trustees. Jack mused and replied: "Bob, no one who knows me will accuse me of modesty, but I must confess to you that we never anticipated this."

What was unanticipated was the "success" of ERISA in providing an incentive for voluntary retirement savings, the iron logic of compound interest and exemption from taxation, and a long bull market. Suddenly, the law of trusts that was intended to define conduct for an infinitesimally small portion of the GNP of 18th century Britain was the informing energy underlying legal ownership of the nation's industry. No one understood what they were doing; no one could anticipate the consequences.

There are extensive agency costs in this system as well. In *Fortune and Folly*,[lv] a fascinating study of the public and private pension fund cultures, authors anthropologist William M. O' Barr and law professor John M. Conley found that for all their cultural and other differences, there was one point on which public and private pension funds were alike -- their efforts to avoid accountability for the consequences of their investment decisions. This is understandable in a field where even the most capable professionals have so little ability to control or even predict

what the market will do. The 20 year effort of the federal government to gain control over the Teamsters' union and the "looting" of the New York City plans created a generation of risk-averse fiduciaries.

Perhaps Fortune and Folly's most important conclusion is this one:

In every interview we conducted, fund executives talked at length about assuming, assigning, or avoiding responsibility. As we listened to them, it often seemed as if the funds had been designed for the purpose of shifting responsibility away from identifiable individuals. They described four specific mechanisms for displacing responsibility and avoiding blame; burying decisions in the bureaucracy, blaming someone else, blaming the market, or claiming their hands were tied by the law.[lvi]

The characteristics of trusteeship were not devised with their twenty-first century role in mind. Trustees are severely penalized for improper investment and are not allowed an incentive reward for what they do well. Trustees are, first and foremost, risk averse. This is indeed a strange attribute for the dominant shareholder in a capitalist economy whose prosperity depends on the intelligent assumption of risk. Trustees are most comfortable taking action to avoid the possibility of liability.

Shareholder monitoring, including shareholder activism, is an investment decision. If shareholders are able to spend less in persuading a company to revise its pay plans to more closely tie pay and performance than they will make as a result of improving the incentives, they have made an investment decision. If the returns from this initiative are greater than returns from selling the stock or other kinds of investment decisions, then it is a good investment decision.

The core premise underlying shareholder activism is that a company having informed and effectively involved owners is worth more than one without them, because of the reduced agency costs. A company with informed and effective shareholders will have more informed and effective directors. It will not have a fleet of corporate jets or a Renoir in the boardroom. It will not engage in promiscuous conglomeritization.

There is substantial empirical evidence that good governance not only creates value, it reliably and consistently creates more value than other methods of investing. The recent analyses of Stephen Nesbitt at Wilshire Associates and Lilli Gordon for CalPERS present strong analytic confirmation, while our own LENS fund has outperformed the market for over two years since we began.

The new DOL statement requires trustees to consider activism as a value adding or preserving element in their fiduciary responsibilities as investor. Whether ERISA trustees will ultimately become useful owners (See the cartoon at the end of this paper) depends on two factors -- the DOL's willingness and capacity to enforce its regulation and, more importantly, the conclusion by corporate management that an ownership-based governance system is ultimately in their best interest. Given the alternatives of government regulation, free riding on the activism of public funds (with possible political agendas), or an ownerless system, that conclusion seems justified. Whether, given commercial political reality, it will be reached is another question.

In addition to their other seeming disqualifications, trustees have no particular expertise as "owners." They have no particular expertise as economists, program traders, stock pickers, and many other specialties thought important in the management of an ERISA portfolio. The statute plainly authorizes the hiring of experts and even the delegation of fiduciary requirements (See the quoted sentence at the beginning of this section). As soon as "ownership" becomes widely recognized as an essential component of an ERISA manager's exercise of "prudence", appropriate specialized firms predictably will develop. Competition will ensure that such firms "prove" their worth. If, for example, a trustee engages an "ownership manager," who only involves itself in governance situations by invitation of the company management and produces results

that are statistically inferior to those of a manager who approaches the challenge solely from the perspective of maximizing trust values, he will run the risk of being judged "imprudent". Trustees are unlikely to run such a risk, so the creation of a "market" for ownership managers is likely to solve problems of conflict of interest and collective action.

