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ARTICLES

ACTIVIST SHAREHOLDERS, CORPORATE DIRECTORS, AND INSTITUTIONAL INVESTMENT: SOME LESSONS FROM THE ROBBER BARONS

ALLEN D. BOYER*

History never repeats itself,
but it rhymes.

—Mark Twain

I. INTRODUCTION

American business has crossed, with little celebration, an economic watershed. As of this decade, 53 percent of the equity in American corporations has passed into the hands of institutional shareholders: public pension funds, private pension funds, mutual funds, insurance companies, foundations, and managed trust funds.[1]

In the nation's largest fifty companies, institutional investors own 50.1 percent of outstanding shares. In the next largest fifty companies, they own 59.2 percent of the shares. In some leading industries, the concentration is higher: 56 percent of the aerospace industry, 59 percent of the electrical industry, and 61 percent of the transportation industry. For some companies, institutional ownership is still higher: 65 percent in Minnesota Mining & Manufacturing, 72 percent in Pfizer, and 73 percent in Eli Lilly.

The voting power that this ownership represents commands respect. But it is the character of these owners, as well as the size of this ownership interest, which poses a new issue for corporate governance. This decade marks the first time in the history of the business corporation that institutional investors, and not private individuals, have controlled a majority interest in public corporations.

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* New York Stock Exchange Division of Enforcement. Opinions expressed in this article are solely those of the author and are not necessarily those of the New York Stock Exchange or any of its officers.

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1. All figures in the first two paragraphs are given in WILLIAM M. O'BARR & JOHN M. CONLEY, FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING 33-39 (1992).

In recent years, the advent of the institutional investor has been seen as a coming Golden Age for corporate governance.[2] Such large investors, it is prophesied, will have the means and incentive to govern corporations effectively, thereby keeping their firms competitive and preventing management from wasting assets. Effectively and efficiently, the institutional investor will reunite ownership and control.

Visions should be closely inspected, however, and this one is no exception. Its promise of halcyon days to come can be tested against the reality of two eras in which powerful shareholders *did* take a role in corporate governance: the 1980s and the Gilded Age, the era of the robber barons (approximately 1862 to 1902). These eras share a reputation as periods of corporate buccaneering, with all that term connotes of audacity, lucre, and slaughter. This is not mere legend: it represents historical fact and economic reality. The waste and chicanery which marked the Gilded Age and the 1980s trace directly to the active role which shareholders took in managing corporations.

The Gilded Age and the 1980s saw a close nexus established between corporate ownership and stock-market trading. That is why they were characterized by control struggles—takeover bids in the last decade, railroad wars in the last century. Investors trafficked in corporations as functions of their shares. Raiders bought control of firms by buying shares—carrying off *coups d'etat*, so to speak, amid the turbulence of Wall Street panics. They ran the firms they had acquired not to make a profit from business, but to raise those firms' value in the eyes of the market. Business profits were not their object; they meant to make their profit in the market, either by raising their holdings' value (measured by shares) or by selling control of these firms to their competitors.

Because control was at issue, the possible returns on stock-market trading were magnified. Speculation flourished. When entire firms were

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2. *See* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION 117-21 (1976) (suggesting that all 5% shareholders should have right to designate directors); LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER, 209-11 (1988) (proposing that shareholders should have right to nominate 20-25% of board); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 907-08 (proposing that 10 or 20 of largest shareholders should have exclusive access to proxy machinery); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 905 (1991) (concluding that institutional investors should use voting power to elect professional outside directors to corporate boards); Patrick J. Ryan, *Rule 14a(8), Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 103-04 (1988) (stating that institutional voice validates "corporate democracy" provisions of proxy rules). *But see* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (taking into account different roles of institutions); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 505-06 (1991) (concluding that institutional ownership unlikely to bring fundamental changes in corporate governance system).

potentially for sale, every share carried a takeover premium. Rather than simply trading shares, operators in the market tapped a new source of wealth: the assets of the firms that had issued those shares. As an intrinsic part of the process, both ages were characterized by active shareholders—investors who saw themselves as rivals to corporate management. These shareholders fought to dominate firms, directly managing what they indirectly owned. The parallels are very suggestive. Consider the following illustrations:

> *Example*: Faced with a hostile takeover bid, a massive purchase of its outstanding shares, a target firm's board holds an emergency meeting. The board blunts the threat by releasing a huge quantity of new shares into friendly hands; the raider counters by suing to have this issue enjoined.

These were the facts in the 1984 case of *Norlin Corp. v. Rooney, Pace Inc.* and in the 1985 case of *Asarco, Inc. v. MRH Holmes A Court*. These were also the facts in the 1868 case of *Fisk v. Chicago, R.I. & P. Railroad* and during Henry Villard's 1883 bid for the Northern Pacific Railway.[3]

> *Example*: Investors who hold massive quantities of low-grade bonds (bonds now made even lower-grade by the shakiness of their corporate issuer) decide to hedge their risks by pushing boldly ahead. They bring in funds by making short sales of stock in the firms that issued the bonds—thereby offsetting any losses due to a fall in the bonds' value.

Matching bond positions with short sales was a situation often faced by Daniel Drew, who in the 1860s served as treasurer, "speculative director," and *eminence grise* of the Erie Railway. Equipped with bonds which were convertible into shares and re-convertible into bonds, Drew specialized in manipulating the price of Erie stock.[4] He long enjoyed the reputation of being the most cunning trader on Wall Street, until dethroned by his gifted pupil, Jay Gould. And, more than a century later, matching bond positions

3. *See* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 258 (2d Cir. 1984); Asarco, Inc. v. MRH Holmes A Court, 611 F. Supp. 468, 470 (D.N.J. 1985); Fisk v. Chicago, R.I. & P. R.R., 53 Barb. 513 (N.Y. App. Div. 1868); ROBIN W. WINKS, FREDERICK BILLINGS 244-48 (1991) (describing machinations in Henry Villard's takeover attempt of Northern Pacific).

4. *See* CHARLES F. ADAMS & HENRY ADAMS, CHAPTERS OF ERIE, 5-7 (1871) (describing Drew's bond deal with Erie Railway); JOHN STEELE GORDON, THE SCARLET WOMAN OF WALL STREET 159-60 (1988) (same).

Drew is widely credited with coining the phrase "stock-watering" and authoring a jingle about the perils of selling short: "He who sells what isn't his'n / Buys it back or goes to prison." His life has received numerous treatments—including, reportedly, a Nazi propaganda film about the iniquity of American capitalism. *See generally* CLIFFORD BROWDER, THE MONEY GAME IN OLD NEW YORK: DANIEL DREW AND HIS TIMES (1986).

with short sales would be a strategy recommended to investors who had found themselves over-committed in junk bonds.[5]

> *Example*: In order to discourage takeover bids, a corporation revises its charter to give its directors (who had been elected annually) five-year terms.

Martin Lipton recommended this in 1991. Jay Gould did this in 1869.[6]

> *Example*: Claiming that their company needs an injection of new capital, and that this is the only available method of obtaining funds, a firm's managers announce that they will sell their business's assets to a start-up shell corporation, which will pay for those assets with its own stock. A fiduciary, which holds in trust shares in the old corporation, brings suit to enjoin this restructuring. The fiduciary alleges that it is obliged to take this action because of its duty to its beneficiaries; it charges that the old corporation's assets would bring more from the market than the new corporation will pay, and that management self-interest has kept them from pursuing this option.

This situation leads back to the issue of institutional ownership. It recalls the Bendix-Martin Marietta takeover battle of 1982, in which Bendix made a tender offer for control of Marietta and Marietta countered with a tender offer for control of Bendix. Citibank, as trustee for the Bendix employee stock ownership plan, had custody of 23 percent of Bendix's shares. *It tendered these to Marietta*, explaining that its fiduciary obligation required it to realize the highest share price available, even if this meant selling control of Bendix.[7] So often did these issues emerge during the 1980s that guidelines were developed to cover such situations.[8] The above scenario, however, antedates even the Gilded Age. It reflects the facts of *Treadwell v. Salisbury Manufacturing Co.*, handed down by a Massachusetts court in 1856.[9]

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5. Jill Dutt, *Junk Holders Won't Sell This Idea Short*, N.Y. NEWSDAY, May 4, 1990, at 49.

6. *Compare* Martin Lipton & Steven Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 190 (1991) *with* KENNETH D. ACKERMAN, THE GOLD RING: JIM FISK, JAY GOULD, AND BLACK FRIDAY 1869 43-44 (1988).

7. The bank also mentioned pressure by Marietta's lawyers. HOPE LAMPERT, TILL DEATH DO US PART: BENDIX V. MARTIN MARIETTA 111-16 (1983); ALLAN SLOAN, THREE PLUS ONE EQUALS BILLIONS: THE BENDIX-MARTIN MARIETTA WAR 201-07 (1983).

8. *Labor Department Advisory Opinion on Fiduciary Responsibility in Connection with Attempted Corporate Takeovers*, 11 Pens. Rep. (BNA) 633 (May 7, 1984); O'BARR & CONLEY, *supra* note 1, at 181-85 (discussing application by Department of Labor of fiduciary rule to proxy voting by private pension funds).

9. 73 Mass. (7 Gray) 393 (1856).

Active shareholders, those who directly manage the firms in which they hold stock, are creatures of the market. It is by buying in the market that these shareholders acquire rights to a voice in corporate governance; it is because the market is willing to finance their bids that they can aspire to controlling firms. Thus, when shareholders are active, the market is willing to allocate the ownership of corporate assets. Or, put slightly differently, when shareholders seek to be active managers, it means that the market has eclipsed the firm as the mechanism that determines how assets are allocated. Essentially, the market breaks up firms.

The Chinese ideogram for *crisis* is a combination of two other characters: the ideogram for *danger* and the ideogram for *opportunity*. The crisis which American corporations face is the transition to a new age of institutional dominance. The wealth and sophistication of these shareholders will give them the power to run public corporations. The lesson taught by the Gilded Age is that active, direct shareholder management involves a troubling set of tendencies and temptations. These dangers will have to be neutralized before we can grasp the opportunity that institutional ownership may afford.

II. A Few Words on Theory

To analyze the public corporation requires a series of reappraisals. It is necessary to consider shareholders, who in a technical and legal sense are the owners of the enterprise, as a species of mercenary contingent remaindermen. It is necessary to consider not only when firms will be organized within the market, but also when the market may supplant the firm. Most important, it is necessary to buttress and illustrate theory with fact. Economic history, it is beginning to be realized, has been overlooked too long as an aspect of law and economics.

A. Ownership vs. Contract: Participants' Status in the Publicly Held Corporation

Shareholders are often said to be the *owners* of corporations—a term which is short, descriptive, and wrong.

As Eugene Fama has noted, analysis must "first set aside the typical presumption that a corporation has owners in any meaningful sense."[10] More broadly,

> [O]wnership of capital should not be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among

10. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288, 289 (1980).

> inputs. In this "nexus of contracts" perspective, ownership of the firm is an irrelevant concept. Dispelling the tenacious notion that a firm is owned by its securities holders is important because it is a first step toward understanding that control over a firm's decisions is not necessarily the province of securities holders.[11]

By investing in common stock, shareholders are selling, for a return, their services as bearers of risk. While hoping that a profit will eventually be earned, they contribute capital up-front, agreeing to accept the risk that a loss may result.[12]

The corporation is a network of contracts.[13] Properly understood, this means that the corporation must be seen as a functioning, active system of checks and balances. We cannot consider shareholders to be *owners*. The idea of *ownership* rests essentially on the idea that, within a system, some party's rights are paramount. This has no validity in an institution, like the public corporation or the modern securities market, that rests upon the idea of exchange.[14] To use the value-laden title of *owner* connotes too much. It is essential that shareholder rights be balanced against the rights of other parties with a stake in the firm—that is, that "ownership" be separated from control. This distinction is necessary for the operation of the modern business enterprise.

In complex organizations, the separation of theoretical ownership from day-to-day control is inevitable and desirable. The need to compete effectively and the pressure of economies of scale lead to the development of firms that are simply too large and complex to be controlled by a single entrepreneur. It becomes necessary for decisions to be made on a decentralized basis throughout the organization. Separating ownership from control allows the marriage of money and brains; it allows firms to employ individuals as managers without simultaneously requiring that the individuals possess a concomitant financial stake. This broadens the pool of managerial talent that can be employed. Under a different rule, requiring that ownership and control be united, only those wealthy enough to bear the risk of managing firms would be eligible to run them.[15]

At the same time, letting investors contribute funds without requiring that they take on managerial responsibilities enhances opportunities for

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11. *Id.* at 290.

12. *Id.* at 290-92.

13. Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989).

14. If shareholders deserve to be called *owners* because their capital guarantees repayment of the firm's contracts—well, then corporate managers deserve the title even more, because it is their role in the firm's day-to-day operations and strategic planning which plays the most significant part in determining whether the firm will make a profit. On this view, it is managers who hold primary responsibility for paying the firm's contracts.

15. Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 333 (1983).

firms to draw in capital. Requiring all shareholders to participate actively in corporate management would discourage shareholding and hence investment.[16] Moreover, the very fact of dividing management and control may make it possible for a firm to have the audacity necessary to compete and innovate; hired managers take risks that owner-managers would not.[17]

A side effect of the division between ownership and control is agency costs. These include, most significantly, the costs associated with the risk that managers will fail to act so as to maximize shareholder returns.[18] Agency costs are the profits made by corporate managers above their contract rights: whatever makes an officer's salary or employee perquisites unduly generous. Agency costs also include the costs of inefficiency and monitoring for inefficiency. As well as these actual outlays, agency costs may include gains not made by the firm due to managerial laziness. Managers, if not monitored constantly, may take their responsibilities lightly and not pursue opportunities as competitively as they should.[19]

B. *The Dangers of Shareholder Control*

To date, analysis has focused on agency costs and the ways in which these may be avoided. We recognize that if no one monitors management, managers may improperly divert an undue and improper share of the firm's wealth to themselves. But in analyzing how firms come to suffer such costs, we must recognize that the problem is not simply self-interest on management's part. Self-interest, at least potentially, characterizes *all* parties.

Agency costs are simply one variety of costs that a firm can suffer when one group within the firm manages to combine the power to dispose of the firm's assets with the ability to enjoy the firm's wealth. Turning firms over to shareholder management will produce problems that are the mirror image of those caused when hired managers are left unsupervised. If agency costs are to be feared when management controls a firm, there will be principal costs—a term which only seems to be an oxymoron—when and if shareholders gain control.

The modern business corporation operates on the premise that managers will have the power to control the firm's operations, while shareholders will have the right to enjoy the firm's wealth. In the case of management, the firm's efficiency is threatened—that is, avoidable and improper costs may

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16. *Id.*

17. "[R]estricting residual claims to agents in the decision process leads to decisions (for example, less investment in risky projects that lower the costs of outputs) that tend to penalize the organization in the competition for survival." Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 306 (1983).

18. This formulation draws on David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 230. *See also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-09 (1976).

19. *See* Jensen & Meckling, *supra* note 18, at 308-10.

be suffered—when management complements its power to manage with the ability to enjoy the firm's wealth, through the failure of monitoring systems. In the case of shareholders, the same dangers will arise at any juncture where the ability to manage the firm is added to the shareholders' right to enjoy the firm's wealth (as, for example, when shareholders use their voting strength to direct corporate operations).

When shareholders can seize and wield control, the structure of the corporation gives them a troubling incentive to take inappropriate business risks. In the public corporation, shareholders are protected by limited liability and have an escape mechanism for realizing the value of their investment—an open, liquid market for their shares. To protect their stake in the business enterprise, they do not need the right to manage it.

Moreover, shareholders contribute only the equity portion of the corporation's capital. The firm also rests upon commitments of physical and human capital. In these circumstances, shareholders bear only a disproportionately small share of the risks to which they could subject the firm. In their seminal article, Michael Jensen and William Meckling illustrated this paradigmatic situation:

> Potential creditors will not loan $100,000,000 to a firm in which the entrepreneur has an investment of $10,000. With that financial structure the owner-manager will have a strong incentive to engage in activities (investments) which promise very high payoffs if successful even if they have a very low probability of success. If they turn out well, [the owner] captures most of the gains, if they turn out badly, the creditors bear most of the costs.[20]

Creditors will not lend to a start-up firm with such a capital structure—but a cunning entrepreneur can still place himself or herself in such a high-potential, low-risk situation. One simply buys control of an existing firm *to which loans and other fixed commitments have already been made.* Takeover artists who bought control of established firms followed precisely this path, taking speculative risks with the inputs furnished by others. The monetary loans which were advanced to them, so that they could close such deals, bore investment ratings that Jensen and Meckling would have predicted—they were rated as junk. But the "creditors" who bore the risks of their failures were not just lenders; they included the governments and communities that supported acquired companies, as well as employees, who could not so readily withdraw their labor.

It is also likely that controlling shareholders will subject corporations to risks that are pathologies of shareholders' ordinary interests.[21] Ordinarily,

20. *Id.* at 334.

21. By "pathology" is meant an immoderate and extreme version of ordinary tendencies. For instance, corporate managers (whose role within a firm is to manage operations) often are given to extend such operations into the building of empires, even when these become unprofitable at the margins.

shareholders are interested in yield and liquidity. Given control, they may use their new-found power to recognize profits immediately, even if this impairs the company's long-term prospects.[22]

Only if shareholders gave up their theoretical right to control the firm, an anachronistic power which they had inherited from the trading groups of the early modern era, could their investments form part of the fungible pool of capital which finances the modern corporation.[23] That shareholders have recovered this power, that they have jimmied open their purely technical "ownership" rights into the ability to buy and sell the firm, has resulted in the great disaster of our time. As Louis Lowenstein noted in 1983, even before the junk-bond fever had reached its height,

> The mere knowledge that [shareholders] are free at any time to sell the business, and not just their shares, may have seriously disruptive consequences, because it gives to investors with a characteristically short-term focus the power to turn the assets into cash without notice. What Machlup long ago called the "special advantages" of the stock exchange—"the transformation of what are short-term credits from the private viewpoint into long-term savings from the social viewpoint . . ."—have been quite unexpectedly dissipated.[24]

Thus the 1980s created the problems we are paying for in the 1990s.

C. The Firm, the Market, and Transaction Costs

The circumstances in which firms will exist within the market, organizing production by direction and not by bargaining, has been laid out by Ronald Coase. The defining characteristic of the firm, Coase has posited, is that it replaces the price-based bargaining mechanism with managerial direction.

> Within the firm, individual bargains between the various cooperating factors of production are eliminated and for a market transaction is substituted an administrative decision. The rearrangement of production then takes place without the need for bargains between the owners of the factors of production.[25]

The critical factor is organizing costs. A firm will exist because it is possible "for transactions to be organized within the firm at less cost than would be incurred if the same transactions were carried out through the market."[26]

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22. Robert H. Hayes & David Garvin, *Managing As If Tomorrow Mattered*, HARV. BUS. REV., May-June 1982, at 71, 74 (present-value calculations favored in financial analysis consistently "support a decision to operate on the goose and remove some of its golden eggs prematurely, even though doing so impairs its future egg-laying ability").

23. *See infra* text accompanying notes 52-55.

24. Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 262 (1983).

25. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 16 (1960).

26. Ronald H. Coase, *The Nature of the Firm: Meaning*, 4 J. L. ECON. & ORG. 19, 19 (1988).

A firm will grow "until the costs of organising an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organising in another firm."[27]

To talk of relative costs and a firm's expansion vis-à-vis the market means that *the firm exists in equilibrium with the market.* Relative costs determine whether the firm will expand or contract. When a firm is relatively more efficient at deploying assets than the market, those assets will be deployed within the firm. When a firm is relatively less efficient at organizing assets—when its costs of deploying those assets are greater than the costs the market will incur in deploying them—then the market will organize those assets. While Coase spoke directly to the question of when firms will exist and grow, these insights also can be applied conversely. Firms will cease to grow when the market's transaction costs drop. If the market's costs drop sharply, firms will be driven out of existence—broken up, with their assets redeployed by the market.

In a hostile takeover,[28] a bidder purchases a controlling interest in the target firm by making a tender offer for the firm's shares, which are traded in the market. The price offered by the bidder offers a premium above the price at which the shares are traded. After amassing a controlling interest, the bidder uses this newly-acquired voting power to depose the previous management. The new management then runs the firm along new lines—enacting programs on the basis of which it announced its bid. It cuts costs or makes new profits, and thereby finds the monies necessary to repay the costs of the acquisition.

The hostile takeover, thus, is a transaction in which the market supplants a firm—ejects its management and reorganizes its assets. This is true as a matter of function and mechanism. Whether the target firm's assets are disposed of in the market or placed under the control of a management whose values are more closely synchronized with the perceptions of the market, the market sets the terms of the transaction. Control of the target is purchased through the market. If the takeover succeeds, it is because the bidder's expectations have met those of the market. The funds expended to buy control have met the price set by the stock market for the firm's shares.