No enabling legislation is necessary. The pension funds can create new institutions by requiring that service providers serve only pension funds or furnish other satisfactory proof of lack of conflict of interest. PWBA could issue an opinion that a "pensions only" institution will be presumed to have complied with conflict of interest problems, thus revising a rebuttable presumption for other institutions.

Pension funds always have the question of whether to perform services themselves or to buy them from outsider vendors. In questioning how the bureaucrats of pension funds can be expected to act as "owners" to any better effect than the corporate bureaucrats whom they are expected to monitor, one is driven to the need to acquire the necessary competencies. So long as the law draws a clear line between pension service providers and other financial institutions, there will be incentive for the imaginative and the able to create firms providing specialized "ownership" services. These firms can create standards for performance that will permit ERISA trustees to evaluate their services in the same manner as other professionals. Above all, a firm offering "ownership services" to pension funds will not be distracted by the temptation of selling products to managements. This elimination of conflict of interest assures constancy and competency in the exercise of ownership responsibility.

12. Conclusion

"...(T)here are no successful systems of corporate governance, past or present, without committed and knowledgeable long term shareholders, managements with the preconditions and incentives for long term performance, and with such managements being properly accountable to their shareholders..."[lvii]

This paper suggests that both for reasons of power legitimacy and business competitiveness that a "real" governance system for large corporations is desirable. We further argue that the present system does not work and is based on demonstrably false premises. Both law and theory suggest that accountability to ownership is the optimum structure. We have set forth here a series of recommendations -- "Pension Fund Capitalism" -- to permit the emergence of "ownership shareholders" with an incentive to be informed and active in monitoring corporations in which they invest.

Nothing meaningful will occur, however, unless the three most affected parties conclude that it is in their self interest for the changes to take place. The government must explicitly adopt the policy that commercial competitiveness is a national priority and that an effective governance system is a necessary precondition for such success. Government can view a system in which its guidance significantly provides a framework within which institutional owners effectuate the oversight necessary for legitimacy and competitiveness as one that affords adequate protection against the threats of excessive corporate power for the citizens. Institutional investors need a government drawn "bright line" delineating the limits of permissible conflict of interest in acting as an ERISA fiduciary. Conflict has been so rife over the last twenty years that government's acquiescence has created the impression that the "exclusive benefit" rule prescribed by ERISA will not be enforced. So long as government takes this attitude, it is folly to expect commercial enterprises voluntarily to complicate their lives and diminish their profits. A PWBA directive might encourage the creation of new ERISA specific fiduciary ownership institutions -- there is so much money available for management services that the market will take care of the rest.

Most importantly, management of the great American corporations -- the leadership of the Business Round Table -- will need to adopt the notion that "creative tension" between themselves and their owners is a preferable system of government that other alternatives, including a continuation of the present that might be styled "phony governance." There have been indications that the necessary statesmanship can be forthcoming; there have been contrary indications particularly in the area of executive compensation and the willingness to go to the extreme of pushing the government into accounting in order to protect options. Ultimately, what will work is the market. Companies having effective governance perform better, are valued more highly in the market, have a lower cost of capital -- and the cycle goes on. Daimler Benz in listing on the NYSE demonstrates that the exchange providing the highest standards of governance makes available capital on the most favorable rates. This -- in a capitalist system -- is the ultimate reality.

ENDNOTES

[i] Letter to Horatio G. Spaford, March 17, 1814.

[ii] Harvey H. Segal, *Corporate Makeover: The Reshaping of the American Economy*, Viking, New York, 1989, pp. 5-6.

[iii] Arthur M. Schlesinger, Jr., *The Age of Jackson*, Little Brown & Co., Boston, 1945, p.75.

[iv] 53 S. Ct. 487,490 (1932).

[v] *Id.*, p. 7.

[vi] *The Economist*, 7/30/94, p. 57.

[vii] Lindbloom, Charles E., *Politics and Markets: The World's Political Economic Systems*, Basic Books, 1977, p. 356.

[viii] Barnet, Richard J. and Muller, Ronald, *Global Reach, The Power of the Multinational Corporations*, 1974, p. 15.

[ix] Hurst, James Willard, "The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970", University of Virginia, 1970.

[x] Dan Clawson, Alan Neustadtl and Denise Scott, *Money Talks*, Basic Books, 1992.