To say that the market sets a price is to say that the market perceives a profit. To say that the market perceives efficiency gains is also to say that the market perceives that its costs of organizing the firm's assets are

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27. Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA (n.s.) 386, 395 (1937).

28. The takeover is addressed first and primarily, even though buyouts have been larger and at least equally disruptive, due to the heightened impact of hostile tender offers. The hostile tender offer set the tone for corporate control transactions during the 1980s, anticipating the corporate auction and the hostile LBO. *See* HOUSE COMM. ON ENERGY AND COMMERCE, SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE, 99TH CONG., 2D SESS., CORPORATE TAKEOVERS: PUBLIC POLICY IMPLICATIONS FOR THE ECONOMY AND CORPORATE GOVERNANCE 2 (Comm. Print 1986).

lower than the firm's costs of organizing transactions within the firm. It perceives that the firm can be run more in accord with its own perceptions of efficiency. In backing the hostile bid, the market brings the firm's internal efficiency into line with the market's perceptions of efficiency.

The same process can be observed at work in leveraged buy-outs and corporate restructurings. When corporate managers take their firm private, they do so at a price set by the market's perception of what the firm can earn—that is, the market's perception of efficiency. In paying out dividends, changing equity structure, or taking on debt, managers are seen to be responding to the market's perceptions. Replacing equity with debt, in particular, has been hailed as the establishment of an entente between corporate managers and the market. By assuming obligations that must be regularly met, managers are considered to be binding themselves to meet the market's demands.[29]

D. Inefficient Firms or Hyperefficient Markets? An Inquiry into Corporate Recapitalizations

The standard explanation of corporate takeovers, offered countless times during the 1980s, is the inefficiency of the target firm's management. Take one representative assertion:

> The takeover boom is a treatment for a disease that is destroying American productivity: gross and widespread incompetent management. Takeovers are part of a free-market response, working to unseat corporate bureaucracies, control runaway costs and make America competitive again.[30]

Translated to Coasean terms, this claims that the target firm's costs of organizing production have risen to such a level, due to inefficient management, that the market (whose costs have remained steady) can now more efficiently organize the same transactions. The market sees a gain to be made by selling the firm's assets to an individual who will carry out the same transactions at lesser costs—thus arranging, via a price-based transaction, to have the same production functions carried out at lower cost.

The classic explanation of the process has been offered by Frank Easterbrook and Daniel Fischel:

> Tender offers are a method of monitoring the work of management teams. Prospective bidders monitor the performance of managerial

29. Michael Jensen, *The Takeover Controversy: Analysis and Evidence*, *in* KNIGHTS, RAIDERS AND TARGETS 314, 322-23 (John C. Coffee, Jr. et al. eds., 1988) (stating that "[d]ebt creation . . . enables managers effectively to bond their promise to payout [sic] future cash flows").

30. Carl Icahn, *The Case for Takeovers*, N.Y. TIMES MAG., Jan. 29, 1989, at 34. The seminal work in this field is Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

> teams by comparing a corporation's potential value with its value (as reflected by share prices) under current management. When the difference between the market price of a firm's shares and the price those shares might have under different circumstances becomes too great, an outsider can profit by buying the firm and improving its management. . . . The source of the premium is the reduction in agency costs, which makes the firm's assets worth more in the hands of the acquirer than they were worth in the hands of the firm's [former] managers.[31]

Note that this treats the takeover premium, the heightened price at which the target's shares are sold at the height of the tender offer, as tied to the agency costs. The takeover bid can be at a significantly higher level than the trading price because the bid forecasts the value the shares will have under new management. In tendering shares at this price, the market is accepting the value placed on the firm by the bidder. In sum, because the target's former management has been inefficient, share prices have been depressed. In backing the tender offer, the market is selling the firm. The market has awakened to the target firm's true value.

As if parodying Calvinist theology, this vision of takeovers presented commercial practice as a morality play. It equated profit with virtue. Ultimately, because a firm's management had been inefficient, it became possible for long-suffering stockholders and quick-witted arbitrageurs to trade shares at a price significantly above normal. In selling control of the target, they reproved the old managers for their laziness. At the same time, by selling to the bidder, who had cleverly recognized the target's true worth, they unlocked a new era of prosperity—an era in which true value would be recognized. The invisible hand of the market punished sloth, acclaimed insight, and showered rewards on all deserving parties.[32]

It was soon observed, however, that inefficient firms were not the only ones being taken over. More often than not, firms seemed to become targets because they were well-run and profitable.[33] The biggest leveraged buy-outs (LBO's), moreover, were possible only when no one proposed to make radical changes in the firm's lines of business. These buyouts could be financed only when the firm turned out staples which no one proposed to change; this made possible the accurate forecasting of returns. RJR Nabisco,

31. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1173 (1981).

32. Similarly, the gains reported in LBO's were also ascribed to reductions in agency costs—reductions in corporations' internal inefficiencies. When corporate managers bought their companies, they liberated themselves from the bureaucracy which controlled large enterprises. If they now had to balance a heavy load of debt, so much the better: this would focus their attention, preventing procrastination. *See* G. Bennett Stewart, *Remaking the Public Corporation From Within*, HARV. BUS. REV., July-Aug. 1990, at 131.

33. *See* Lipton & Rosenblum, *supra* note 6, at 197-202; Lowenstein, *supra* note 24, at 291-94.

in addition to a large number of food brand names, made cigarettes and countless snack items. Its customers were addicted, either culturally or chemically.

The answer lies in remembering that Coase spoke of *relative* efficiency. To say that the market will supplant the firm when the firm's costs of deploying assets are greater than the market's costs of trading them did not say that broken-up firms were inefficient in some absolute sense. It concluded only that such firms' internal costs must have been higher than the market's trading costs.

Both the firm's costs *and* the market's costs can rise or fall. For a takeover to occur, it is not necessary that the target firm have become so inefficient that its internal transaction costs have *risen* above the market's. It is only necessary that the market's transaction costs be lower than the firm's costs: *This will happen irrespective of the firm's costs and efficiency if the market's transaction costs drop.* The corollary to Coase's theory of the firm is that the firm will be supplanted by the market whenever it is easier to trade assets in the market than to organize them in the firm.[34]

When a hostile takeover succeeds, the market, finding it agrees with the value placed on the firm by the takeover bidder (because the bidder has offered a higher price for shares), sells control of the firm to the bidder. The market reallocates the firm's assets.

The importance of perceived efficiency levels to the reallocation process may be seen even more clearly in the case of leveraged buyouts. When RJR Nabisco became the subject of the largest buyout in history, with different bidders competing for the right to control its assets, what was *really* the cause of the firm's dissolution? The usual analysis was that the firm had become inefficient, that its executives had spent too much money on management perquisites and company jets. The market saw efficiency gains, profits to be garnered by selling the jets and cutting the executives adrift. But the other side of the story was that the market had long been preparing, eagerly, to break up the company.

Kohlberg Kravis Roberts & Company had stalked RJR Nabisco for at least a year beforehand. Other buyout teams had presented plans to the firm's management, begging for the opportunity to sell the firm (that is, to sell securities representing the firm's recapitalized worth). What was the real cause of the buy-out—unduly high firm administration costs, or unnaturally lowered market transaction costs? However high the firm's internal ineffi-

34. Corporate shareholders, of course, are not obliged to conform their preferences to those of the market. A given firm's shareholders might be content with the absolute level of their company's efficiency, irrespective of how this compares to that of the market. However, given the transferability of shares and the control premiums which become available at such junctures, even such loyal shareholders will face substantial pressure to conform their expectations—that is, to sell control. Moreover, as institutional shareholding increases, those who control firms are increasingly less likely to be loyalist shareholders than to be fund managers with an incentive to gain the extraordinary returns of control premiums.

ciencies may have risen, they met the market's transaction costs coming down.[35]

E. Stock Market Hyperefficiency

In discussing how the stock market prices securities and firms, it is necessary to remember that the market reacts to psychological as well as economic factors. Any market, institutionally, comprises individuals who operate under a common set of assumptions—using a base of common information, sharing a commercial consensus which allows them to strike bargains.[36] This set of understandings and expectations defines the market's perimeter. The participants' willingness to trade is the psychological side of this common analytical mindset.[37] The side of the securities market which is analytical, and described by the theory of the efficient capital market, has for its other side the herd instinct which has given us a history of Wall Street panics.

Just as transaction costs include all factors which inhibit trading in a market, so those transaction costs will be reduced by anything which facilitates trading. This can be either a physical or technological factor which makes it commercially easier to trade, or a psychological factor which encourages trading. A pragmatic equation may be drawn between "higher efficiency," "lower costs," and "eagerness to trade." These terms are different ways of describing the essential phenomenon: a reduction in the friction of trading, of organizing assets through bargain transactions.

If the market suddenly becomes preternaturally willing to trade shares—able to trade them with greater ease because new mechanisms for doing so, or because a new class of buyers have suddenly emerged, able to sell them at higher prices or in larger quantities—the market's transaction costs will be lowered de facto. At such junctures, even a firm that is efficiently managed may find that the market regards it as inefficient. Its internal costs may not have changed, it may be functioning as effectively as ever—but suddenly the market has become more willing to trade. It has become hyperactive, or *hyperefficient.*

Stock market hyperefficiency lowers the cost of trading securities. When the market is preternaturally willing to buy and sell, there is less risk to

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35. BRYAN BURROUGHS & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 100-01, 151-53 (1990).

36. Jonathan Baskin, *The Development of Corporate Financial Markets in Britain and the United States 1600-1914: Overcoming Assymetric Information*, 62 BUS. HIST. REV. 199, 200 (1988) (arguing that extent of market is defined by perimeter within which all have equal access to relevant information).

37. David E. Van Zandt, *The Market as a Property Institution: Rules for the Trading of Financial Assets,* 32 B.C. L. REV. 967, 974-75 (1991) (stating that market can also be defined in quasi-jurisdictional terms, as area within which certain common understandings will be enforced). This sharing of assumptions can be seen as a willingness to submit to enforcement mechanisms. *Id.*

acquiring an asset: the new owner can dispose of it more readily. Liquidity guards against potential loss. The fact that an asset can be traded, of itself, makes it more likely that it *will* be traded. Such hyperefficiency is likely to raise the value of an asset—if not in intrinsic worth (however that may be measured), then in terms of market valuation. All else being equal, liquidity enhances an asset's value; in some analysts' eyes, the very fact that an asset is liquid makes it more valuable.[38] Moreover, a hyperefficient market makes it easier to follow the so-called Bigger Fool strategy: to buy any security, no matter how risky or expensive, on the expectation that some buyer will appear to buy it back, even if price and risk have climbed. The more participants in the market, the more efficient the trading mechanisms, the lower the risks—and the lower the transaction costs—of such an approach.

In the hyperefficient market, a boom may feed on itself. When the securities market has grown accustomed to takeovers, buyouts, and restructurings, and has come to believe that these transactions of themselves create value, all public corporations may be viewed as potential takeover candidates—on the auction block—whether or not the firms desire it. Firms which are reluctant to accept a takeover bid or to restructure may find themselves under pressure to do so if the market feels that takeovers and restructurings offer a short-cut to maximizing profits.[39] Recent history demonstrates the force of this pressure. Between January 1984 and November 1985, the Standard & Poor's 500 stock index rose 13 percent. It has been estimated that 70 percent of this rise was due to actual or predicted restructurings.[40]

Ultimately, when a hyperefficient securities market finds it in itself to ignore transaction costs, firms will become targets even if they are efficiently run. Their internal administrative costs remain steady while the market's transaction costs, outside, drop to levels which change the organizational equilibrium. That a firm becomes the target of a hostile takeover does not necessarily mean that the firm is inefficiently run. It means, just as likely, that the market has simply become willing to trade the firm's assets out from under it.[41]

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38. *See* Lawrence Ledermann & Michael Goroff, *Recapitalization Transactions*, 19 REV. SEC. & COMMODITIES REG. 241, 245 (1986) (arguing that active trading of firm's shares may increase value of business).

39. MALCOLM C. SAWYER, THEORIES OF THE FIRM 151 (1979). Sawyer argues:

> If there is competition for funds, then it is expected that the price (of finance capital) will rise. If many firms are maximizing profits in similar situations . . . then [those] others will be earning a higher rate of profit than the firm in question. In the competition for funds, it is argued that those firms will be able to offer (if necessary) a higher price for the funds than the firm X. If there are sufficient of these profit-maximizing firms, relative to the finance available, then firm X will not be able to obtain any funds at a price which it has a prospect of paying.

Id.

40. Christopher Farrell, *Takeovers and Buyouts Clobber Blue-Chip Bondholders*, BUS. WK., Nov. 11, 1985, at 113 (citing current study by Goldman, Sachs & Company).

41. Compare the comments of Ronald Gilson: "[A]n innovation in the capital market

F. *Stock-Market Hyperefficiency In Historical Context*

A period of hyperefficiency in the securities markets may be identified as a period in which a new mode of trading overtakes the existing trading mechanisms. It may be marked by the introduction of some new investment vehicle or by the growth of the market through the arrival of new participants. It may involve the pursuit of new investment objectives, which means a new valuation system. New types of securities may both reflect and facilitate new patterns of trading. All these issues involve stresses which the market is forced to accommodate.

Hyperefficiency is not to be measured by trading volume alone. During the 1890s, turnover averaged 82 percent per annum. During the next decade it was even higher—approximately 214 percent per year, spiking at 372 percent in 1903. During the 1980s, turnover averaged 52 percent a year (by some estimates, as high as 200 percent, counting activity in such derivatives as options and futures). This is still relatively high, considering that turnover averaged 35 percent in the 1930s, 16 percent in the 1940s and the 1950s, and 22 percent in the 1970s. These eras were not marked by merger booms. But turnover was also high across decades in which the market did not break up firms: 98 percent in the period 1910-19, 88 percent for the 1920s.[42]

Nor is hyperefficiency to be measured solely in terms of completed mergers and acquisitions. The great merger waves of American history took place in the periods 1895-1905, 1925-29 (peaking in 1929), 1965-68, and the early 1980s. While the first and the last of these waves represent markets that broke up companies, the merger waves of the 1920s and 1960s do not fit this pattern.[43]

Intrafirm control struggles, proxy battles, takeover bids, and even greenmail raids have been known ever since shares began to trade on the open market.[44] These examples of shareholder activism, however, have always been the exception rather than the norm. This is true of the antebellum period; investors bought shares not because they sought control, but because they wanted to avoid its responsibilities.[45] Just as this was true

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in the 1980's changed the efficient boundary of the firm by lowering the barriers to hostile takeovers, principally through the development of a widespread market for junk bonds." Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Governance Environment*, 61 FORDHAM L. REVIEW 161, 168 (1992).

42. JOHN DENNIS BROWN, 101 YEARS ON WALL STREET: AN INVESTOR'S ALMANAC 253-54 (1991).

43. DAVID J. RAVENSCROFT AND F. M. SCHERER, MERGERS, SELL-OFFS, AND ECONOMIC EFFICIENCY 20-23 (1987); *see also* NAOMI R. LAMOREAUX, THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS 1895-1904 (1985); RALPH L. NELSON, MERGER MOVEMENTS IN AMERICAN HISTORY 1895-1956 (1959).

44. For early examples, see WALTER WERNER & STEVEN T. SMITH WALL STREET 125-28 (1991) (further discussion *infra*, text accompanying notes 101-11).

45. JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970 26-29 (1970) (stating that "assurance of limited drafts upon investor time and energy" furthered growth of corporate investment just as much as "formal legal limits on shareholder responsibility for debts").

before the turmoil of the Gilded Age, so it was true afterward. George Stigler and Clare Friedland have observed, "It is a mystery of the literature of the 1920s and 1930s that the takeover and the unfriendly merger are simply not discussed."[46]

The distinguishing characteristic of the hyperefficient market is that it puts firms into play, providing the context for hostile tender offers and leveraged buy-outs. In this respect, the Gilded Age and the 1980s stand alone.

Several factors dictated that hyperefficiency would break loose at these junctures. In both cases, the market had been primed; it had been stocked with firms that new valuation structures made attractive targets. Irresponsible credit policies financed corporate marauding. With new generations of investors (populations whose arrival helped define the eras) came new trading mechanisms which overwhelmed existing patterns and conventions.[47]

G. *Shareholder Activism and Corporate Break-Up*

It is necessary to analyze corporate control changes not in terms of what a bidder will offer, but in terms of what shareholders desire and demand—which is, after all, the mechanism by which changes in control are effectuated. The corporate raider or buy-out bidder can afford the takeover premium only by bringing into the valuation process the goodwill

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46. George J. Stigler and Claire Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J.L. & ECON. 237, 248 (1983). Perhaps the only notable corporate raider of the 1920s and 1930s was Cyrus Eaton, who stalked the utility companies controlled by Chicago magnate Samuel Insull. MATTHEW JOSEPHSON, THE MONEY LORDS: THE GREAT FINANCE CAPITALISTS 1925-1950 95 (1972).

47. Despite high turnover and a large number of mergers, as well as a speculative fever which has become legendary, the 1920s was not a hyperefficient market. The business consolidations of the 1920s included a very large number of mergers between utility companies. These were usually placed into stratified corporate pyramids held together by very high leverage. *See* WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET 276-353 (1927). The need to preserve these firms' independent existence, and the fact that such mergers took place in an expanding market (so that consolidation brought symbiotic benefits for both acquired and acquiring firms) probably accounts for the general friendliness of these mergers.

For similar reasons, the conglomerate mergers of the 1960s were also friendly. Conglomeration gave acquired firms access to greater capital resources, while maintaining their separate existence as divisions of larger enterprises. Mergers under such conditions did not provoke resistance from target firm executives. Gilson, *supra* note 41, at 165-66.

Relative legal contexts are also very significant. The Gilded Age came before regulation. In the 1980s, regulation was temporarily out of fashion; competition was the buzz-word, even when this meant placing corporate control on the auction block. In the years just after World War I, both Ford Motors and General Motors recapitalized themselves. Had they done so under the legal rules prevailing in 1988, both probably would have suffered feeding frenzies like that endured by RJR Nabisco. ROBERT LACEY, FORD: THE MEN AND THE MACHINE 175-77 (1986) (discussing Ford recapitalization); ROY C. SMITH, THE MONEY WARS: THE RISE AND FALL OF THE GREAT BUY-OUT BOOM OF THE 1980s 57-62 (discussing Ford recapitalization); DANA L. THOMAS, THE PLUNGERS AND THE PEACOCKS 118-24 (1967) (discussing GM recapitalization).

of the firm—the right to break up the firm. The premium has been paid in order to make the shareholders tender—why tender except for a price above the market? And the goodwill must be brought into the valuation in order to pay the tender premium.

It is customary to assume that a takeover or buyout bid offers a premium because the buyer thinks that this new value can be unlocked from the target firm. However, this control premium exists only because of the prospect of a change in control. Therefore, *the control premium can come into existence only when and only because shareholder restiveness makes feasible a change in control.* Only in these circumstances is the right to control the firm a cognizable, *real* prospect. Where a change in control is *not* at issue (that is, when shareholders have not prepared, or are unwilling, to effectuate their right to sell the firm's assets), this premium does not exist.

Theoretically, the premium is the value the bidder believes it has discovered. Practically, the premium is the difference between book value and bid value—what the bidder will pay for shares of a target firm's stock. As such, it is identical with the firm's goodwill—its value as an enterprise.[48] It is also the value for which shareholders are willing to give up their shares, *i.e.* to transfer control. This value fluctuates as shareholders are willing to buy or sell. If the premium exists because it has become feasible to pry away control, its amount is set by the difficulty (*i.e.* the expense) of purchasing the shares from their current owners.

It has been accepted that a target firm is taken over because its true value, ignored by current managers, is actually high enough to attract a bidder who will offer a takeover premium. However, it must be recognized, equally, that the takeover premium is set by what shareholders ask. Therefore, takeovers and buyouts should *not* be seen as ways in which the market polices itself, with bidders alerting all participants to the true values of corporations. They should be seen as ways in which shareholders wring value out of the firm.[49] There is a ruthlessness to this process, but it is Hobbesian rather than Darwinian.

III. SHAREHOLDERS, MANAGERS AND THE STOCK MARKET: STUDIES IN COMPETING HISTORIES

We have come to our present pass, essentially, because Adolf Berle was right about the future of the corporation and wrong about its past.

To Berle we owe the recognition that the potential for abuses of corporate power (mistreatment of shareholders by financial skulduggery

48. Methods of figuring capitalization at the turn of the century make explicit the assumptions of the present day. *See infra* text accompanying notes 73-77.