[xi] William Greider, *Who Will Tell the People*, Simon & Schuster, 1992, pp. 331-332.

[xii] Hurst, *op. cit. supra* at p. 58.

[xiii] Epstein, Edward J., *Who Owns the Corporation? .A Twentieth Century Fund Paper*, Priority Press, New York, 1986, p.13.

[xiv] Eisenberg, Melvin Aron, "The Structure of Corporation Law," *Columbia Law Review*, Vol. 89, No. 7, November 1989, p. 1461.

[xv] *Id.*, p. 1474.

[xvi] Marlene Givant Star, "Paying for Approval", Pension and Investment Age, July 24, 1989, p.1.

[xvii] Eisenberg, op. cit. supra, p. 1477.

[xviii] Eisenberg, op. cit. supra.

[xix] Dobrzynski, Judith, Business Week, 8/8/94, p. 27. Korn/Ferry found in 1991 that 82 percent of board vacancies were filled by recommendations by the chairman. Korn/Ferry Organizational Consulting, "Reinventing Corporate Governance: Directors Prepare for the 21st Century. Results of Fortune Company Directors," January 1993.

[xx] Lipton, Martin and Lorsch, Jay W., "A Modest Proposal for Improved Corporate Governance," The Business Lawyer, Vol.48, No. 1, November 1992, p.64.

[xxi] Drucker, Peter, "The Bored Board", in Toward the Next Economics and Other Essays, Harper & Row, New York 1981, p. 110.

[xxii] Makihara, B. Minoru, CEO of Mitsubishi Corporation in a speech at Suffolk University, 4/29/94. There is concern that "corpocracy - control of the state by business - exists in modern Japan. Consider the following fictionalized account by author Tom Clancy, Debt of Honor, (Putnam, 1994), at p. 120: "Japan was not a democracy in any real sense, rather like America in the late Nineteenth Century, the government was in fact, if not in law, a kind of official shield for the nation's business. The country was really run by a relative handful of businessmen - the number was under thirty, or even under twenty, depending on how you reckoned it - and despite the fact that those executives and their corporations appeared to be cut throat competitors, in reality they were all associates, allied in every possible way, co-directorships, banking partnerships, all manner of inter-corporate cooperation agreements. Rare was the parliamentarian who would not listen with the greatest care to a representative of the zaibatsu."

[xxiii] Private letter to the author from Allen Sykes.

[xxiv] The Cost of Talent: How Executives and Professionals are Paid and How it Affects America, 1993.

[xxv] Hurst, op. cit. supra. at p. 87.

[xxvi] See, for example, Power and Accountability, Robert A.G. Monks and Nell Minow (1991), Corporate Governance, Robert A.G. Monks and Nell Minow (1995), and sources cited therein. See also, Conflicts of Interest in the Proxy Voting System, James E. Heard and Howard D. Sherman, Investor Responsibility Research Center (1987)

[xxvii] ERISA, Section 404(a)(a)(A)

[xxviii] See, however, Politics and Public Pension Funds by Roberta Romano, Manhattan Institute, June 1994 - "public pension funds may be free of some of the particular types of conflicts which afflict private funds, but they are subject to many other, mostly political, which make activism on their part of dubious value."

[xxix] France, in particular, has had great difficulty accommodating the goals of both privatization and of protecting what are thought to be industries vital to the national industry. The pattern of insuring "control" over publicly held companies through the issuance of special shares - the "noyaux durs" (the functional equivalent of the "golden share" in the UK) - to safe affiliates was rudely jolted when Swedish Volvo withdrew from a much acclaimed merger with Renault. At the end of the day, the Swedish interests were not prepared to cede "control" of the merged enterprise to a "nominee" of the French government. The French are now in the process of trying

to create a funded pension system. "Because of the lack of big institutional investors and the stable long term shareholders they represent, French industry has been forced to seek alternatives. One such has been a relatively high reliance on bank loans and direct equity investment by banks. Another has been the creation of complex systems of cross-share holdings. The pattern of cross-shareholdings is also open to criticism... "The system can reduce the rigor of shareholder discipline"... Financial Times, "Grey on Top, Thinning Below", 7/27/94, at p. 11.

[xxx] U.S. Department of Labor "Interpretive Bulletin 94-1" (7/29/94)..