49. The tender offer bidder and the LBO buy-out group are to be considered as shareholders. The bidder, even if it holds no shares when launching its bid, becomes such through the tender offer process. The buy-out team, similarly, become shareholders through the actual process, or in the representative sense of holding equity in the surviving firm.

within the firm, mistreatment of the public by unfair trade practices outside the firm) is inherent in the structure of the modern corporation. This was expressed in Berle's articulation of the "separation of ownership and control"—the recognition that the modern public corporation, while technically the property of its shareholders, is run by managers who may hold only an infinitesimal fraction of its shares.

Berle believed that managers required strict policing. Since their power over corporate assets vastly outstripped their ownership interest, managers could not be adequately policed by the market; they were playing with other people's money. "Those who control the destinies of the typical modern corporation own so insignificant a fraction of the company's stock that the returns to them from running the corporation profitably accrue to them in only a very minor degree."[50] He thus taught scholars of the corporation that agency costs lay hidden within the separation of ownership and control.

Corporate managers could accumulate earnings within the firm, using their power to time the dates on which earnings were received and dividends were declared. In the meantime, they were likely to be covertly changing the firm's capital structure—redistributing profits with warrants, blank-check stock, or new classes of securities, or diluting shareholder rights with stock dividends or no-par shares. These managers were not above confusing investors with corporate pyramids and accounting tricks, and courts had been willing to let them change the nature of outstanding shares, even such basic characteristics as rates of return.[51]

Berle's contribution, vis-à-vis the shareholders of the modern corporation, was to note that the shareholders could no longer control the firms in which they held stock. He stated:

> The stockholder is therefore left as a matter of law with little more than the loose expectation that a group of men, under a nominal duty to run the enterprise for his benefit and that of others like him, will actually observe this obligation. In almost no particular is he in a position to demand that they do or refrain from doing

50. Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 9 (rev. ed. 1968).

51. *See id.* at 141-206. Such issues had occupied Berle for the decade prior to the publication of The Modern Corporation and Private Property. *See* Adolf A. Berle, *Compensation of Bankers and Promoters Through Stock Profits*, 42 Harv. L. Rev. 748 (1929); Adolf A. Berle, *Convertible Stock Bonds and Stock Purchase Warrants*, 36 Yale L.J. 649 (1927); Adolf A. Berle, *Non-Cumulative Preferred Stock*, 23 Colum. L. Rev. 358 (1923); Adolf A. Berle, *Non-Voting Stock and "Banker's Control"*, 39 Harv. L. Rev. 673 (1926); Adolf A. Berle, *Participating Preferred Stock*, 26 Colum. L. Rev. 303 (1926); Adolf A. Berle, *Problems of Non-Par Stock*, 25 Colum. L. Rev. 43 (1925); Adolf A. Berle, *Promoters' Stock in Subsidiary Corporations*, 29 Colum. L. Rev. 35 (1929); Adolf A. Berle, *Publicity of Accounts and Directors' Purchases of Stocks*, 25 Mich. L. Rev. 827 (1927); Adolf A. Berle, *Subsidiary Corporations and Credit Manipulation*, 41 Harv. L. Rev. 874 (1928).

> any given thing. Only in extreme cases will their judgment as to what is or is not to his interest be interfered with.[52]

As individuals, shareholders were powerless. Instead, their protection lay in the fact that a market for their shares existed. Berle continued:

> The net result of stripping the stockholder of virtually all his power within the corporation is to throw him upon on an agency lying outside the corporation itself—the public market. . . . A shareholder who possesses common stock in the expectation that it will ultimately pay large dividends, though in fact it is paying none, would, nevertheless, regard his expectation as reasonably satisfied if the price of his stock were to mount steadily so that he could realize his expectation by sale of his security for cash through the machinery of a public market.[53]

In yielding control, shareholders had achieved the liquidity which made their shares marketable. "For property to be easily passed from hand to hand," Berle wrote, "the individual relation of the owner to it must necessarily play little part. It cannot be dependent for its continued value upon his activity."[54] Ultimately, the share of stock became a "liquid token," an item to be traded in the stock market, essentially separate from the ownership interest it represented. Management controlled the firm; management exercised the *jus disponendi*, the right of an owner to manage property. Shareholders controlled only their shares. Berle noted:

> Finally, as the token becomes more and more separated from the physical properties through the interposition of managements and their endowment with legal power which can be traced through to the physical assets, the "*jus disponendi*" over the physical property ceases to be in the owner of the token. His real right of disposition is a right of disposition over the token itself, over any returns which may distributed to him, and over the proceeds of its sale. He has, in fact, exchanged liquidity for control.[55]

The shareholders' safeguard was the market—their right to sell their shares.

A critical element of Berle's hypothesis was his belief that shareholders' rights, as the modern corporation arose, had either fallen into desuetude or been usurped by corporate managers. In the past, he argued, shareholders had been both owners and managers of their companies. They might delegate day-to-day tasks to executives, but they carefully supervised the firm's operation. They voted in person, and not by proxy; they removed directors whenever they saw fit. State law supported them, limiting corporations'

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52. BERLE & MEANS, *supra* note 50, at 44.
53. *Id.* at 247.
54. *Id.* at 250.
55. *Id.* at 251.

purpose, size, and duration. Courts frowned on attempts to evade liability, to water the balance sheet with dubious valuations, and to change the nature of the firm. Shareholders were

> protected in their property rights by a series of fixed rules under which the management had a relatively limited play . . . [Managers] occupied, in fact, a position analogous to that of the captain and officers of a ship at sea; in navigation their authority might be supreme; but the direction of the voyage, the alteration of the vessel, the character of the cargo, and the distribution of the profits and losses were settled ahead of time and altered only by the persons having the underlying property interest.[56]

That this thesis must be revised has been made clear by a recent book: *Wall Street*, begun by Professor Walter Werner and completed by Steven Smith.[57] A history of New York's early securities markets, *Wall Street* is noteworthy for its painstaking reconstruction of the "corporate system" as it functioned between 1790 and 1850: what shares were traded in early markets, who traded them, and what patterns of trading and ownership emerged. *Wall Street* shows that the basic institutions of the American corporate system have remained remarkably and fundamentally the same since their inception.

Against the "erosion doctrine" of shareholder rights, Werner and Smith posit an "inherence thesis":

> From the time of the first public corporations, shareholders were owners who did not directly exercise control over their property. There never was an admired era in which shareholders possessed and exercised more rights in public corporations than they do today, and there has never been an erosion from such an era.[58]

The early tendency of states to charter corporations for specific purposes, which Berle had read as a restraint on corporate management, in fact betokened state interest in promoting business enterprise.[59] Corporate managers enjoyed the same operating latitude which would be enjoyed by their twentieth-century counterparts, and often abused it as badly.[60] So similar were these corporations to those of the present day that one can even identify takeover bids and corporate greenmail.[61] About proxy voting, Berle was simply wrong. Proxy voting was not imposed by management in order to facilitate its control; it was available from the very first.[62]

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56. *Id.* at 125-26.

57. WERNER & SMITH, *supra* note 44.

58. *Id.* at 117-18.

59. *Id.* at 103-12.

60. *Id.* at 119-25.

61. *Id.* at 125-28.

62. *Id.* at 118-19. Werner and Smith stated that "[t]hose who held shares as investments attended shareholder meetings as rarely as they do now. At the 1841 annual meeting of the Massachusetts First National Bank of Boston, there were eight shareholders present and 227 votes represented out of 3,200 shares." *Id.* at 118.

Early investors never sought to control the firms they owned. Indeed, they bought shares precisely because they *were* liquid. "Marketability, always useful, was particularly desirable when few forms of wealth had it."[63] As early as the 1790s, investors were market players rather than careful proprietors: "While early shareholders may not have had the voting rights Berle attributed to them, they did have a stock market which Berle overlooked."[64] Thus, from the earliest days of the stock market and the public corporation, managers managed independently and shareholders invested passively.

While honoring Berle's achievement, we must admit his oversights.[65] Because Berle failed to appreciate fully the sophistication of early securities markets, he implicitly assumed that the development of the stock market had trailed behind the development of the business corporation. Thus, he believed that the market for shares had appeared at a time when shareholders' status within the firm was changing. The market's emergence gave shareholders an escape valve, thus helping to change their role. Berle's oversight was one of timing. Because the market has always existed alongside the corporation, it has always served as the external adjunct of internal corporate governance. The market's existence has never *changed* the shareholders' role. Rather, it has always *defined* that role.

Moreover, because Berle misunderstood the historical identity of the shareholder class, subsequent writers on the corporation have misinterpreted the frauds he saw being perpetrated on Wall Street. The symptoms were clear and he described them accurately. Corporations *were* being deliberately mismanaged; stockholders *were* being systematically defrauded. But these abuses of corporate power were not pathologies of the division of ownership and control. They were not the problems to be expected from entrusting management to those without correspondingly large ownership interests. They were not abuses visited by managers *qua* managers upon shareholders *qua* shareholders. Rather, these abuses were pathologies of the *union* of ownership and control. *Shareholders* who held management positions committed these abuses, shareholders who used their control of the firm to enrich themselves at the expense of other shareholders.

If profits were to be reshuffled by issuing a new class of shares, or voting control were to be surreptitiously shifted, or equity were to be siphoned out of the firm by a new issue of warrants (an action whose profit would later be recognized by the action of the market), it was shareholders,

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63. *Id.* at 5.

64. *Id.* at 118.

65. In some areas, Berle's interpretation of corporate history is not incorrect. The textile industry of early New England, for example, presents a model of corporate owner-management like that he described. *See* 1 VICTOR S. CLARK, HISTORY OF MANUFACTURES IN THE UNITED STATES 1607-1860 456-58 (1929). One case in which the shareholders appear to assume a management role is *Burr's Executors v. M'Donald*, 44 Va. (3 Gratt.) 219 (1846) (shareholders assume control of firm, albeit too late to do much more than feud with creditors over distribution of assets).

and it could only be shareholders, who stood to gain. This misconduct relied upon control of the issuing corporation, either by purchase or by reliance, but it was shareholders, *not* managers, who were the guilty parties. When the same individuals shared ownership and management roles, management had opportunity and means, but it was the shareholders who had the motive and enjoyed the rewards.

This state of affairs is confirmed by Thorstein Veblen. Veblen saw, like Berle, both the separation of ownership and control and the critical nexus between firm and market.[66] But while Berle focused on the tactics used to defraud shareholders, Veblen analyzed the strategy followed by those captains of industry who made their money in arbitraging between the value of the firms they controlled and the securities markets.

> In the capital market the commodity in which trading is done . . . is the capitalized putative earning-capacity of the property covered by the securities bought and sold. . . . [T]his putative earning-capacity of a given block of capital, as it takes shape in the surmises of outside investors, may differ appreciably from the actual earning-capacity of the capital as known to its managers; and it may readily be to the latter's interest that such a discrepancy between actual and imputed earning-capacity should arise.[67]

Thus, when the market overvalued a stock, those who controlled a firm might sell, or sell short. Or they might take more direct action. "[U]nder these circumstances the men who have the management of such an industrial enterprise, capitalized and quotable on the market, will be able to induce a discrepancy between the putative and the actual earning-capacity."[68]

Berle said that he wanted to be the Marx of the shareholder class.[69] As the godfather of all contemporary analysis of corporation law, he succeeded better than he knew—or worse. He stands in relation to the junk-bond wave of the 1980s as Marx does to Stalin's purges and famines.

Berle spoke of agency costs and shareholder oppression. Following him, we believed too easily in managers' shortcomings and shareholders' rights. Corporate raiders were welcomed with declarations that they would curb management misconduct and raise share prices using the market to liberate the shareholder class from management misrule, for all firms across the market. Seeking to avoid the agency costs of which Berle had warned us, American business stepped unwittingly into the abuses which he had de-

66. In 1904, 28 years before *The Modern Corporation and Private Property*, Veblen wrote: "The ready vendibility of corporate capital has in great measure dissociated the business interest of the directorate from that of the corporation whose affairs they direct and whose business policy they dictate." THORSTEIN VEBLEN, THE THEORY OF BUSINESS ENTERPRISE 159 (1904).

67. *Id.* at 154-55.

68. *Id.* at 156.

69. JORDAN A. SCHWARZ, LIBERAL: ADOLF A. BERLE AND THE VISION OF AN AMERICAN ERA 62 (1987).

scribed—those which occurred when dominant shareholders controlled corporations. In avoiding a speculative danger, the corporation was called upon to endure a dangerous period of speculation.

IV. The Disruptive Effects of Shareholder Activism

The Gilded Age began in April 1862, when Gilprin's Gold Room opened in lower Manhattan, offering speculators the chance to bet on Confederate success and wartime inflation. The Gilded Age ended on May 9, 1902, between 10 a.m. and noon, in the financial *götterdämmerung* of the Northern Pacific Railroad corner, when E. H. Harriman's bid for control of the railroad and J. P. Morgan's belated counterbid to retain control sent share prices rocketing from $172 to $1000 in an hour's time.[70]

The 1980s began on Saturday, October 6, 1979, when Paul Volcker, chairman of the Federal Reserve Board, announced a change in monetary policy. Michael Lewis summed up the effect with smart-aleck precision, writing in *Liar's Poker*:

> Volcker announced that the money supply would cease to fluctuate with the business cycle; money supply would be fixed, and interest rates would float. The event, I think, marks the beginning of the golden age of the bond man. . . . Bond prices move inversely, lockstep, to rates of interest. Allowing interest rates to swing wildly meant allowing bond prices to swing wildly. Before Volcker's speech, bonds had been conservative investments, into which investors put their savings when they didn't fancy a gamble in the stock market. After Volcker's speech . . . the bond market was transformed from a backwater into a casino.[71]

As the 1980s had begun ahead of schedule, so they ended ahead of schedule, in the closing months of 1988. In October and November of that year, competing teams of investment bankers put RJR Nabisco through the largest LBO in history. In December 1988, Drexel Burnham Lambert, the firm which had started and ridden highest on the junk-bond boom, agreed to plead guilty to six felony counts.[72]

These endpoints have been chosen in terms of psychological time, representing the way in which market periods define themselves by prevailing perception. The likeness of the Gilded Age and the 1980s, in terms of the forces and dealings which defined both ages, suggests that their frameworks be similarly defined.

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70. See, respectively, Robert Sobel, Panic on Wall Street 136 (1988 ed.), and Edmund C. Stedman, The New York Stock Exchange 399-400 (1905).

71. Michael Lewis, Liar's Poker: Rising Through the Wreckage on Wall Street 35-36 (1989); *see also* William Greider, Secrets of the Temple: How the Federal Reserve Runs the Country 124-53 (1987).

72. On Drexel's downfall, see N.Y. Times, Dec. 22-23, 1988 (numerous stories on Drexel settlement, Michael Milken, Frederick Joseph, and 32 months of insider-trading investigations); on RJR's devolution, see Burroughs & Helyar, *supra* note 35.

A. *Chop Shop Pricing and Break-Up Value: Hyperefficient Methods of Share Valuation*

Underlying the hyperefficiency of both the Gilded Age and the 1980s was a new system of share valuation. Shares were being valued not by the standards of passive investors (persons who had no desire to actively manage a firm's business) but by the standards of other corporations (persons willing to take control of a target firm, in every sense). When this new valuation became the touchstone, shares which had traded as tokens in the market, available at a price reflecting trading value, were discovered to have higher values if analyzed as fractional interests in the physical assets of their issuers. Similarly, the assets held by a corporation, whose worth was calculable in sales figures, industry ranking, appraisal, replacement costs, or amortization, were discovered to have a lower potential sales price if a buyer bought their ownership by purchasing shares in the stock market rather than negotiating with executives who managed those assets.

These points were made by Dean LeBaron and Lawrence Speidel in a discussion published by the Federal Reserve Bank of Boston. The passive investors of earlier years, LeBaron and Speidel argued, measured stocks by price-earnings ratios, price-book value ratios, and potential yields. The corporate investors of the 1980s began valuing the firms whose stocks they held as if the issuers were rivals or subsidiaries—analyzing pension assets, tax assets and liabilities, market share, goodwill, and potential synergy. This shift in valuation structure, to the "chop shop" method, led them to look at other firms as potential acquisitions.[73]

Shares were now being valued in terms of the business that issued them. And just as ineluctably, corporations were now being valued as functions of their shares. The opportunity summed up in the phrase "the market for corporate control" was really a description of arbitraging between these values. In both the Gilded Age and the 1980s, it was profitable to buy firms in the stock market because those firms' real-world value, their value

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73. Dean LeBaron & Lawrence S. Speidell, *Why Are The Parts Worth More Than The Sum? "Chop Shop," A Corporate Valuation Model*, *in* THE MERGER BOOM (Lynn E. Browne & Eric Rosengren eds., 1987), *discussed in* SMITH, *supra* note 47, at 277-80.

In 1987, in a report accompanying proposals for reform of tender offer legislation, the United States Senate noted the same shift.

> According to the Wall Street Journal, it was the shift to using "break up value"—the value of a company if dismembered and its parts sold off—as the cornerstone stock valuation method . . . that led to the enormous rise in stock prices. "The concept of breakup value came into prominence as a direct byproduct of the feverish takeover boom and everything that went with it: arbitrage, leverage, junk bonds, even inside information [and the belief that] [h]igher [stock] prices would come from takeovers, restructurings and corporate stock repurchases alone. . . . [I]nvestment bankers began thinking it was impossible to overpay for a company."

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, TENDER OFFER DISCLOSURE AND FAIRNESS ACT OF 1987, S. REP. No. 265, 100th Cong., 1st Sess. 78 (1987) (citing James B. Stewart & Daniel Hertzberg, *Before the Fall: Speculative Fever Ran High in the 10 Months Prior to Black Monday*, WALL ST. J., Dec. 11, 1987, at 14) (alteration in original).

as collections of assets or competitive strength, was greater than the value of their shares in the stock market.

In the 1870s and 1880s, the reckless building of railroads, accompanied by the reckless issuance of securities to finance them, facilitated this process. Railroad expansion

> involved staking claim to untapped regions by building branch or feeder lines into them. Branches were costly and risky ventures at best, but if the parent road did not build them someone else might. Every hamlet in the West hungered for a rail connection and listened eagerly to any promoter with plans in his pocket. These local projects, called "sucker roads" by Gould, preempted a piece of the territory and loomed as potential menaces if they should fall into the hands of rival roads or evolve into larger lines. . . .
>
> Too late railroad managers realized that system building did not immunize them at all but merely enlarged the battlefield. . . . Moreover, the cost of building new lines and buying old ones imposed financial strains on every company. The strong were forced to cut or eliminate dividends; the weak flirted with bankruptcy. Expansion also flooded the market with masses of new securities that ultimately dragged it downward by sheer weight.[74]

Many of the municipalities which issued bonds had to go into default when these ventures failed to pan out. In the meantime, the bonds were in the market.[75] Jay Gould, the dark genius of corporate finance, recognized that the profit in owning a transcontinental enterprise—a railroad, or a telegraph company—was not to be made from operating the firm, but by playing off its physical assets and financial capital against each other. Buying and selling corporations—or threatening to buy and sell other people's corporations—would be more lucrative than simply doing business. In building railroads, American business was unwittingly stoking the fires of speculation.

The bust-up takeovers and buy-out feeding frenzies of the 1980s, similarly, were also created with the best of intentions by the antitrust policy of the 1950s. The Celler-Kefauver Act, passed in 1950, favored acquisitions which did not monopolize a given market, and so gave firms an incentive to expand into unrelated fields. This prompted the conglomerate mergers of the 1960s merger wave.[76] As if setting up pins in a bowling alley, this primed the economy for the 1980s. The finance behind conglom-

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74. MAURY KLEIN, THE LIFE AND LEGEND OF JAY GOULD 177-78, 296 (1986).

75. An example of the litigation thus engendered is Loan Ass'n v. Topeka, 87 U.S. (20 Wall.) 655, 662 (1874), holding that a state may not spend (and hence tax) for private purposes. This is discussed in MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1870-1960 at 23-24 (1992).

76. *See* NEIL FLIGSTEIN, THE TRANSFORMATION OF CORPORATE CONTROL 191-212, 226-28 (1990) (discussing effect of Celler-Kefauver Act); Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537, 1558 (1981) (arguing that conglomerate form mimicked external capital markets).

erate-building taught businessmen to value firm performance in purely financial terms, establishing the valuation structure of the junk-bond boom. Moreover, conglomerate firms could easily be broken up—and were. The corporate break-ups of the 1980s undid the conglomerate mergers of the 1960s.[77]

B. *Monetary and Credit Contexts*

Both the Gilded Age and the 1980s were alike in their fiscal context. Both marked the shift from a period of fiscal inflation to one of stable money. After the inflation caused by Civil War financing, the remainder of the nineteenth century marked one long, gradual tightening of the money supply, as Republican administrations renounced greenback currency and resisted the free coining of silver. The 1980s saw the reversal of the inflation tolerated by the Nixon and Carter administrations. The sad irony of both eras (or the tragedy, or the simple stupidity) was that, within the overall fiscal tightening, the regulatory structure left open certain opportunities for careless lending—even for reckless or consciously irresponsible lending. This stoked the inferno of hyperefficiency.

Gilded Age banking policy, which focused on tariffs, bimetallism, and the balance of payments, ignored the age's most important development: the money brought into being, *sans* mint involvement, by bank credit and checking. Willard Hurst has put the problem neatly:

> Contests over public and private controls on money between 1860 and 1908 were misdirected in proportion as they fastened on coin and currency and neglected bank lending, which had become the principal source of the money supply. In the free-banking laws which became the norm in the states and were taken as the pattern for the national bank system, law contributed to creating the problem, joining calculated, permissive public policy to the driving energies of businessmen. Having thus fostered private agencies for expanding deposit-check money, legislators left this principal component of the money stock substantially alone through two generations of unsettling fluctuations in credit, punctuated by costly financial crises.[78]

A crash in 1873 brought on a depression; a crash in 1884 brought on a depression; a crash in 1893 brought on a depression; a panic in 1907, halted at the last moment by J. P. Morgan, hastened the creation of the Federal Reserve.

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77. Amar Bhide, *The Causes and Consequences of Hostile Takeovers*, 1989 J. APPLIED CORP. FIN. 36, 49 ("In short, the targets of 'bust-up' takeovers clearly appear to be companies that had diversified through acquisition"); Randall Morck et al., *Do Mangerial Objectives Drive Bad Acquisitions?*, 65 J. FIN. 31, 47 (1990) (stating that "hostile bust-up takeovers simply undo past conglomeration").

78. JAMES WILLARD HURST, A LEGAL HISTORY OF MONEY IN THE UNITED STATES, 1774-1970 191 (1973) (citation omitted).

Gilded Age banking law, as a matter of structure, established a financial house of cards. National banks were required to keep a portion of their reserves on deposit. Because these deposits could be with other banks and because New York City banks paid interest on such "bankers' balances," funds which had been paid over to the tellers of country banks tended to become concentrated in the vaults of commercial banks in New York City. Typically, the New York banks then used this money to make call loans to brokerage houses; some 60-70 percent of reserve deposits seem to have been used this way.[79] Call loans were used to finance margin purchases. A broker whose customer had paid down only 10 percent of the purchase price used a call loan to make up the other 90 percent of the money needed to fill the order.[80]

This tied the stock market to the banking system. A failure in one system produced a panic in the other. A stock market drop meant a sudden depreciation of the collateral securing the loans into which the nation's bank reserves had been put. If nationwide hard times caused runs on banks, country banks had to pull in their New York deposits. This required the calling-in of call loans, with a market decline as brokers sold stocks to repay their obligations.[81] Even in good times this system fueled speculation. Funds which had originated as savings deposits ultimately financed high-risk margin trading.

During the 1980s, a similar source of free capital was available for takeovers, buyouts, and other corporate restructurings. In Florida, Texas, and California, savings and loan associations had been deregulated. Freed by state legislators from restraints on what investments they could make, the thrifts poured money into junk bonds. It has been estimated that at least 15 percent of Drexel's junk-bond issues came from the thrifts.[82] Florida's Centrust Savings Bank (formerly Dade Saving & Loan) had a junk bond portfolio of $1.35 billion. California's thrifts, headed by Lincoln Savings & Loan under Charles Keating, were even better customers.

> With the passage of time, as Keating reached further and further in search of high yields, Lincoln's junk bond portfolio got increas-

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79. JOHN T. HOLDSWORTH, MONEY AND BANKING 268-70 (1917).

80. *Id.* at 270-74. The other side of this issue was the banks' willingness to certify checks used in such stock market transactions. Standards on certification were very loose; banks would certify checks without accepting them (as now provided under § 3-411 of the Uniform Commercial Code). Such over-certification, practically speaking, meant a lavish extension of credit.

The risks posed by this practice were first identified in the wake of the Panic of 1873, but remained a problem until well past the turn of the century. The banks simply refused to obey the laws forbidding over-certification. O. M. W. SPRAGUE, HISTORY OF CRISES UNDER THE NATIONAL BANKING SYSTEM 97-105, 354-59 (1910); STEDMAN, *supra* note 70, at 424.

81. See Charles P. Kindleberger, *The Panic of 1873 and Financial Market Volatility and Panics Before 1914*, and Jack Wilson et al., *Financial Market Panics and Volatility in the Long Run*, with related discussion, both in CRASHES AND PANICS: THE LESSONS FROM HISTORY 69, 85 (Eugene N. White ed. 1990).

82. MARTIN MAYER, THE GREATEST-EVER BANK ROBBERY: THE COLLAPSE OF THE SAVINGS AND LOAN INDUSTRY 281 (1990).

> ingly rancid. By the time of the 1988 examination, no less than 77 percent of it was in bonds that not only were not rated by Moody's or Standard & Poor's—they were not rated at all! Lincoln's junk bond holdings [had] become a litany of bankrupt or troubled companies: Integrated Resources, Revco, LTV, Western Union, Southmark, Pacific Asset Holdings, Gearhart, Lear Petroleum, Hyponex, Buyer's Club, First Texas Savings, E. C. Garcia, Busse Broadcasting (which never made a penny), and many others. Lincoln bought Eastern Airline bonds at a little more than par shortly before Eastern was put into bankruptcy court.[83]

Imperial Savings, based in San Diego, held $1.5 billion in junk bonds. To the north, in Los Angeles, Columbia Savings and Loan held $4 billion in junk-bond issues. Its affiliate, Columbia Savings Charitable Foundation, held $16 billion in junk bonds. Columbia had an office in the Drexel Building in Beverly Hills. This was the site of Michael Milken's trading room, the Pentagon of the junk-bond movement; Columbia's office suite was guarded by Drexel's security men.[84]

C. *New Investors and New Investments*

The bull market of the 1980s involved a very large section of the population. Not only did this include individuals who invested directly, in individual stocks; it also included indirect investment through pension and mutual funds. As these institutions' stake increased and their managers' role expanded, the size and activity of the investing population grew phenomenally. The Gilded Age, too, had seen a new group of investors enter the market. During the war, Jay Cooke's bond drives had broadened the class of those who owned securities; those who had purchased federal bonds formed a market for new issues of railroad and industrial stock.[85]

In the 1980s, high-yield bonds were the central phenomenon. The junk market, which had amounted to only $30 billion in 1980, doubled to $60

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83. *Id.* at 184-85.

84. STEPHEN PIZZO ET AL., INSIDE JOB: THE LOOTING OF AMERICA'S S & L'S 397, 405, 407 (rev. ed. 1991).

Insurance companies also provided funds. Restricted from investing in common stocks, they took the opportunity to buy speculative bonds. First Executive, a California insurance firm, held between $5 and $7 billion in Drexel junk. Its connections with Milken made possible its meteoric rise from the brink of insolvency to a role as a "pioneer of new-wave insurance products." CONNIE BRUCK, THE PREDATORS' BALL: THE JUNK-BOND RAIDERS AND THE MAN WHO STAKED THEM 90 (1988). "In speeches Milken gave in 1986, he took pleasure in alluding to these successful upstarts, First Executive and Columbia, which had flouted conventional industry practices." *Id.* at 92.

85. ROBERT SOBEL, THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK MARKET 70 (1965). Cooke "recruited a small army of 2,500 subagents among bankers, insurance men, and community leaders and kept them inspired and informed by mail and telegraph. He taught the American people to buy bonds, using lavish advertising in newspapers, broadsides, and posters." EDWARD C. KIRKLAND, INDUSTRY COMES OF AGE: BUSINESS, LABOR AND PUBLIC POLICY 1860-1897 20-21 (1961; Quadrangle ed. 1967).

billion in 1984, passed $80 billion in 1985, and mushroomed from there: $120 billion in 1986, $160 billion in 1987, and more than $200 billion in 1989.

> In December 1983, of industrial companies with bonds rated by Standard & Poor's, only 32 percent were rated BB or lower. Just three and a half years later, in May 1987, however, 57 percent were rated BB or lower. The median industrial bond was junk.[86]

This expansion of low-grade debt occurred in a market from which equity was being drained. While the junk market grew, more than $500 billion in equity vanished.[87]

The Gilded Age was also an age of new investments. New local railroads capitalized themselves with local bond issues. The great transcontinental railroads, laying down thousands of miles of track, were authorized to issue bonds for every twenty-five mile section completed.[88] One investment, the commodity future, was a direct by-product of the Civil War. The large contracts announced in 1861, as Lincoln's government prepared to provision its army, created a prospective demand for wheat and pork that the Midwest's trading floors emerged to handle.[89] Cornelius Vanderbilt followed a policy of declaring large stock dividends on the railroads he controlled and others followed suit.[90] At the turn of the century, as the trusts were formed, huge amounts of common and preferred shares found their way to the market.[91]

Changing technology also played a part. The stock ticker was put into service on November 15, 1867. Because this provided current information on changes in stock prices, it offered the opportunity to participate in market movements. The ticker broadened stock trading beyond lower Manhattan. So important was this advance that the ticker was accorded its own chapter in Edmund Stedman's 1905 history of the New York Stock Exchange.[92] As a technological innovation, the stock ticker prefigured program trading. Today, investors who buy index options are betting with as much acumen—which also means, just as blindly—as their grandparents who followed the tickertape. Index options and futures are the raw material of program trading, the means by which program trading hedges the risks of large portfolios. The stock ticker made it possible for people to believe they

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86. LOUIS LOWENSTEIN, SENSE AND NONSENSE IN CORPORATE FINANCE 56 (1991).

87. *Balancing Acts: A Decade of Debt Is Now Giving Way to the Age of Equity*, WALL ST. J., Dec. 16, 1991, at A8.

88. WINKS, *supra* note 3, at 252.

89. Early cases involving commodity futures reveal this history by speaking of barrels of "mess pork." *See, e.g.*, Waterman v. Buckland, 1 Mo. App. 45, 46 (1876).

90. GORDON, *supra* note 4, at 87-88.

91. *See* Thomas R. Navin & Marian V. Sears, *The Rise of A Market for Industrial Securities, 1887-1902*, 29 BUS. HIST. REV. 105 (1955).

92. STEDMAN, *supra* note 70, at 435-41.

could react to the market; program trading lets investors believe that they have anticipated the market.[93]

D. *Stock-Market Raids on Producing Firms*

To bid in the market for corporate control was to make a raid, through the stock market, on the assets of the producing economy. The takeover raider or buyout bidder could offer a premium because the bid was for control—Berle's *jus disponendi*, the profits in being able to dispose of the issuing firm. The hyperefficient market could sustain an inflated value for the target's shares because the value of the firm's physical assets was being factored into share prices.

A hundred years ago, the same opportunity for arbitrage was exploited by Jay Gould. As Matthew Josephson put it in *The Robber Barons*:

> With his unsentimental eye [Gould] saw at once that it was useless to engage in a legitimate shipping and passenger business while waiting for the thinly settled prairies to fill up. Nothing justified the present building and operation of large railroad systems save that other entrepreneurs would do so if he did not . . . . [T]here were only two ways of making the operation pay: by owning an unchallenged monopoly of a given territory and "charging all the traffic would bear" (though this was not certainly profitable) or by manipulation of its capital in the markets—and none knew how to do this better than Jay Gould.[94]

Buying a sucker road into some other railroad's territory or threatening to lay down new lines of track, was a means of extortion. Profits could be wrung out of shares. If litigation was to be feared, it could also be used against an adversary. Maury Klein, Gould's most recent and most open-minded biographer, lays out the situation plainly. The "most classic of Gould operations," Klein has observed, was "the attack on a large, established company through the instrument of a small, obscure competitor into which he breathed new life."[95]

Beginning in 1875, Gould mounted a campaign against Western Union, then the largest telegraph company in the United States and a crown jewel of the Vanderbilt family holdings. His vehicle was the Atlantic & Pacific Telegraph Company. In July 1875 Gould opened the campaign by making large purchases of Western Union stock. This was accompanied by a rate war and a skirmish on the technological front. (Gould temporarily lent his patronage to Thomas Edison, who had developed a new system of telegraphy.) In 1877 the fighting stiffened, with railroads being brought into

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93. *See* PETER L. BERNSTEIN, CAPITAL IDEAS: THE IMPROBABLE ORIGINS OF MODERN WALL STREET (1992) (discussing development of modern investment theory and derivative securities).

94. MATTHEW JOSEPHSON, THE ROBBER BARONS: THE GREAT AMERICAN CAPITALISTS 1861-1901 195-96 (1st ed. 1934).

95. KLEIN, *supra* note 74, at 197.

action. Gould bought heavily into the Michigan Central Railroad, which competed with a Vanderbilt line, the Michigan Southern Railway. At the same time, he opened a second front, among the railroads west of Chicago, by placing himself on the boards of two lines which could compete against Vanderbilt interests in that region. A proxy fight for control of the Michigan Central catalyzed matters. Gould lost the shareholder vote, but he had shown his strength. In August 1878, the Atlantic & Pacific sold a controlling interest to Western Union, as William Vanderbilt bought off Gould.[96]

The campaign which placed Gould in control of Western Union, begun two years later, was just as strategically sophisticated. Having organized a bear pool, Gould began by shorting Western Union stock. From a vantage point on the board of American Union, yet another telegraph company, he intensified direct competition with Western Union. This was done with skirmishes over telegraph rates (which sometimes escalated into a real trade war, with actual seizures of telegraph stations) and Gould's announcement of plans to lay a new transatlantic cable. This brought up the price of American Union stock, while driving down further the price of Western Union. Around this point, masking his actions as cover purchases of his earlier short sales, Gould bought 90,200 shares of Western Union—thereby becoming the firm's largest shareholder. Litigation over access to telegraph lines and a proxy fight with Western Union kept the pressure on. By January 1881, Gould became a director of Western Union. This brought the firm within his orbit, and meant immediate profits which he recouped in his persona of shareholder.

> The final agreement contained something for everyone. Western Union issued $15 million in stock to exchange for American Union shares, a price Gould estimated at twice the latter's original cost. It issued another $8.4 million in stock to take up outstanding American & Pacific shares at 60. Gould had owned much of this stock since 1877, when his associates happily sold their shares to Western Union at 25. Finally, Western Union appeased its shareholders with a stock dividend of $15.5 million representing earnings invested in the company but never capitalized.[97]

In his own day, Gould was called a corporation blackmailer,[98] an epithet which looks forward to the greenmail of the 1980s. Gould's strategies were more complex than those employed by latter-day greenmailers. His threat was couched in terms of business competition and hammered home with lawsuits and bear raids; the takeover barons simply bought large stock positions and threatened to buy more shares (enough to depose the target's current management) if they were not bought out. But what Gould did to Western Union was what Sir James Goldsmith would do to Goodyear, or

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96. *Id.* at 197-205.

97. *Id.* at 277-80 (quote at 280).

98. *Id.* at 276 (citing ALEXANDER NOYES, FORTY YEARS OF AMERICAN FINANCE (1909)).

Ronald Perelman would do to Gillette—threaten the target firm's independence, while hacking out part of its value as a going concern.[99]

E. *Shareholder Activism in the Gilded Age*

Gould remains the consummate example of the active shareholder. Moreover, he was representative of the shareholders of his era. Throughout the Gilded Age, corporate shareholders were an uncommonly restive and mutinous lot. If some may only have been inspired by Gould, some others anticipated him. In 1868, while Gould only had begun the machinations which would be described in *Chapters of Erie*, the Virginia Supreme Court decided the case of *Stevens v. Davison*.[100] The events narrated in this opinion—dubious board meetings, massive issues of watered stock, suspect leases of corporate property, and lucrative private contracts with directors—prefigure Gould's career.

Over the rest of the century, shareholders fought managers for control of corporate enterprises. They sued to control the development of Pennsylvania forest land.[101] They battled over shoe factories in New Hampshire.[102] They fought for rights to hotels in Omaha.[103] They fought for control of newspapers in Iowa, mining property in Texas, mining property in California, unimproved acreage in Kentucky, packet lines on the Mississippi River, and steamer lines between New York and Virginia.[104]

Much litigation emphasized matters of corporate control. In 1888, when the Southern Pacific Company absorbed the lines of the Houston & Texas Central Railway, it touched off a series of lawsuits which lasted fully thirty years.[105] Shareholders were willing to do outright battle for possession of enterprises: cotton-seed mills in the Deep South, iron foundries in New York State, railroads in the Pacific Northwest.[106] In northern Alabama, the members of the Sheffield & Tuscumbia Street-Railway feuded bitterly over

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99. *See* Nathaniel C. Nash, *Wall Street Bemoans a New "Greenmail" Season*, N.Y. TIMES, Dec. 28, 1986, § 4, at 4.

100. 59 Va. (18 Gratt.) 831 (1868); *see also* Johnston v. Jones, 23 N.J. Eq. 216 (1872) (railroad's principals, who had granted control of railroad to manager who was constructing its lines, secretly elected new board of directors in order to transfer control of railroad to outside interest, forcibly taking possession of one section of track).

101. Watts's Appeal, 78 Pa. 370 (1875).

102. Charlestown Boot & Shoe Co. v. Dunsmore, 60 N.H. 85 (1880).

103. Hotel Co. v. Wade, 97 U.S. 13 (1877).

104. *See* Gold Bluff Mining & Lumber Corp. v. Whitlock, 55 A. 175 (Conn. 1903); Sawyer v. Dubuque Printing Co., 42 N.W. 300 (Iowa 1889); Manufacturers' Land & Improvement Co. v. Cleary, 89 S.W. 248 (Ky. 1905); Hutchinson v. Green, 1 S.W. 853 (Mo. 1886); Leslie v. Lorillard, 18 N.E. 363 (N.Y. 1888); Cates v. Sparkman, 11 S.W. 846 (Tex. 1889).

105. The history of litigation over matters of corporate control is summarized in Southern Pac. v. Bogert, 250 U.S. 483, 489 n.1 (1919), the decision which finally settled the issues.

106. *See* Ervin v. Oregon Ry. & Navigation Co., 27 F. 625 (S.D.N.Y. 1886); Perry v. Tuscaloosa Cotton-Seed Oil-Mill Co., 9 So. 217 (Ala. 1891); Burden v. Burden, 159 N.Y. 287 (1899); McNab v. McNab & Harlin Mfg. Co., 16 N.Y. 448 (1891).

the control of their streetcar lines.[107] But litigiousness went far beyond this. Shareholders second-guessed even minor decisions: an executive's decision to sell a tract of land in Louisiana,[108] the location of a gate on a Kentucky turnpike.[109] When a land company distributed its Texas land scrip among its shareholders, an action compelled by legal deadlines, a small, dissatisfied minority of shareholders took the issue into the appeals courts.[110] Such disputes might even outlive the corporation within which they had originated. The receiver of an insolvent national bank, appointed under federal law, might find himself challenged by a suit brought in state court.[111]

The cases which this record represents are only those most illustrative of control struggles. The shareholder activism of the Gilded Age is also illustrated by those cases which seek to compel the payment of dividends, which challenge directors' actions as ultra vires, which claim that directors' decisions are self-interested and therefore voidable, and which challenge mergers. This activism is seen in patterns of history which were so common as to be almost unremarkable—for example, Edmund Stedman's off-hand remark that the stock of the New York & New England Railroad "[f]or years . . . used to advance sharply before each annual election, on rumors of 'buying for control.'"[112]

F. Parallels in Capitalization

Ultimately, when translated into accounting terminology, shareholder activism reached the level of ideology. It became a system of beliefs and conventions motivating (as well as reflecting) real-world actions. In both the Gilded Age and the 1980s, shareholders' eagerness to help themselves to corporate wealth was reflected in corporations' balance sheets. The right to control the firm, the *jus disponendi* highlighted in takeover battles, took on more importance as a corporate asset, being magnified on the corporate ledgers.

The takeover bidder or buy-out management team could offer a premium because it was bidding for control—the profits anticipated from being able to dispose of the target firm. The hyperefficient market could sustain an inflated value for the target's shares because the value of the firm's physical assets had been factored into the purchase price. A Heisenbergian logic was at work here. Because the possibility of controlling the target raises the value of the target's shares—the possibility or actuality of a control bid yielding them this premium—market players came to believe that increasing a firm's capitalization could be justified due to and through the process of a change in control.