[xxxi] See - Rule, Charles F. - Letter to Institutional Shareholder Services (ISS).

[xxxii] Cary, William L., "Federalism and Corporate Law: Reflections Upon Delaware," Yale Law Journal, (83)4, March 1974, Pp. 663-705.

[xxxiii] The Brancato Report, Vol. I, Edition 3, September 1994, p. 3.

[xxxiv] The Department of Labor's Enforcement of the Employee Retirement Income Security Act (ERISA), A REPORT prepared by the Subcommittee on Oversight of Government Management of the Committee on Governmental Affairs, United States Senate, April 1986, p.70.

[xxxv] Dent, George W., Jr., "Towards Unifying Ownership and Control in the Public Corporation", 5 Wisconsin Law Review (1989), p. 881, 907.

[xxxvi] McWhirter, Darien A., Sharing Ownership, John Wiley & Sons, Inc. 1993.

[xxxvii] Sykes, *ibid.* at p. 15.

[xxxviii] Dent, George W., Jr. "Toward Unifying Ownership and Control in the Public Corporation", 1989 Wisconsin L.Rev., pp. 881, 914, 915.

[xxxix] Parker, Hugh, Letters to a New Chairman, The Director Publications Ltd. 1979.

[xl] See, for example, Stobaugh, Robert A., "More and More Directors Are Owners," New York Times, January 1, 1995.

[xli] Taylor, William, "Can Big Owners Make a Big Difference?" Harvard Business Review, Sept. 1990.

[xlii] Gilson, Ronald J. and Kraakman, Reinier, "Reinventing The Outside Director: An Agenda for Institutional Investors," Presented at the Solomon Brothers Center, June 14-15, 1990, p 47, 48.

[xliii] ERISA requires investment managers to diversify to the maximum extent practical - unless to do so is clearly harmful to the fund. Public pension plans can escape the vulnerability of "back door socialism" best through indexing.

[xliv] Testimony of Robert A.G. Monks, Securities and Exchange Commission, December 17, 1986.

[xlv] DOL Interpretive Bulletin, *op.cit.supra*, at fn. #30.

[xlvi] Several analyses estimate the level of "management fees" for ERISA plans at 1/2 percent of capital. This suggests that up to \$15 Billion is currently being paid. Charles Ellis and Wilshire Associates have suggested that the results of stock management have been zero value added. In view of the large sums available and the problematic benefit of other forms of "management," it seems not unreasonable to require trustees to expend reasonably on being informed and active shareholders. This appears to be the recommendation of the DOL in its 7/28/94 statement.

[xlvii] Porter, Michael E., "Capital Choices: Changing the Way American Invest in Industry", Council on Competitiveness, 1992, p. 92.

[xlviii] Paul Carroll, Big Blues, The Unmaking of IBM, (Orion, 1993) at p. 222.

[xlix] Monks, Robert A.G. and Minow, Nell, Power and Accountability, Harper Business, 1991, p. 111.

[l] Letter from Peter F. Drucker to Robert Monks, 6/17/93. Peter Drucker, along with former New York State Controller Ned Regan has advocated periodic business audits by expert outside parties to provide perspective in evaluating a company's performance. My own view is that professionals belong inevitably to the person paying them (or, at least the person most likely to pay the largest bills in the intermediate run). There are few professional service organizations in the United States who did not provide corroboration of this - harsh seeming - judgment in connection with "fairness opinions" during the 1980s.

[li] Welch, Jack, "Nightmare on Wall Street", Fortune, Sept. 4, 1994, p. 41.

[lii] 32 Stanford L.Rev. 1 (1979).

[liii] Hayek, F.A., The Political Order of a Free People, Chicago, 1979, p.82.

[liv] ERISA Sec. 405 (C) (1) DOL Interpretative Bulletin, op.cit. supra, at p. 6.

[lv] O'Barr, William M. and Conley, John M., Fortune and Folly: The Wealth and Power of Institutional Investing, with economic analysis by Carolyn Kay Brancato, Business One Irwin, Homewood, IL, 1992.

[lvi] Id., p. 85 (emphasis added). See also Pound's piece on Balance in Governance.

[lvii] Sykes, Allen, for the October 1994; (No 2.4) edition of CORPORATE GOVERNANCE, an International Review.