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107. *See* Moses v. Scott, 4 So. 742 (Ala. 1888); Moses v. Tompkins, 4 So. 763 (Ala. 1888); Nathan v. Tompkins, 2 So. 747 (Ala. 1887).

108. North Am. Land & Timber Co. v. Watkins, 109 F. 101 (5th Cir. 1901).

109. Bardstown & Green River Turnpike Co. v. Rodman, 13 S.W. 917 (Ky. 1890).

110. Rogers v. Phelps, 9 N.Y.S. 886 (N.Y. Sup. Ct. 1886).

111. Brinckerhoff v. Bostwick, 88 N.Y. 52 (1882).

112. STEDMAN, *supra* note 70, at 352 n.1.

In effect, self-confidence became intangible property. That the firm would be worth more under new management had been an opinion, or a wish; now it became a statement in the black and white of an offering circular. It was a self-fulfilling prophecy. If the money can be brought in from the market, the firm will be more efficient.

During the 1980s, leverage financed the premiums paid in tender offers and LBO's. Debt was hailed as a disciplining force: to take it on was viewed as a way of signalling that a firm's management would hereafter be more sensitive to the concerns of the marketplace.[113] (Certainly it reduced a manager's potential for independent action.) The other side of this mythology was a belief in the dedication of the owner-manager. If Michael Milken preached the gospel of high-yield bonds, if Kohlberg Kravis Roberts & Co. sought out entrepreneurs and bestowed corporations upon them (contingent upon their investing their own money), then the owner-manager was the cult hero of the junk-bond boom.

Traditionally, securities analysis focused on the "margin of safety," an analysis of how far a firm's earnings could fall from present levels while leaving enough income to service its debt. By 1987, this had been eclipsed by a new finance, which questioned how much a firm's earnings would have to *increase* from existing levels, merely to ensure that the takeover or buyout became profitable. In 1985, the Metromedia Communications buyout illustrated this point. As the prospectus put it,

> Based on current levels of operations (assuming no growth in revenues), the Company's cash flow would be insufficient to make interest payments on the Debt Securities (other than the Serial Senior Notes) and it would have to use other funds, to the extent available, to make such interest payments. However, the Company has historically experienced significant rates of growth in broadcast revenues and cash flow. Although the Company does not expect its rate of revenue and cash flow growth to continue at its historical level, it nevertheless expects continued growth which, if attained, would generate sufficient cash flow. . . .[114]

Who stood to benefit was revealed by a subsequent line: payment on Metromedia's debt securities "would consume all or substantially all of such cash flow." If further profits could be made from the firm, they were destined for its creditors.

Practically speaking, *increase in earnings* did not mean *gains in productivity*; it meant *partial liquidation*. The prospectus for the Storer Communication LBO put this very matter-of-factly.

> It is anticipated that cash flow from operations, after debt service, will not be sufficient to fund all of the projected capital expenditure

113. *See* Jensen, *supra* note 29, at 322-23.

114. *Quoted in* JAMES GRANT, MONEY OF THE MIND: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN 373-74 (1992). *See also* LOWENSTEIN, *supra* note 2, at 40, 146.

> requirements necessary to enhance and maintain Storer's television broadcast and cable businesses during the next five years, absent sales of assets of Storer during such period. No decision has been made as to which assets will be sold or when sales will occur.[115]

Selling the corporate assets was a real-world illustration of what it meant to hold the corporate *jus disponendi*. In accountants' terms, the power to control the firm equalled goodwill, the firm's value as a going concern.

Similar methods of accounting had found acceptance in 1901, when United States Steel was created by J. P. Morgan. The firm's tangible assets totalled $682 million. Against this, Morgan set a vastly larger capital structure:

> $303,000,000 in mortgage bonds; $510,000,000 in preferred stock; and $508,000,000 in common stock; making a grand total of $1,321,000,000. . . . But of this capital approximately half represented purely "water"; two-thirds of the preferred stock and all of the common could be accounted for only by "good-will."[116]

U.S. Steel was not a fly-by-night operation. It was the biggest industrial combination in American history, only barely surpassed by the biggest mergers of recent years. In this context, "goodwill" included the power to dominate steel production. That this practice was routine, rather than arrogant, is shown by the fact that small financings were just as overt.

In the era of the trusts, the ability to monopolize production was explicitly taken into account when figuring up an enterprises's capital. The property belonging to the monopoly which was being organized, the corporate "property" for which shareholders in existing firms exchanged their outstanding shares, explicitly capitalized the new firm's anticipated power to control the market. That is, the shareholders acquired the power to control a firm which could exercise such control.

In *See v. Heppenheimer*,[117] a case arising out of the failed Columbia Straw Paper Company, a trust's organizers explained their plan of operations:

> They say that the cost of producing the paper was less than $20 a ton, and that . . . by a concentration of the ownership of the mills they found and believed that the price could easily be maintained . . . at about $28 a ton, which would pay interest on the bonded debt, with 1 per cent. per year for a sinking fund, and a dividend at 8 per cent. per year on the preferred stock of $1,000,000, and leave a very large dividend. . . . In short, they estimated the value of the property upon a capitalization of the profits expected to be

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115. *Quoted in* GRANT, *supra* note 114, at 384.
116. JOSEPHSON, *supra* note 94, at 429.
117. 61 A. 843 (N.J. Ch. 1905).

> made out of its use by control of the price of its product.[118]

The right to control the corporation's assets, the firm's potential competitive strength under new management, augmented the book value of the company's assets.[119]

G. *Bankruptcy Proceedings as an Adjunct to Corporate Control Struggles*

The inevitable shortfall between financial projections and economic reality made for another similarity between eras: the use of bankruptcy proceedings as an adjunct to corporate control struggles. In the court papers of the last century, no signifier more clearly indicates a struggle for corporate control than the two-word phrase, *receiver appointed.* This does not mean that a firm is insolvent; it means, more frequently, that someone has taken the firm over, or is trying. State insolvency laws, functioning in the absence of a national bankruptcy law, offered a ready vehicle for deposing a firm's management. To be a receiver was to collect the firm's revenues, eject opponents from its offices, and represent it in lawsuits.[120]

The Field Code of New York State, which gave judges broad powers to appoint receivers in *ex parte* proceedings, was particularly open to abuse.[121] George Templeton Strong wrote:

> The abused machinery of law is a terror to property owners. No banker or merchant is sure that some person calling himself a 'receiver,' appointed *ex parte* as the first step in some frivolous suit he never heard of, may not march into his counting room at any moment, demand possession of all his assets and the ruinous sus-

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118. See v. Heppenheimer, 61 A. 843, 846 (N.J. Ch. 1905). So confident had the promoters been, their prospectus analyzed the anticipated monopoly profits without addressing the actual value of the paper mills which were being acquired. *Id.*

119. *See* J. Bradford De Long, *Did J.P. Morgan's Men Add Value? An Economist's Perspective on Financial Capitalism, in* INSIDE THE BUSINESS ENTERPRISE: HISTORICAL PERSPECTIVES ON THE USE OF INFORMATION 205, 205 (Peter Temin ed., 1991) (stating that in 1910-12, "the presence on one's board of directors of a partner in J. P. Morgan and Company added about 30 percent to common stock equity value," *i.e.*, relative to book value).

120. An example of such a control struggle was Smith v. New York Consol. Stage Co., 18 Abb. Pr. 419 (N.Y. Ct. Common Pleas 1864), and the decisions which accompany it, Siney v. New York Consol. Stage Co. and People v. New York Common Pleas.

These cases and their ancillary motions—decided in rapid succession between December 1864 and February 1865, and litigated with steel-tip pens rather than word-processors—show the intensity of takeover litigation in the Civil War era. They feature (1) an assignment for benefit of creditors, by a solvent corporation; (2) a suit to enjoin the assignee from acting; (3) a request to have a receiver appointed; (4) a counter-suit by the assignee, with an interlocutory writ of prohibition quashing the receiver's appointment; (5) intervention by a shareholder; (6) a contempt action against the assignee; (7) a contested motion to authorize a sale of the firm; and (8) an appeal by the intervening shareholder. Judge Albert Cardozo, who sat in this matter, ranks with his brother judge George Barnard among the most pliable of judges and the most faithful allies of Boss William Tweed.

121. *See* GORDON, *supra* note 4, at 161-64.

> pension of his whole business, and when the order for a receiver is vacated a week afterwards, claim $100,000 or so as 'an allowance' for his services, by virtue of another order, to be enforced by attachment.[122]

It was through a receivership that Gould strengthened his grip on the Erie Railroad. His receivership helped him stave off Daniel Drew's attempt to regain control. Later Gould anticipated the prepackaged bankruptcy. In May 1884, knowing that creditors would try to take possession of the insolvent Wabash Railroad, he forestalled such action by having a friendly receiver named *before* the railroad actually defaulted on its bonds.[123]

Insolvency proceedings, however tortuous, offered most of the advantages now available under Chapter XI of the Bankruptcy Code. In railroad wars, Maury Klein has noted, "[to] hammer a rival into bankruptcy only made it a more formidable enemy, since a bankrupt road need not pay interest on its bonds and could therefore slash rates with impunity."[124] From the 1880s onwards, as the continent filled up with an overbuilt system of competing lines, America's railroads seem to have spent as much time in reorganization as in normal operations.[125]

This historical background offers the key to understanding the bankruptcies, workouts, and restructurings that followed the junk-bond boom. True, some of these have been cheerless and unintended transactions, undergone by firms which found themselves unable to meet obligations: Integrated Resources, Southland Corporation, Eastern Airlines, Macy's. But even more important than these, in terms of the junk-bond movement, have been the refinancings which drew little attention because they fit so seamlessly into the process.

Only half of Drexel's success came from its ability to launch junk-bond takeovers. The other half came from its experience in refinancing troubled acquisitions through exchange offers made under Section 3(a)(9) of the Securities Act of 1933, and Michael Milken's phenomenal ability to find junk-bond buyers whenever a Drexel client needed to sell. This kept the rate of default on Drexel junk low.

> Drexel completed its first 3(a)(9) in 1981. Over the next five years, it would do about 175 of these exchange offers, the majority for

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122. 4 GEORGE T. STRONG, THE DIARY OF GEORGE TEMPLETON STRONG 264 (Allan Nevins & Milton H. Thomas eds., 1952), *quoted in* GORDON, *supra* note 4, at 164.

123. KLEIN, *supra* note 74, at 90-91, 329-30; *see also* Sage v. Memphis & L. R. R. Co., 125 U.S. 361 (1888) (involving similar action by Gould ally).

124. KLEIN, *supra* note 74, at 178.

125. ALBERT FISHLOW, AMERICAN RAILROADS AND THE TRANSFORMATION OF THE ANTE-BELLUM ECONOMY 186 (1965) (18% of railroads in receivership in 1877, 20% in receivership as of 1894). On the financial changes and innovations evolved during the process of such work-outs, see Peter Tufano, *Business Failure, Redefinition of Claims, and Financial Innovation: A Nineteenth Century Case Study*, Harvard Business School Working Paper 93-021 (Sept. 19, 1992).

> troubled companies, involving a total of $7 billion of junk debt. . . . It seems plausible that a higher default percentage, or a sudden slew of defaults of Drexel-underwritten junk issues, might have dulled the growing institutional appetite for junk in this country in the early eighties. But if there ever was the possibility of an externally generated braking to Milken's machine, the 3(a)(9) removed it.[126]

The dark side of this process emerges from the comments of Meshulam Riklis, an early Milken client: the bonds he has issued, Riklis reportedly has stated, will never be repaid in his lifetime.[127] Not long before Drexel filed for bankruptcy, Drexel personnel estimated that one-third of all outstanding junk bonds were ripe for refinancing.[128] Among the takeover barons, bankruptcy became what it had been for the robber barons: the extension of high-stakes finance. It presented a deliberate policy of evading financial responsibility.

V. Rules and Structures of Corporate Governance: The Law's Answer to Shareholder Disruption

It is no accident that the two eras remembered for corporate buccaneering are the same eras in which shareholders fought for an active management role. It was as a shareholder that the stock-jobber launched market raids and garnered profits. It was in the guise of a stockholder, and could only be in the guise of a stockholder, that the corporate buccaneer boarded the target. A corporation's management could only be altered by changing or pressuring its board of directors. The parties most effectively placed to pressure the board, through litigation or suasion, were the shareholders. Whatever other personae the market operator or takeover artist might assume, in both the Gilded Age and the 1980s, the shareholder stood at the center of the stage.

A. Introduction and Overview

The shareholder activism of the Gilded Age was a turbulent interlude in the history of corporate governance. The activist shareholder caused difficulties to which the law soon found solutions. The division of ownership from control, in the modern era, rests on changes wrought in the latter part of the nineteenth century—changes which restored the previous balance of power.

A related series of revolutionary changes, in the decades following the Civil War, produced the modern business corporation. Incorporation was

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126. Bruck, *supra* note 84, at 76-77. While other firms had junk-bond default rates as high as 17%, default affected less than 2% of all Drexel issues.

127. *Id.* at 38.

128. *Drexel Gears Up For Restructuring Bonanza*, Corp. Fin. Wkly., Dec. 18, 1989, at 1.

no longer done by special charter, which required a special legislative act specifically creating each corporation and detailing the purposes for which it could operate. Incorporation was now done under general statutes, letting virtually anyone incorporate for virtually any purpose.[129] Restrictions on corporate size were raised and finally abolished, and corporate existence, which had been limited, was made perpetual.[130]

It was in this context that our existing rules on corporate governance emerged, the rules by which the modern business corporation has functioned. Among the principles given force at this juncture were (1) the business judgment rule, a judicial reluctance to let shareholders or courts second-guess director decisions; (2) the principle that directors have virtually absolute discretion over paying out corporate dividends; (3) a new, expansive tolerance for directors' self-interest; and (4) a new law of corporate combinations, which gave directors the initiative and ignored protest except when it came from a substantial block of shareholders.

The United States did not develop any law which assigned fiduciary duties to shareholders who controlled corporations. (When duties apply to controlling shareholders is a vague and difficult issue even today—particularly today.) Instead, we developed a law which assigned authority and responsibility to corporate directors.

B. *The Transformation of the Business Judgment Rule*

When corporations were formed pursuant to special charters, it was simple to locate the seat of authority within each firm. The charters declared that the directors were to manage the corporation. This was a direct allocation of power, just as specific as the provisions which set the number of directors and the terms of their election.[131]

Today, still, power and authority reside with the board of directors. The modern business judgment rule enforces this by providing, essentially, that *when directors act in good faith and with due care, they will not be held liable for losses caused by their errors in judgment.* But the germ of this rule developed in a context quite different from the one in which it has been applied. Its broad and unshakable application is the result of a policy choice by the courts which have applied it. A doctrine developed in response to issues which arose under special charters was applied to corporations chartered under general-incorporation statutes. Originally it had

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129. *See* Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEG. STUD. 129, 129 (1985).

130. The most succinct history of this corporate revolution is offered by Justice Brandeis' dissent in Louis K. Liggett Corp. v. Lee, 288 U.S. 517, 541-80 (1933).

131. Examples are found in Conro v. Port Henry Iron Co., 12 Barb. 27 (N.Y. App. Div. 1851) and Union Mutual Fire Ins. Co. v. Keyser, 32 N.H. 313 (1855). In the case of the Pennsylvania Railroad, the chartering process was intended to provide for a company "whose internal structure mirrored republican institutions so as to prevent the rise of overpowering corporate executive authority." James A. Ward, *Power and Accountability on the Pennsylvania Railroad, 1846-1878*, 49 BUS. HIST. REV. 37, 38 (1975).

protected directors from liability for minor infringements of special charters; now, in the modern business corporation, it represented a general charter of authority for directors.

Under special charters, cases arose in which a dissident shareholder claimed that the directors had gone beyond the powers granted by the charter. Responding to such claims, courts developed a rule that good-faith actions which exceeded the limits of corporate authority did not result in liability. Thus did the maxim *de minimis non curat lex* mesh with the law of ultra vires.

Courts inquired whether the action complained of worked a fraud on the corporation or its shareholders. If it did not, the question was whether the board had acted negligently in making the decision which allegedly exceeded their powers. In the leading case of *Hodges v. New England Screw Co.* (1850), the Rhode Island Supreme Court phrased the issue in very modern terms. The court assumed arguendo that the action complained of—a restructuring which would spin off the firm's business into a new subsidiary—violated the corporate charter.

> The question then will be, was such violation the result of mistake as to [the board's] powers, and if so, did they fall into this mistake from want of proper care, such care as a man of ordinary prudence practices in his own affairs. For, if the mistake be such as with proper care might have been avoided, they ought to be liable. If, on the other hand, the mistake be such as the directors might well make, notwithstanding the exercise of proper care, and if they acted in good faith and for the benefit of the Screw Company, they ought not to be liable.[132]

Even as the spread of general incorporation laws lessened the importance of ultra vires issues, this doctrine was transposed—imperceptibly but steadily, and very nearly verbatim—to the new-model business corporation. In *Spering's Appeal* (1872),[133] the Pennsylvania Supreme Court treated this analysis as one of general application. Primary attention was paid to the directors' general duty and whether they had acted with prudence in managing the corporation; only after this analysis was the case's ultra vires question raised. This served as precedent for *Briggs v. Spaulding* (1891),[134] which completed the transposition. In *Briggs*, the United States Supreme Court examined the duties of directors of national banks—corporations formed under a general incorporation law. "[T]he degree of care to which

132. 1 R.I. 312, 346 (1850), *on reh'g*, 3 R.I. 9 (1853). *New England Screw* grew out of a recapitalization. The New England Screw Company, finding itself in financial difficulties, voted to spin off a subsidiary, the New England Iron Company. The Screw Company sold the Iron Company foundry equipment valued at $182,000, receiving cash and $100,000 in stock (a one-third interest; the other two-thirds was to be sold to new investors, bringing in a badly-needed $200,000). *Id.* at 313-15.

133. 71 Pa. 11, 20-21 (1872).

134. 141 U.S. 132 (1891).

these defendants were bound," Chief Justice Fuller concluded, "is that which ordinarily prudent and diligent men would exercise under similar circumstances."[135] Language originally applied to corporations formed under special charters had been adopted as the law of the land for business corporations chartered under general statutes.[136]

The business judgment rule strengthened management's hand in dealing with shareholders. When directors faced liability for failure to meet detailed restrictions on their power, a rule of good-faith compliance did not notably expand their powers. They were still bound by the terms of their corporate charters, and this rule gave them only a limited flexibility, a penumbra of discretion at the margin of corporate activity. But when directors had few restrictions on their power—as was the case in modern business corporations—giving them freedom to act, so long as they did so in good faith—was to give them virtual carte blanche. Moreover, as this rule emerged, courts decisively put down suggestions that directors were liable for any losses their decisions caused—a standard that would have given shareholders tremendous leverage.[137]

If the duty of care was thus defined in terms that favored managers, so too was the emerging duty of loyalty. Over the course of the nineteenth century, courts and legislatures were increasingly willing to allow self-dealing by directors with the corporations they governed.

A quarter-century ago, Harold Marsh set down the way in which the standard for review of self-interested transactions by corporate directors had changed.

> In 1880 it could have been stated with confidence that in the United States the general rule was that any contract between a director and his corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction. . . .
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135. Briggs v. Spaulding, 141 U.S. 132, 152 (1891).

136. From banking institutions, this rule soon found itself extended to ordinary business corporations. *See, e.g.*, Johnson v. Stoughton Wagon Co., 95 N.W. 394 (1903).

For a general discussion of the development of the business judgment rule and other devices for policing director discretion, see HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937 56-64 (1991). Such developments in the corporate area illustrated a larger trend. The substitution of a single prudent-man standard for an existing "three-tier classification of negligence—gross, ordinary, and slight"—was urged by numerous writers on torts throughout the 1870s. HORWITZ, *supra* note 75, at 115.

137. These suggestions developed from the metaphor of the director as trustee. The authorities supporting this argument are laid out in the respondent's case in Hun v. Cary, 82 N.Y. 65, 68-69 (1880). Of course, along the way, directors never quite grasped the freedom some courts would have given them. The *Spering* court, for example, suggested that directors would not be liable for honest errors, "even though they may be so gross as to appear to us as absurd and ridiculous." Spering's Appeal, 71 Pa. 11, 24 (1872).

> It could have been stated with reasonable confidence in 1910 that the general rule was that a contract between a director and his corporation was valid if it was approved by a disinterested majority of his fellow directors and was not found to be unfair or fraudulent by the court if challenged; but that a contract in which a majority of the board was interested was voidable at the instance of the corporation or its shareholders without regard to any question of fairness.[138]

The importance of this shift is readily apparent. When self-interest made voidable any contract between a director and the corporation, shareholders held a veto power over transactions when a conflict of interest, however slight or theoretical, could be proven. Beyond this, the earlier rule had a chilling effect on director initiative; it made it possible for shareholders to challenge any transaction in which director self-interest could be asserted. And, as *Treadwell* and *New England Screw* illustrated, shareholders were adept at identifying conflicts of interest.

The newer rule, by contrast, provided safe harbors for director action, offering ways to insulate board action from shareholder review. Obtaining approval by a disinterested majority of the board was a procedural safe harbor. Proving the fairness of the transaction offered a substantive safe harbor. In sum, the effect was a shift of power to the directors and away from the shareholders.[139] It should not be forgotten that this change took place under fire. Shareholders constantly pressed against director authority; their litigiousness is shown in the dozens of cases that tested both rules.[140]

This evolution reflected industrial and commercial developments. The increasing scope of business enterprises—whether measured by complexity of tasks undertaken or as a matter of simple geographic extent—worked against imposing a stricter rule of director duty. A stricter standard would have required an impossible degree of attention.[141] Likewise, as corporations changed to meet competitive pressures and expanding markets, relying upon

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138. Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36-40 (1966).

139. As a practical matter, the possibility of upholding a transaction by proving its fairness may have absorbed more attention than proving that the transaction had been approved by a disinterested majority of directors. Long before the end of the nineteenth century, courts which upheld self-interested contracts emphasized the fairness of the terms. *See, e.g.*, Richardson's Ex'r v. Green, 133 U.S. 30 (1889) (Court's review for fairness created opportunity to prevent fraud); Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1875); Jesup v. Illinois Cent. R.R., 43 F. 483 (C.C.N.D. Ill. 1890) (per Justice Harlan); Stewart v. St. Louis, Ft. S. & W. R.R., 41 F. 736 (C.C.D. Kan. 1887).

140. Examples are given in Marsh, *supra* note 138, at 35 (citations *passim* throughout).

141. One ground for the decision in *Spering's Appeal* was that it would not be possible to obtain directors if a stricter standard obtained. "[I]t is evident," the court wrote, "that gentlemen elected by the stockholders from [among] their own body ought not to be judged by the same strict standard as the agent or trustee of a private estate." *Spering's Appeal*, 71 Pa. 11 at 21. The retention of this standard, even as directors increasingly became professional managers with a close, technical knowledge of the business, also favored directors.

their boards to facilitate business alliances and explore new opportunities, the likelihood increased that a director might be found, in some capacity, on both sides of a proposed transaction.

Once it had been established that prudent decisions by directors would be upheld, and that even self-interested actions could be lodged within legal safe-havens, courts accorded one final level of authority to directors. Decisions upholding director action coalesced into an attitude favoring director control. Courts began this trend by declining to hold directors liable; this developed into a generalized reluctance to intervene in business matters. The modern business judgment rule, as it took shape, presumed that directors' actions were valid and that courts would not ordinarily second-guess decisions which directors had taken. For shareholders, this mindset spelled disenfranchisement. Not until the 1980s, when the junk-bond boom called into question managerial competence and loyalty, would shareholders enjoy similar power.[142]

C. *Shareholder Power and Shareholder Actions*

While the business judgment rule was evolving, shareholders' ability to challenge corporate managers was being channeled into the derivative suit. This process also furthered the separation of ownership and control—that is, restricted the shareholders' ability to challenge corporate managers.

By institutionalizing the derivative suit, courts recognized a right in shareholders to police management misconduct. This was, in itself, a major concession to shareholders. In the early decades of the nineteenth century, whether shareholders or courts even had such power was uncertain.[143] But what this development gave shareholders with one hand it took away with the other: "[S]uch suits required shareholders to establish that the directors had a legal duty to undertake or avoid a certain activity. If the activity was within the directors' discretion, the suit would be sustained."[144] Legal duties were notoriously hard to establish, particularly when the business judgment rule each year brought more and more matters within the directors' discretion.

Equally important, in the name of identifying individual shareholders' complaints with corporate grievances, and for the stated purpose of preventing a multiplicity of suits, the courts limited shareholders to one

142. Even the development of the trusts, in some cases, led to reassertion of director control. Theoretically, trust-building bypassed individual corporate boards; shareholders assigned control of entire industries by surrendering their shares to overall trustees. Among the earliest antitrust cases were decisions which held that trust-building of this sort was unlawful because it meant that a corporation would be controlled by persons other than its directors. New York v. North River Sugar Ref., 24 N.E. 834 (N.Y. 1890); Mallory v. Hananer Oil-Works, 8 S.W. 396 (Tenn. 1898).

143. *See* Dodge v. Woolsey, 59 U.S. (18 How.) 331, 343-44 (1855); Robinson v. Smith, 3 Paige Ch. 222 (N.Y. 1832); Hodges v. New England Screw, 1 R.I. 312, 350-56 (1850).

144. Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 Geo. L.J. 1593, 1665 (1988).

proceeding. Characterizing management misconduct as a wrong to the corporation left little room for the assertion of shareholders' personal claims. Throughout the Gilded Age, individual shareholders brought personal actions against corporate officers, claiming that actions which affected the value of their investment had damaged them personally. Indomitably brought, such suits were invariably dismissed; exceptions were only grudgingly carved out.[145] This judicial policy served to funnel shareholder grievances into the derivative suit—meaning that management had to fight each claim only once. Victory in a derivative suit achieved victory overall.

The Supreme Court fostered the derivative suit with its decision in *Dodge v. Woolsey* (1855).[146] By the 1880s, however, the Court clearly had become irritated with shareholder litigiousness. In *Hawes v. Oakland* (1881),[147] it warned in no uncertain terms that the shareholders' derivative rights to defend the corporation's interest should not be routinely invoked in controversies "between the shareholder of a corporation and that corporation itself, or its managing directors or trustees, or the other shareholders."[148]

In *Hawes*, a single stockholder asserted that the directors of the Contra Costa Water-works Company had violated their fiduciary duties by providing water *gratis* for all municipal purposes of the City of Oakland, "whereas it is only entitled to receive water free of charge in cases of fire or other great necessity."[149] The Court had seen so many similar suits that its patience had worn thin. "[I]s a bitter litigation with the city to be conducted by one stockholder for the corporation and all other shareholders, because the amount of his dividends is diminished?" Justice Miller asked. "The question answers itself."[150]

The Court dismissed Hawes' complaint. Justifying its actions by "the frequency" of suits "by a single stockholder of a corporation,"[151] it tight-

145. *See* Greaves v. Gouge, 69 N.Y. 154 (1877); Palmer v. Hawes, 40 N.W. 676 (Wis. 1888) (shareholder unsuccessfully claimed misconduct of corporate officer excused her from having to deliver stock pledged as security for note, as proper management would have obviated need to collect assessment for which pledged stock served as collateral).

Among those attorneys who argued against individual shareholders who sought to sue corporate directors was Abraham Lincoln. Between 1855 and 1859, Lincoln represented the directors of the Ohio & Mississippi Railroad Co. in protracted litigation. Replying to charges that two directors had engaged in improper self-dealing, misused corporate funds, illegally purchased stock, and improperly used their status as creditors to threaten the railroad, Lincoln asserted defenses based on board approval and the plaintiffs' lack of standing. A 43-page pleading filed by him in this matter constitutes the longest manuscript known to exist in Lincoln's handwriting. *See* Clark & Morrison v. Page & Bacon (available from the Lincoln Legal Papers Project, Springfield, Illinois).

146. 59 U.S. (18 How.) 331 (1855). The Court allowed a shareholder to sue a bank's directors, in equity, to prevent their complying with an illegal statute, *i.e.*, paying a tax unlawfully imposed by the State of Ohio.

147. 104 U.S. 450 (1881).

148. Hawes v. Oakland, 104 U.S. 450, 454 (1881).

149. *Id.* at 451.

150. *Id.* at 462.

151. *Id.* at 454.

ened restrictions on derivative suits, barring collusive actions and requiring that shareholders exhaust intracorporate remedies before filing suit. These limitations proved so serviceable that they descended through the federal rules, and presently survive in Federal Rule of Civil Procedure 23.1.[152] Actions taken in the name of judicial economy served equally well the purpose of supporting director authority.

D. The Definition of Fiduciary Duty

The other side of affirming director control was asserting director responsibility. It was always understood that directors generally represented the other shareholders in two senses—in that they managed the corporation's activities on behalf of the other shareholders, and that they likewise would oversee the distribution of the corporation's wealth to the other shareholders. Just as Gilded Age case law supported and affirmed the directors' authority to manage the firm, so it clarified and strengthened the directors' responsibility toward shareholders.

As long as special charters spelled out the purpose of business enterprises, defining directors' roles on a case-by-case basis, developing a general law of director responsibility was of secondary importance. The increasing complexity of business, however, made it more desirable to control directors by imposing a general fiduciary duty. When management must react to changing events, fiduciary duties are "more efficient than detailed contracts or detailed regulation since they restrict the fiduciary's opportunity to cheat without the costly drafting of elaborate rules while leaving him free to use his special skills in the [shareholder's] interest."[153]

Even after the corporation had become familiar and the securities market had matured, American law did not recognize corporate directors as holding a fiduciary duty toward their shareholders. Merrick Dodd put the matter bluntly: "No case seems to have arisen in the United States during the period from 1800 to 1830 in which the principles of fiduciary law were applied to the directors or officers of business corporations."[154] Despite this late start, however, courts after 1830 rapidly and readily treated directors as fiduciaries, making explicit what had been earlier only an assumption.[155]

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152. HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 1041 (3d ed. 1983).

153. Alison G. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 760 (1978).

154. E. MERRICK DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860 70 (1954). In England, corporate law had already reached the issue of fiduciary responsibility. In other fields of agency law, this principle already applied. The dicta of one New York case anticipated the course the law would take, but that was the most that could be said before 1830. *Id.* at 70-71.

155. In an 1832 case, Robinson v. Smith, the chancellor had "no hesitation" in declaring that "the directors of a monied or other joint stock corporation . . . are personally liable as trustees." 3 Paige Ch. 222, 231 (N.Y. Ch. 1832).

One intermediate stage of analysis treated manufacturing corporations as incorporated

Other changes necessitated clarification of the nature and extent of the directors' responsibility. Corporations complicated their financial structure by issuing new classes of securities.[156] As successful railroads took over competitors, the combined group of shareholders in the surviving enterprise became increasingly heterogenous: the common and preferred shareholders of the A & B Railroad might be in conflict with those who had held common and preferred shares in the C & D Railroad, recently absorbed by the former firm, and all these groups might be in conflict with the bondholders. This context led courts to declare that the directors' fiduciary obligation ran to *all* classes of shareholders. Directors became the "trustees, and representatives of the common property, and the entire interests of all the stockholders, of every class and description."[157]

Such assertions were significant. If the directors represented all shareholders, this meant that all shareholders were, so to speak, put in their place. Given these precedents, domineering shareholders found it harder to demand that the directors carry out their personal wishes at the expense of other shareholders. But the rhetoric of fiduciary obligation took on a character of its own. The force with which courts described directors' duties also worked to reinforce director control.

New York courts held firmly to the view that corporate contracts involving conflicts of interest were voidable without regard to their fairness. Often such courts' language was strident:

> To hold otherwise, would be to overturn principles of equity which have been regarded as well settled since the days of Lord Keeper Bridgman, in the 22d of Charles second, to the present time—principles enunciated and enforced by Hardwicke, Thurlow, Loughborough, Eldon, Cranworth, Story and Kent, and which the highest courts in our country have declared to be founded on immutable truth and justice. . . .[158]

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versions of partnerships, and thus built around the partnership's reciprocal duties. This vision of the corporation may have influenced Berle's interpretation of the corporation's early legal history. *See* Revere v. Boston Copper Co., 32 Mass. (15 Pick.) 351, 357 (1834); Kean v. Johnson, 9 N.J. Eq. 401, 416-17 (N.J. Ch. 1853); Hodges v. New England Screw Co., 1 R.I. 312, 354 (1850).

156. Preferred shares, originally, were common shares given special entitlements: prior payment of dividends and priority in dissolution. Corporations issued them to raise capital in times of financial hardship. Such circumstances ensured that management's duty, with regard to balancing obligations among different classes of stock, would not be a purely academic question. *See* Kent v. Quicksilver Mining Co., 78 N.Y. 159 (1879); George H. Evans, Jr., *The Early History of Preferred Stock in the United States*, 19 AM. ECON. REV. 43 (1929); George H. Evans, Jr., *Preferred Stock in the United States: 1850-1878*, 21 AM. ECON. REV. 56 (1931); George H. Evans, Jr., *Early Industrial Preferred Stocks in the United States*, 40 J. POL. ECON. 227 (1932).

157. Chase v. Vanderbilt, 62 N.Y. 307, 315 (1875); *see also* Ervin v. Oregon Ry. & Navigation Co., 27 F. 625, 630-32 (C.C.S.D.N.Y. 1886) (persons who acquired control of corporation thereby became subject to duty to deal fairly with minority shareholders, which included duty to share with them in value of larger combined enterprise).

158. Cumberland Coal and Iron Co. v. Sherman, 30 Barb. 553, 578-79 (N.Y. App. Div.

Not much farther along this rhetorical trajectory lay Justice Cardozo's declaration in *Meinhard v. Salmon* that the principal of a business enterprise is a "trustee . . . held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[159]

Since *Meinhard* was published, no lawyer or judge has written the word *punctilio* without calling to mind this specific passage. The allusion is inescapable. When language is this self-conscious, it establishes a distance between the judge and the subject matter of the opinion. The distance which Cardozo set and the severity of the language which he employed indicates that this is an opinion hiding much between the lines.

The courts which used this language did not rely upon it exclusively. They scrutinized closely, and shrewdly, the fairness of challenged transactions between directors and corporations. The courts' ability to identify the real issues of a transaction suggests that this rhetoric helped to cover a different purpose. In this regard, the observations of John Hetherington are very much on point:

> Ambiguity breeds vehemence. Further, the knowledge that fiduciary principles cannot be precisely and minutely enforced leads to the use of strong language as a control mechanism. This type of judicial rule-making has the effect of discouraging bargaining among parties. Bargaining is facilitated by precise ex ante allocations of rights: lacking such an allocation, parties do not know what they are giving up or receiving, and the likelihood of negotiation is reduced as its difficulty is increased.[160]

To make bargaining harder in the short run makes it more difficult for shareholders to object to management decisions. It subordinates them to management. Emphasizing directors' responsibilities gave directors a more powerful role.

Over the long run, when the courts discourage corporate bargaining, the parties will find themselves in a situation governed by relational exchange—a flexible, give-and-take relationship, rather than discrete, transaction-by-transaction deal-making. The shareholders will accept the risk of equity financing because of its higher potential reward, as well as their lack of power to enforce an arrangement which would give them greater rights (stricter targets, more regular deadlines, and higher pay-outs). Management will accept a fiduciary duty toward the shareholders because this arrange-

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1859); *see also* Wardell v. Railroad Co., 103 U.S. 652, 651 (1880) (shunning conflicts of interest is "among the rudiments of the law"); Stewart v. Lehigh Valley R.R., 38 N.J.L. 505, 523 (1875) ("Fraud is too cunning and evasive for courts to establish a rule that invites its presence."); Munson v. Syracuse, G. & C. Ry. Co., 8 N.E. 355, 358 (N.Y. 1886) (fiduciary selflessness is "great rule of law").

159. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

160. J.A.C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9, 11 (1987).

ment, although it requires managers to place shareholder interests above their own (a duty described in tones of thunder), gives them relative freedom of action. The resulting situation illustrates Coase's theory of the firm: A rule which makes bargaining harder increases the importance of management authority, locking the firm more tightly under its managers' control.

E. Control of Corporate Dividends

Among the powers which directors acquired over the course of the nineteenth century, none was more important than the right to determine whether, when, and in what amounts corporate dividends would be paid to shareholders. This power reinforced the directors' authority to manage the corporation. It allowed them to plow back earnings into the firm, financing new projects without having to seek support from outside parties—monies which might come with strings attached. It gave them new power over shareholders. Once dividends became discretionary payments of the corporation's wealth (rather than regular, predictable distributions of what the firm had earned), and it was settled that this discretion rested with corporate directors, shareholders could be feasted or starved as management saw fit. This arrangement reversed traditional rights. Shareholders, the firm's nominal owners, now became dependent on management's good will for the enjoyment of their ownership privileges.

At the start of the nineteenth century, the language of debt—the terms employed in traditional borrowing and lending—furnished the vocabulary for describing all forms of financing. A stock's worth was measured in terms of par value (as bonds are still valued today). Dividends were described as percentage returns, as if they were yields on a bond investment.[161] Most important, in terms of corporate internal affairs, was that dividend payments were expected to be as regular and predictable as interest payments—a regular pro rata distribution of the earnings of the corporation.[162] In 1915, Harvard economist William Z. Ripley wrote:

> A generation ago it was the common practice to divide all profits in sight and to finance new [railroad] construction by the issue of

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161. Baskin, *supra* note 36, at 226. Not until October 13, 1915, did the New York Stock Exchange cease to quote prices in terms of par and begin requiring that prices be quoted in dollars. 1992 New York Stock Exchange Fact Book 80.

162. In 1881, the British shareholders of the Pennsylvania Railroad demanded that "all earnings be distributed" as dividends. Baskin, *supra* note 36, at 233; *see also* New York, Lake Erie & W. R.R. v. Nickals, 119 U.S. 296, 302 (1886) (preferred shareholders arguing that they had debt-like right to have dividends declared each year); Middlesex R.R. v. Boston & Chelsea R.R., 115 Mass. 347, 351 (1874) (interurban company leased its lines, "receiving in return only a fixed rent, payable in the form of a dividend to its shareholders"); Jackson's Adm'rs v. Newark Plankroad Co., 31 N.J.L. 277, 278 (1865) ("the defendants having made large profits, to wit, five percentum on each share of their capital stock, declared a dividend thereof to each of their shareholders"); Scott v. Eagle Fire Ins. Co., 7 Paige Ch. 198, 203 (N.Y. Ch. 1836) ("if directors without reasonable cause refuse to divide what is actually surplus profits," stockholders may sue to obtain such dividends).

> securities. . . . But a few roads, undoubtedly well in advance of their time, during the '80's began to devote a good part of their earnings to new construction and betterment.[163]

This state of affairs, not surprisingly, meant high returns to shareholders.

> What the average rate was in any locality, or during any period, it is of course impossible to state, but the record of average annual dividends on $20,000,000 of New England manufacturing capital for a decade is probably as good a clue in this direction as we possess. That rate was about 10 per cent, and we know that it does not include compensation for the personal services of proprietors or other subsidiary forms of revenue. . . .[164]

In the 1860s, war profits whetted shareholders' appetites. In 1861, the average dividend of twenty-four large New England manufacturers (including many textile firms) was 8 percent. This rose in 1862 to 10 percent, to 25 percent, and "in one case to 66 per cent; and 1865, when dividends ranging from 25 percent to 50 per cent were common, was stated to be 'the most profitable year known in the history of the New England States.'"[165]

As an operational matter, this pattern of dividend distribution made the corporation unstable. When dividends became de facto fixed charges, the firm had too little flexibility. Thorstein Veblen accurately summed up the problem: there was "no provision for the shrinkage of assets, a slight and doubtful provision for a shrinkage in earnings." A corporation run on such lines was organized "for prosperity, not adversity . . . . It [was] not designed to carry on in a falling market."[166]

By the early years of the twentieth century, this paradigm had been reversed. Only in the most egregious case, one in which management announced its intention to retain dividends *and* articulated an improper reason for doing so, could shareholders count on compelling the payment of dividends.[167] This change strengthened the corporation. It was now less at risk, less helpless in economic downturns. Managers now had control of the corporate pursestrings, and shareholders, who had been accustomed to masters' rights, were reduced to the status of hopeful and servile clients.

The early victories which boards of directors won were ambiguous. In *Pratt v. Pratt, Read & Co.*,[168] the decision was written to turn on its facts. The court decided that shareholders had no cause to complain that an ivory-working firm was being expanded to make piano keys; the firm's financial

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163. WILLIAM Z. RIPLEY, RAILROADS: FINANCE AND ORGANIZATION 244 (1915).

164. 1 VICTOR S. CLARK, HISTORY OF MANUFACTURES IN THE UNITED STATES 1607-1860 378 (1916). *See generally id.* at 372-78.

165. CLARK, *supra* note 164, at 372-78; 2 VICTOR S. CLARK, HISTORY OF MANUFACTURES IN THE UNITED STATES 1860-1914 37 (1928).

166. THORSTEIN B. VEBLEN, ABSENTEE OWNERSHIP AND BUSINESS ENTERPRISE IN RECENT TIMES 93 (1923).

167. The most notorious example is found in Dodge v. Ford, 170 N.W. 668 (Mich. 1919).

168. 33 Conn. 446 (1866).

condition did not require intervention on behalf of minority shareholders.[169] In *Williston v. Michigan So. & N. I. Railroad Co.*,[170] the ambiguity of terms defining when dividends were payable forced a preferred shareholder to argue that he was actually a creditor—an argument that was easily defeated.[171] In 1875, a shareholder could still plausibly argue that "the power to declare dividends is not vested in the directors, [but] rests with the court"—as if courts sat to enforce shareholder demands.[172]

As late as 1890, when *Hunter v. Roberts, Throp & Co.* upheld directors' discretion over dividends, the Michigan Supreme Court justified its decision with whole pages of financial analyses, and hedged its judgment by warning that directors could not accumulate profits indefinitely. The solidifying rule had not yet achieved the status of blackletter law; such detailed work spoke of a case-by-case approach. But if this change came with the imperceptibility of a glacier's advance, it came just as inexorably.[173] By 1899, the New York Court of Appeals could dismiss a shareholder challenge on dividend matters without even bothering to cite authority for this stand.[174] Shortly after the turn of the century, the rule was written into blackletter with a final wave of decisions.[175]

Alongside this shift in the right to control dividends was a large shift in how firms and markets were understood. In 1824, discussing the corporation, Justice Story wrote that corporate assets comprised a "trust fund" for the benefit of creditors.[176] Such analysis, with its metaphors of *trust* and *debt*, treated the corporation as a static corpus—something to be carefully administered, for the sake of a definite class of persons, under strict rules of law. By 1905, things had changed. In that year the United States Supreme Court was asked to pass judgment on the legitimacy of commodities trading. This was the most free-wheeling of markets; its volatility scoffed at the debt-focused analysis of the previous century. The

169. Pratt v. Pratt, Read & Co., 33 Conn. 446, 459-60 (1866).

170. 95 Mass. (13 Allen) 400 (1866).

171. Williston v. Michigan So. & N. Ind. R.R., 95 Mass. (13 Allen) 400 (1866).

172. Beers v. Bridgeport Spring Co., 42 Conn. 17, 22 (1875).

173. *See* Hunter v. Roberts, Throp & Co., 47 N.W. 131 (Mich. 1890). In this field, Jay Gould helped make new law. In Williams v. Western Union Tel. Co., 93 N.Y. 162 (1883), the New York Court of Appeals upheld the massive stock dividends issued to consolidate Western Union and American Union Telegraph. The grounds were that a stock dividend, even one of this scale, was, like any other dividend, within the directors' discretion. In other jurisdictions Gould would not have been so lucky. *See* Martin v. Zellerbach, 38 Cal. 300, 318 (1869) (share dividend which transformed entire value of corporation disallowed).

174. Burden v. Burden, 159 N.Y. 287, 308 (1899) ("plaintiff is in the position of all minority stockholders, who cannot interfere with the management of the corporation so long as the trustees are acting honestly and within their discretionary powers").

175. *See, e.g.*, Hamblock v. Clipper Lawn Mower Co., 148 Ill. App. 618 (1909); Raynolds v. Diamond Mills Paper Co., 60 A. 941 (N.J. Ch. 1905); DONALD KEHL, CORPORATE DIVIDENDS 156-58 (1941) (cases collected); *see also* Anderson v. W. J. Dyer & Bro., 101 N.W. 1061, 1063 (Minn. 1904) (rare case in which shareholder proved bad faith in management's withholding of dividends).

176. Wood v. Dummer, 30 F. Cas. 435, 436 (C.C. Me. 1824) (No. 17,944).

Court approved the feverish activity of the trading floors. "Speculation of this kind," Justice Holmes wrote, "is the self-adjustment of society to the probable."[177]

If speculation was society's adjustment to the probable, then, conversely, if one is to adjust to the probable, one must speculate. The stability of debt, credit, and trust had been exchanged for the volatility of equity. Courts were prepared, now, to accept that values would fluctuate: the worth of money, the price of securities, the wealth of firms, and the level of dividends.

F. Statutory Developments

Completing the superiority which corporate directors achieved, in this same era, were a series of structural changes wrought by legislation. These changes, essentially, took away the individual shareholder's power to veto major changes in the corporate enterprise. By denying shareholders this power, these changes gave directors fuller scope to move the firm into new lines of business, facilitating expansion and consolidation.

Originally, any one shareholder had the power to block any major change in the corporation's operations. Unanimous consent was required to dissolve the firm,[178] to consolidate it with another enterprise,[179] or to materially change or expand its business.[180] Nor could a minority shareholder be forced out by subterfuges such as collusive foreclosures in which the majority counted on a friendly mortgagor to eliminate a minority interest.[181] The courts that decided these cases explicitly rejected the suggestion that cashing out dissident shareholders was appropriate.[182]

However valid this rationale, this rule corrupted the mechanisms of corporate governance and became the instrument for shareholder solipsism and economic blackmail. Even before the advent of neoclassical economics and marginal utility theory, shareholders grasped that the power to block a merger was the power to extort money from the firm. The number of cases in which single shareholders litigated against firms in which they held stock suggests that shareholders fought to wring out the last dollar of profit from every proposed merger or consolidation.[183]

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177. Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 247 (1904).

178. Campbell v. Mississippi Union Bank, 4 Miss. (6 Howard) 625, 681 (1842).

179. Clearwater v. Meredith, 68 U.S. (1 Wall.) 25, 40-41 (1863); New Orleans, Jackson & Great N. R.R. Co. v. Harris, 27 Miss. 517 (1854); Lauman v. Lebanon Valley R.R., 30 Pa. 42 (1858).

180. Kean v. Johnson, 9 N.J. Eq. 401 (N.J. Ch. 1853); Stevens v. Rutland & Burlington R.R., 29 Vt. 545 (Ch. Chittenden County 1851).

181. Wright v. Oroville Gold, Silver & Copper Mining Co., 40 Cal. 20 (1870).

182. *See, e.g., Kean*, 9 N.J. Eq. at 413-14 (refusing to allow cashing out of dissident shareholders).

183. Authorities are collected in Zabriskie v. Hackensack & N.Y. R.R., 18 N.J. Eq. 178, 184-85 (N.J. Ch. 1867). Courts developed ways of dealing with such intransigence. If a shareholder failed to make a timely objection, he or she might be deemed estopped to

As late as 1867, in *Zabriskie v. Hackensack & New York Railroad,* the New Jersey courts allowed a single shareholder to prevent the expansion of a railroad in which he held stock. This decision to protect individual economic rights, however, proved to be little more than a last-ditch rear-guard action. The ground defended in New Jersey had already been given up elsewhere.

In New York and Massachusetts, legislatures and courts had already obviated the requirement of unanimous shareholder consent.[184] At the turn of the century, a nationwide wave of statutory amendments established the legal regime which exists today: corporate management approves mergers or consolidations which shareholders thereafter approve by voting, and which go into effect unless disapproved by a sizeable fraction (usually one-third) of the shareholder vote.[185] Even the modern-day cash-out merger, in which dominant shareholders eliminate minority holdings without even the rigmarole of articulating a business purpose for this action, is foreshadowed in the case law of this era.[186]

These changes represented a complete *volte-face* from the early conventions of corporate governance. Where the law had shown solicitude for the free consent of every individual shareholder, it now unflinchingly supported paramount management power.

G. *Tangents and Spill-Overs*

Even as the corporation became a creature of private law, directors were aided by developments in the public-law realm—specifically, constitutional law. The decision to treat the corporation as an independent legal entity, rather than as an aggregate of its members, left shareholders without a theoretical basis for claiming a voice in corporate matters. This outcome

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complain. Gifford v. New Jersey R.R. & Transp. Co., 10 N.J. Eq. 171, 176 (N.J. Ch. 1854). Some transportation companies, being quasi-public entities, were considered able to condemn a dissident stockholder's shares, thereby becoming able to utilize a de facto cash-out merger. Black v. Delaware & Raritan Canal Co., 24 N.J. Eq. 455 (N.J. Ch. 1873).

184. Durfee v. Old Colony & Full River R.R., 87 Mass. (5 Allen) 230 (1862); Buffalo & N.Y. City R.R. v. Dudley, 14 N.Y. 336 (1856).

185. New York and New Jersey both took such action in 1896. Act of May 27, 1896, ch. 932, §§ 57, 58, 1896 N.Y. Laws 994; New Jersey General Corporation Act 1896, § 105, subdiv. 11. *See generally* Christopher Grandy, *New Jersey Corporate Chartermongering 1875-1929*, 49 J. ECON. HIST. 677 (1989). Illustrating the trend are Norton v. Union Traction Co., 110 N.E. 113, 118-19 (Ind. 1915) (applying 1903 Indiana statute requiring simple majority); Allen v. Ajax Mining Co., 77 P. 47, 48 (Mont. 1904) (applying 1899 Montana statute requiring approval by two-thirds of shareholders); Winfree v. Riverside Cotton Mills Co., 75 S.E. 309, 310 (Va. 1912) (applying 1903 Virginia statute requiring simple majority); Germer v. Triple-State Natural Gas & Oil Co., 54 S.E. 509, 512 (W. Va. 1906) (applying 1901 West Virginia statute requiring 60% approval). Statutes are surveyed at WALTER NOYES, A TREATISE ON THE LAW OF INTERCORPORATE RELATIONS 100-04 (2d ed. 1909). *See also* William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69, 77-97.

186. "As early as 1904, the term 'freezing out' had appeared in the reports." Carney,

was underscored when *Santa Clara County v. Southern Pacific Railroad*[187] held that the corporation, *constitutionally*, was a legal person. As Herbert Hovenkamp has written,

> The doctrine that a corporation is a constitutional person meant that the corporation's directors or managers had the power to assert the corporation's constitutional claims. The far less cited corollary was that the shareholders *lacked* standing to assert these rights. . . . Thus an important effect of the *Santa Clara* decision . . . was to enlarge the gap between ownership and control that characterized the development of the classical corporation.[188]

Other support came from outside the realm of law altogether; accounting developments also assisted directors. Traditional business records, in use at the start of the Gilded Age, simply monitored expenses and income. Their usefulness lay in preventing embezzlement and making possible an even distribution of profits—tasks which accorded with the notion of the corporation as a simple body of co-venturers following one clearly defined purpose. Toward the end of the nineteenth century, however, new methods of using business records developed. As firms developed new products, they began to keep data that reflected the technical efficiency and relative costs of making different line items. As firms revised marketing and distribution policies in keeping with new expansion strategies, data on price-cost differentials and product-by-product net income were gathered.

These figures conferred the power to run the firm more effectively than it had ever been run before. These figures also tended to stay within the firm, held by management and its director allies. In an age when disclosure was not the legal norm, and before investors had learned to look behind their dividend payments, much more information came to the boardroom table than was relayed to the shareholders. This informational disparity

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supra note 185, at 97 (citing Theis v. Spokane Falls Gaslight Co., 74 P. 1004, 1006 (Wash. 1904)); *see also* Rossing v. State Bank, 165 N.W. 254, 258 (Iowa 1917) (same); Watkins v. National Bank of Lawrence, 32 P. 914 (Kan. 1893) (upholding action of dominant shareholders); Green v. Bennett, 110 S.W. 108, 115 (Tex. Civ. App. 1908) (same). *But see* Mason v. Pewabic Mining Co., 133 U.S. 50, 59 (1890) (stating that "we know of no reason or authority why those holding a majority of the stock can place a value upon it at which a dissenting minority must sell . . . [any] more than a minority can do"); Jackson Co. v. Gardiner Inv. Co., 200 F. 113, 116 (1st Cir. 1912) (denying majority action); Paine v. Saulsbury, 166 N.W. 1036, 1039 (Mich. 1918); Murrin v. Archbald Consol. Coal Co., 134 N.E. 563, 564 (N. Y. 1921) (per curiam) (same). *See generally* Arthur M. Borden, *Going Private—Old Tort, New Tort, or No Tort?*, 49 N.Y.U. L. Rev. 987 (1974); Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Retrospective*, 56 N.Y.U. L. Rev. 624 (1981).

Some special charters had provided for cashing out shareholders who dissented from a planned merger, *e.g.*, Mills v. Hurd, 29 F. 410, 412 (C.C.D. Conn. 1887) (directing that appointed appraisers fix cash value of stock held by dissenting shareholder).

187. 118 U.S. 394 (1886).

188. Hovenkamp, *supra* note 136, at 42-43. For a detailed discussion of these issues, see Horwitz, *supra* note 75, at 65-107.

reinforced director control; directors knew the business better than shareholders could hope to.[189]

Politics, too, played a subtle part as populist ideology steadily favored director control. In other nations, banks and other large financial institutions had held large stakes in public corporations and, frequently, taken an active management role. In the United States, generations of legislation have prevented this. "Corporate reform" has often meant setting limits on share ownership by banks, bank holding companies, insurance companies, and pension funds.

Antitrust law has prevented individual shareholders from amassing controlling interests in related companies. Congressional investigations, like the Pujo "Money Trust" inquiry of 1912 and the Pecora hearings of 1934, have highlighted and challenged the control exercised by investment bankers. In recent decades, the 1934 Securities Exchange Act may have chilled interest in shareholder control. Ownership of a 5 percent interest requires disclosure, and Section 16 of the Act limits the ability of a 10 percent shareholder to take short-swing profits. The result of such limitations, Mark Roe has argued, has been "the fragmentation of institutional capital." When wealthy institutions were barred from exercising power, this meant "that owners' power would shift somewhere. It shifted to managers, who obtained their power partly by default."[190]

H. Motives and Explanations

Only rarely can one read between the lines of nineteenth century cases. It is hard to tell how firmly courts grasped that they were articulating a policy that favored director control over shareholder "ownership." When one shareholder sought to enjoin a merger which all others favored, the issue was squarely framed—and in resolving such cases, the courts ultimately came down squarely on the directors' side.[191] When a case presented a study

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189. An account of change in one manufacturing company is given by Margaret Levenstein, *The Use of Cost Measures: The Dow Chemical Company, 1890-1914*, *in* INSIDE THE BUSINESS ENTERPRISE, *supra* note 119, at 71, 80. More generally, *see* ALFRED D. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977). The management groups whose emergence Chandler describes were thus able to work from first-hand knowledge of the firm. They effectuated the strategy of plowing funds back into the firm, rather than paying them out steadily as dividends. Separating management's managerial and financial roles was the mark of their victory over outsiders and raiders like Gould.

190. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 65 (1991); *see also* Alfred F. Conard, *Beyond Managerialism? Investor Capitalism*, 22 MICH. J. L. REF. 117 (1988); Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991); Mark J. Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. FIN. ECON. 7 (1990); Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391 (1991).

191. In Sprague v. Illinois River R.R. Co., 19 Ill. 173 (1857), the court stated that the proposition that "one stupid or obstinate holder of one share [may] tie up the hands of all the rest, to their utter ruin . . . needs no refutation. . . . [N]o sane man ever became a corporator with such an understanding or intention." *Id.* at 178.

in internecine warfare, with classes of shareholders pitted against each other, courts looked to directors, trusting them to deal fairly with all parties concerned. When trusts threatened to control industries, courts responded by asserting that only boards of directors could legitimately control corporations. Under special charters, a good-faith compliance rule had protected managers from shareholder suits brought over niggling points of the corporate charter. For corporations formed under general incorporation laws, the broader grant of power responded to the greater influence which shareholders sought to exert.

In a few decisions, facts or pleadings suggest that a shareholder litigant had only recently arrived on the scene—that he or she had bought into the firm and precipitately sued to reverse some established practice. In denying relief in such control battles, courts plainly favored management control.[192] Other decisions treated director authority as a matter of blackletter law, a paramount right so basic to corporate governance that even a marginally relevant authority would suffice to uphold it.[193]

The courts did not articulate a policy lying behind the pattern of decisions. In fact, the shift in power within the public corporation is probably to be explained less by a conscious policy than by a general disposition favoring director control. Even if there was no overt explanation, the results were otherwise inexplicable. By 1912 the process was complete. In that year, following the Money Trust investigations, the Pujo Committee reported:

> None of the witnesses was able to name an instance in the history of the country in which the stockholders had succeeded in overthrowing an existing management in any large corporation. Nor does it appear that stockholders have ever even succeeded in so far as to secure the investigation of an existing management of a corporation to ascertain whether it has been well or honestly managed.[194]

Corporation law had responded so well to the problems of the Gilded Age that it had created the problems of the twentieth century. In shutting out the corporate free-booter, the law had created the powerless, alienated individual shareholder—the figure whose problems Berle would so effectively diagnose.

VI. REMINDERS AND CONCLUSIONS

The misdealings of the Gilded Age featured the blatant manipulation of stock prices, via bull campaigns, bear pools, corners, and squeezes.

192. *See, e.g.*, Neall v. Hill, 16 Cal. 146 (1860); Leslie v. Lorillard, 18 N.E. 363 (N.Y. 1888).

193. Thus did In re La Solidarite Mut. Beneficial Ass'n, 9 P. 453, 454 (Cal. 1886), make use of Gashwiler v. Willis, 33 Cal. 20 (1867).

194. *Quoted in* LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 59-60 (1914).

During the 1980s, the featured abuse was insider trading. In fact, these abuses were only different aspects of the same overreaching: an attempt to supplant the functions of the market with collusive control. When Gould's brokers began selling stock short, or covertly built a position in a firm he hoped to acquire, these manipulative acts were built on advance knowledge of his plan of campaign. When Milken passed word to Ivan Boesky that a firm would shortly become a target, the tip was passed so that a secret purchase would set a price, or to convince traders that a bid was viable—to manipulate the market.

Such sleight-of-hand, raised to the level of practice, meant that the market could not serve its function of allocating resources through the pricing of investment opportunities. Trading on inside information distorts timing, which is critical in markets, such as the stock market, where prices change rapidly. Those who trade on inside information may buy and sell at the best possible moment, but their actions mean that other investors are induced to buy and sell at the wrong time.[195] The result has been the failure of the market process.

A. *Market Failures, Past and Prospective*

The securities market may generally be considered efficient at pricing shares for sale. Whether it is totally efficient, as a theoretical matter, is vigorously debated.[196] When belief in the market's efficiency at pricing shares is extended into the assumption that such stock trading accurately sets purchase prices for the corporations which issued shares, the debate intensifies. That the market is efficient at this remove is doubtful.[197] However, with regard to the machinations carried out under the auspices of Drexel Burnham Lambert, market efficiency was not at issue. Nothing depended on market processes; every effort was made to hoodwink the market.

In May 1985, Milken directed Boesky to buy into Harris Graphics. As Milken had intended, the market, which did not know of their collusion, read this as a signal that the firm was a takeover candidate, and it soon became one. In September 1985, during a tender offer made for Pacific Lumber by the Maxxam Group (his own client), Milken had Boesky amass

195. Such trading is sometimes defended on the grounds that it disseminates information. However, when "inside" information is only foreknowledge of an event which will shortly become public, insider trading has little social value; it adds nothing which the market would not have inevitably learned. *See* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); Michael Manove, *The Harm from Insider Trading and Informed Speculation*, 104 Q. J. ECON. 823, 826-27 (1989).

196. *See* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992); William K. S. Wang, *Some Arguments That the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341 (1986).

197. Compare the arguments of Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 557-58 (1984) with those made by Lowenstein, *supra* note 24, at 274-84.

a position in the target firm. Increasing the market price of Pacific Lumber shares drove up the bid price, meaning that Drexel's percentage-based fee (based on a percentage of the takeover bid's value) would be higher.[198] If this was market failure, one could also point to cases of fraud. Milken's debts to Boesky were repaid with other people's money.

> Because of his extraordinary control over the junk-bond market, Milken could buy back securities at artificially low prices from Drexel clients who had no way of knowing their actual value; sell them to Boesky at a small profit; have Boesky resell the securities to Drexel at a much higher price; and in turn resell them to Drexel clients at still higher prices. This enabled Milken to repay Boesky millions of dollars, even while continuing to earn profits from his trading operations.[199]

The financial battles of the Gilded Age interfered significantly with the market's ability to price investment opportunities. Kenneth Snowden, examining the American stock market between 1871 and 1929, has concluded that share prices often showed a troubling, persistent tendency to deviate from their rational values.[200] While the market did not fail completely, its inefficiencies correlate suggestively with the volatility of the banking system, manipulation by dominant investment bankers, and, most significantly, disparities in information.[201] All of these factors produced situations in which the stock market could not carry out its task. This is illustrated by the Northern Pacific corner, the last and greatest of the battles *cum* debacles of the Gilded Age. In early 1901, E. H. Harriman (backed by the Rockefeller family) and James J. Hill (backed by the House of Morgan) both sought to control the railroads which covered the Midwest and ran to the Pacific Coast. Hill covertly acquired a line Harriman had coveted, the Chicago, Burlington & Quincy Railroad. Not to be outdone, Harriman determined to steal the Burlington away from Hill indirectly by buying control of the Northern Pacific, which held half of the Burlington's shares.

Because Morgan and Hill held very large interests in the Northern Pacific, Harriman sought to buy an absolute majority of the railroad's common and voting preferred stock. He had almost reached this level on Friday, May 3, when Morgan learned of his bid. Over the weekend, Morgan

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198. JAMES B. STEWART, DEN OF THIEVES 185-87 (1991).

199. *Id.* at 183-84. In roughly the same period, a similar system of skimming profits from customer trades was used by some traders in the Chicago futures markets. *See* DAVID GREISING & LAURIE MORSE, BROKERS, BAGMEN & MOLES: FRAUD AND CORRUPTION IN THE CHICAGO FUTURES MARKETS 10-12, 269-80 (1991).

200. Kenneth A. Snowden, *American Stock Market Development and Performance 1871-1929*, 24 EXPLORATIONS IN ECON. HIST. 327, 347-51 (1987).

201. *Id.* Snowden concludes that in "a mature stock market, which services a large and heterogenous investing public, strict disclosure and regulatory oversight may be required to ensure that stock prices do not wander, although modestly, from their rational values." *Id.* at 351.

authorized a counterbid for 150,000 shares. It was this bid and counterbid, between them, that led to the rocketing prices of Tuesday morning, May 5, 1901.

Only a seriously flawed market could bid up the price of a stock from $172 to $1000 in one morning's time, tolerating and even condoning the manipulation behind this escalation. On this occasion, the cornering of one stock corrupted the entire market. As Matthew Josephson wrote,

> Finally in one hour, while all the financial world seemed to turn completely insane, Northern Pacific soared to $1,000 a share—while all the securities, stocks and bonds of the whole country simultaneously fell in a grand smash from 15 to 40 per cent. For money was now fearfully scarce, loaning at 40 to 60 per cent; the shorts and the houses they dealt in were believed to be ruined, and were forced to throw overboard everything else they possessed to repurchase [*i.e.*, make cover purchases of] Northern Pacific stock.[202]

If the market's integrity and efficiency were threatened, so too was the stability of general business. The "ruinous competition" of which the railroads complained, which led them into combinations of ever-increasing magnitude, was due to the fact that the railroads had over-built their market. Laying down buffer networks of unprofitable branch lines, in the 1880s, was what setting up poison pills and retaining investment bankers was in the 1980s: a way to defend against corporate blackmail. In terms of economic development and growth, the energy so expended was wasted. It was spun off into needless friction.[203]

A major player who holds and acts on inside information likely will impair the efficiency of the market, leading to situations in which the efficient market hypothesis will break down. When the trader is large enough, the information conveyed by the simple fact of his or her trading, *i.e.*, simply that he or she buys or sells a position, is significant in itself. This gives major players an incentive to disguise their strategy. They cannot afford to let the price of a stock change too much, lest this reveal what they know and what they plan to do. They must conceal their strategy.

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202. JOSEPHSON, *supra* note 94, at 440. *See generally id.* at 432-44 (discussing history of Northern Pacific Corner).

Hill and Morgan won, but made a peace. They combined with Harriman and William Rockefeller in forming the Northern Securities Company, a holding company which held control of *all* the competing lines. *Id.* at 444. The dissolution of this trust was ordered in Northern Sec. Co. v. United States, 193 U.S. 197 (1904), a decision that vitalized the Sherman Antitrust Act by extending federal regulatory power over industrial facilities, which restrained trade by virtue of their size and power.

203. Nor was the process unrelated to political corruption. In 1868, after progressing to the presidency of the Erie Railway, Gould named Boss Tweed to the railroad's board of directors. In 1988, Columbia Savings & Loan made it possible for California congressman Tony Coelho to invest in a junk-bond fund, yielding a surprisingly high return that Coelho failed to disclose as a campaign contribution. *Compare* ACKERMAN, *supra* note 6, at 43-44 *with* STEVEN PIZZO ET AL., *supra* note 84, at 398 n.10.

This denies the market information that would assist in its pricing function. Therefore, "in a model in which private information is possessed by a trader who is big enough to affect prices, the information efficiency of prices breaks down."[204] This was the case with Gould and Milken. It continues whenever institutional investors use program trading to hedge against losses in the value of their securities portfolios.

> Financial futures allow [an institutional investor] to avoid much of the impact that its own trades will have on the market. If a sale is contemplated, [the institution] can sell a future first and then adjust the stocks in its portfolio later. If the market falls because of the sale of the stock, the fund will be compensated by the money it makes from selling the future. In other words, selling the future allows the fund to avoid telegraphing its intentions to the market. . . .
>
> Since program trading causes the prices of stocks to move without regard to fundamental value, savvy investors have begun to regard periodic mini-crashes as buying opportunities. . . . [T]he more a stock moves up and down, the more chances there are to gain from trading.[205]

That institutional investors may conceal their trading strategies is not a mere possibility. It is already a fact. The results are familiar: stock price movements which are divorced from actual stock values. To speak of periodic mini-crashes is to speak of chronic market failure.

B. *The Transaction Costs of Control Transactions*

As Coase noted long ago, the firm may be considered a set of long-term contracts.[206] These relational arrangements eliminated the costs of a series of transactions among the firm's participants. When the market broke up companies, assets that had been organized within these firms—over the long term, in flexible commitments—found their ownership and use now subject to revaluation and reallocation. Now they were subject to the vagaries of the marketplace.

At the margin, when assets shifted between firm and market, long-term commitments were replaced by sequences of individual contracts. To better the firm's efficiency, the market had to keep bargaining costs down. The market could do this by reducing the number of issues with which bargaining might deal—that is, by standardization and simplification. The give and take inherent in a relational context, within a firm, meant that it was

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204. Jean-Jacques Laffont & Eric S. Maskin, *The Efficient Market Hypothesis and Insider Trading on the Stock Market*, 98 J. POL. ECON. 70, 87 (1990).

205. Richard A. Booth, *In Defense of Program Trading*, WALL ST. J., Apr. 1, 1992, at A16.

206. Although raised by Coase in his 1937 *Economica* article, this received a fuller treatment in 1988. Coase, *supra* note 26, at 28-30.

possible to adjust for individual differences: employer preferences, customer demands, suppliers' schedules, workers' changing or special needs. This now went by the board. When standardization increased, the norm squeezed out the particular. Tolerance for variation was one of the agency costs that the market sought to cut.

Ideally, the firm represented a work team engaged in a joint enterprise. The market, however, treated business organization as a series of piecemeal deals among independent contractors, each of whom could drop the arrangement (employers, usually) or be dropped from it (employees, more often) at any time. In sum, the junk-bond era brought together the worst of both worlds. Added to the instability of the marketplace was the authoritarianism of the firm.[207]

Takeovers and buyouts disrupted the institutions by which American economic production was organized. The "new value" that financiers talked of creating[208] was actually either stored-up value (money realized from the partial liquidation of the nation's industrial base) or fools' gold (money acquired in a stock market where buyers would pay something for anything).[209] The producing economy was badly dislocated. The human cost of takeovers was measured in unemployment and sometimes in suicide.[210] The long-term economic cost has yet to be counted up; seeking short-term profits, firms cut back on research and development.[211] An immediate problem, and one likely to be enduring, has been poor morale throughout the work force, and morale is as important to a work force as it is to an army.[212]

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207. *See* Steven N.S. Cheung, *The Contractual Nature of the Firm*, 27 J. L. & ECON. 1, 8-10 (noting low-cost ways of pricing inputs).

208. Michael Jensen estimated that between 1977 and 1986 shareholder gains from mergers and acquisitions totaled $400 billion: $350 billion actually paid in control premiums, plus $50 billion in enhanced stock prices (market valuations raised by general takeover activity). This sum bears an imprecise but uncanny resemblance to the amount estimated as the cost of bailing out America's savings and loans. *Compare* Michael Jensen, *The Takeover Controversy: Analysis and Guidance*, MIDLAND CORP. FIN. J. 6-32 (1986) *with* MAYER, *supra* note 82, at 2.

209. As Louis Lowenstein has pointed out, a zero-coupon bond—the basic instrument of most of the larger takeovers and buyouts—is a thoroughly dubious investment. The fact that the bond does not pay interest *should* warn the buyer up-front that the seller does not have the money to pay off the obligation and does not foresee having such funds until the bond matures, sometime in the hopeful future. In the meantime, the buyer will have to pay tax on income that the bond is accruing, but which is not received. LOWENSTEIN, *supra* note 86, at 78-79.

210. *See* Susan C. Faludi, *The Reckoning: Safeway LBO Yields Vast Profits but Exacts A Heavy Human Toll*, WALL ST. J., May 16, 1990, at A1 (discussing Revco buyout that cost 63,000 jobs; winner of 1991 Pulitzer Prize). The AFL-CIO estimated that, between 1983 and 1987, 500,000 jobs were lost due to takeover activity. S. REP. No. 265, 100th Cong., 1st Sess. 14 (1987).

211. William J. Broad, *Ridden With Debt, U. S. Companies Cut Funds for Research*, N.Y. TIMES, June 30, 1992, at C1 (noting studies by National Science Foundation and Congressional Office of Technology Assessment).

212. "[M]anagement will be more effective if it creates an environment that stresses

These were the costs incurred by the junk-bond boom—by the shift from long-term to short-term commitment of resources, by the linking of the stock market and the market for corporate control, and by unconstrained shareholder activism. They are substantial. To avoid incurring them again, legal constraints on shareholder opportunism should be maintained.

VII. Closing Considerations

The changes that strengthened the board of directors did not transpose upon the corporation an inflexible and unyielding director autocracy. Under the traditional regime of corporate law, shareholders have done quite well. Functionally, allocating control to directors did not deny power to shareholders; it simply allocated it to an inner circle of shareholders, ones whose links to the firm were more likely to be close and of longer standing.

The traditional regime of corporation law provided a serviceable framework for bringing together finance and commerce. Even with directors established in positions of authority, dividends continued to be paid. When corporations retained and reinvested profits, and with the market providing a way of realizing these increasing values, shareholders gained from growth. Freeze-out mergers were stalled or blocked. De facto mergers were unmasked and shareholder rights enforced. Directors' fiduciary duties were tightened to prevent trading on inside information or to require that directors selflessly sell their firms out from under them. The corporate opportunity doctrine warned directors not to misappropriate advantages that came to them ex officio.

Over the last two centuries—since corporations began to be chartered, and since the New York Stock Exchange opened for trading—a law of corporations has been worked out. This law presumes that directors will run corporations and assigns them fiduciary duties to govern and guide their actions. The law also presumes that shareholders will not run corporations and allows them to pursue their own interests. This law of corporations generally accords directors primacy over shareholders.

While the shareholder class was an unorganized group of individuals, there was no need to assign fiduciary duties to shareholders. They were impotent. Now that is changing. The size of institutional investment means that institutional investors have the power to dethrone corporate directors, upsetting the traditional regime of corporate governance. The investors' mandate to pursue high returns supplies them a motive to take such action.[213]

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support and encouragement rather than constant threats of dismissal." John C. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 Colum. L. Rev. 1145, 1242-43 (1984) (citing sociologists); *see also* Peter F. Drucker, *Taming the Corporate Takeover*, Wall St. J., Oct. 30, 1984, at 30 (employees "from senior middle managers down to the rank and file" demoralized by fear of takeovers).

213. To be sure, significant restrictions are enforced by the rule of fiduciary prudence, as well as ERISA and other statutes—to say nothing of institutional customs that inhibit one

In these changed circumstances, shareholders' freedom to pursue their own interests is a divisive force. It opens the door for institutional investors to liquidate corporate wealth.

Unless we give shareholders responsibilities, we cannot afford to give them power. We must either work out a law of shareholder fiduciary responsibility or ensure that institutional shareholders remain just as powerless as individual shareholders. Managers operate under fiduciary duties. The questions of when workers can withdraw their contributions to the firm, and who may lawfully direct them to do so, form an entire body of law. If shareholders are to take an active role in the firm, we will need to define at least as comprehensively what they must do and what they cannot do. The history of the corporation shows that it can function effectively only when shareholder power is checked and balanced. The recognition is growing that the corporation of the near future will survive only if limits are found for the power of institutional investment.[214]

In any circumstances, corporation law must develop new rules and institutions to discourage shareholders from putting publicly held firms into play. Only rarely have shareholders been able to exercise their theoretical *jus disponendi* over corporate assets. When they have in fact exercised these theoretical rights of ownership, they have left in disarray the institutions of American business. Such a prohibition, however enforced, will save more than it costs.

It should not be assumed that corporate managers are disadvantaging shareholders if they discourage takeover bids by adopting shark repellent measures—staggering or lengthening the terms of their boards of directors, enacting poison pills, or reincorporating in states with statutes which have proven effective at screening out undesirable takeovers. Nor should such defensive measures be associated with inefficiency—read as responses to inefficient management by a firm's directors, or condemned as impairments of the market's overall efficiency at allocating resources.

These measures may be necessary to preserve the firm's existence as an enterprise. Internally, they respond to the extraordinary threat posed by tender offers. They maintain the balance of power between management and shareholders. Externally, such defenses raise the market's costs of buying and selling the assets controlled by the firm. This means that, when

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firm from lending its assets to a bid that dismembers another. *See* O'BARR & CONLEY, *supra* note 1, at 175-205. We are not likely to see CalPERS and TIAA-CREF launching, *á la* Gould, market campaigns of Napoleonic brilliance and daring. But institutional investors still possess the power to force companies into a strategy that produces short-term gains even at the risk of long-term losses, and they possess the power to dismember firms. It was state pension funds, after all, that bankrolled the buyouts done by KKR. GEORGE ANDERS, MERCHANTS OF DEBT: KKR AND THE MORTGAGING OF AMERICAN BUSINESS 46-48 (1992).

214. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 815 (1991) ("there is a strong case for measured reform that will facilitate joint shareholder action *not directed at control*, and reduce obstacles to particular institutions owning stakes *not large enough to confer working control*") (emphasis in original).

market trading costs have been lowered by a hyperefficient market, these defenses restore the functioning equilibrium between the firm and the market. Because it is relative efficiency which matters, such actions say nothing about the firm's absolute efficiency.

Resolution of questions of corporate governance must not be complicated with the specious issue of "corporate social responsibility." Mystifying the issue by making such a connection can only lead to confusion and procrastination. The question of who shall control the corporation is *not* the issue of whether directors may pursue objectives other than the maximization of shareholder profits. This connection can only be made by treating shareholders as a corporation's owners—which they are not.

As a practical matter, "corporate social responsibility" is a settled issue. It died when businesses recognized the publicity value of corporate donations and public relations became an adjunct to commercial planning. It was buried when states recognized and authorized these practices.[215]

As an economic matter, saying that directors should exclusively pursue shareholder profit, deliberately ignoring all other considerations, is actually saying that directors should try to be free riders within a social infrastructure paid for by others. This argument might be tenable if advanced for only one corporation, but it impales itself on its own premises when advanced more broadly. First, this argument assumes that there will be an infrastructure to ride free upon (which there will not be, if no one pays for it). Second, it recognizes that the benefits of the infrastructure are of value to the corporation. What is valuable enough to steal, directors should have the flexibility to pay for.

The present rule allowing corporate expenditures permits this. Berle suggested that, until some system could be worked out to govern corporate expenditures on social items, profit maximization should remain the guiding principle of corporate governance.[216] The present-day network of charity development work and corporate public relations has provided such a system. The overall arrangement is rather like that described by Coase in his work on lighthouses, in which he showed that lighthouse associations, historically, were able to identify potential users and solicit donations from them, thereby providing a public good without legal coercion.[217]

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215. *See* A. P. Smith Co. v. Barlow, 98 A.2d 581 (N.J. 1953). This has been extended by the recent wave of "non-shareholder constituency statutes," allowing directors to take into account, when making decisions, the interests of such stakeholders as employees, customers, and firm-based communities. More than half the states have passed such laws. *See* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 984-96 (1992). This article articulates a distinction between situations in which it is legitimate for a corporate board to take "social responsibility" into account, suggesting that this is appropriate (and, indeed, already accepted) with regard to everyday operating decisions, but questionable with regard to structural decisions, *i.e.* those which involve challenges to directors' control of the enterprise.

216. Adolf A. Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932); *see also* Joseph L. Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458, 1461 (1964).

217. *See generally* Ronald H. Coase, *The Lighthouse in Economics*, 17 J. L. & ECON. 357 (1974).

There is no reason not to require that takeovers, buyouts, and restructurings proceed only after investigation and approval, on their merits, by a specific government body. These control transactions are already governed by a regulatory scheme. Even at the height of the junk bond era, every challenged restructuring and litigated tender offer battle passed under the scrutiny of a government employee—a judge. The Delaware chancery courts and the federal district courts did yeoman service during the 1980s. They ruled indirectly, testing the merits of control bids by opining on what directors' fiduciary obligations made proper or improper. In the bitterest struggles, judges acted as umpires. They were far more impartial than Judges George Barnard and Albert Cardozo had been, twelve decades before, in the battles for control of the Erie Railway, but they were just as closely involved.

If government officials are to be involved this intensely—and the record suggests that they will—such matters should be taken out of the general court system. They should become the province of a government body able to develop a specialized expertise in the field. This board's review of control transactions should address all concerns at issue in a given situation: those of shareholders, managers, employees, customers, and home-base communities.[218]

A final consideration is perhaps the most important. Between capital investment and profit distribution stands business operations—the process by which the individual firm brings its product to market and by which firms as a class allocate economic resources. The business corporation performs the same function in the market economy that socialist regimes have tried less successfully to achieve with centralized planning boards. Nicholas von Hoffman has pointed out this societal dimension of business production:

> How they did what they did defies facile explanation but from 1904, when the car population of the United States was about eight thousand, people built a new universe. Sixteen years later, there were more than eight million cars puttering around. In the interim new forms of road surfacing were invented, plus the machines to use the materials, the automobile insurance industry was created, not to mention over thirteen thousand garages, each with at least one somewhat trained mechanic, and each stocked with spare parts or able to obtain them. Modern gasoline refining had to be invented and, as important, a distribution network to make it available universally also had to be called into existence. . . . Free markets

218. It is not to be anticipated that this process would involve questions very different from those currently addressed by judges dealing with tender offers and buyouts. This proposal relates more to the identity of the government official making a determination on the merits of a control transaction than to the character of the determination.

This recommendation consciously rejects the arguments that "regulated" interests inevitably capture regulatory bodies. Either one takes such arguments seriously, and holds back from regulation, or one does not.

> are necessary, but business and business organization, which are not the same, are more important.[219]

The business corporation is the social institution which carries out technological revolutions. In facilitating investment, it finances emerging technologies. It draws its profits from its ability to educate consumers to the possibility of innovation, creating a demand which technology can support itself by supplying.

The belief that a corporation enjoyed a lost golden age—in which all firms were capably run and in which there was no division between management and control—is one of corporation law's most enduring and influential myths. It influenced Berle, who believed that corporate managers were to blame for the corporation's fall from grace. It has influenced this article, which has treated the activist shareholder as a tempter who lures prosperous firms to their destruction.

Behind this memory lies a subtly different truth. Veblen recognized it:

> In the beginning, that is to say during the early growth of the machine industry, and particularly in that new growth of mechanical industries which arose directly out of the Industrial Revolution, there was no marked division between the industrial experts and the business managers. That was before the new industrial system had gone far on the road of progressive specialization and complexity. . . . Not unusually, the designers of industrial processes and equipment would then still take care of the financial end, at the same time that they managed the shop.[220]

There was a golden age, but it was not the good old days when ownership and control were one. It was the brisk, clear dawn when technology and commerce drove forward together. This is not the tale of a vanished past. It forms the opening chapter of every business epic. Hannah Wilkinson proving to her brothers that sewing thread could be made of cotton as well as linen. (They were so impressed that they built her a factory, the first of the great New England mills.) Thomas Edison running the Edison General Electric Company, before J. P. Morgan merged it into his General Electric. Henry Ford cutting prices, increasing production, and raising pay. Apple Computer under Steven Jobs. Frederick Smith and Federal Express.

For too long we have approached problems of corporate governance by asking how shareholders can better protect their interests. We may get better answers, answers which deal more effectively with more aspects of the business corporation's role, if we ask a different question—how investment can best be used to finance technology. The rules which govern institutional capital should reflect this understanding of the firm's societal role.

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219. Nicholas von Hoffman, Capitalist Fools: Tales of American Business, from Carnegie to Forbes to the Milken Gang 95 (1992).

220. Thorstein Veblen, The Engineers and the Price System 58-59 (1921).