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News Release

CONTRACTS, CORPORATIONS AND CORPORATE GOVERNANCE

Remarks to

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Association, Inc.

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The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff.

Incredible as it may seem, corporate governance in recent years has become a topic that might almost be described as "sensational." In times past, this subject had all the glitter of the Delaware Court of Chancery; its effect on the human mind and spirit was symbolized for a generation of lawyers, I am told, by a corporate law textbook of oppressive bulk (if impressive erudition), authored by William Cary, a former Chairman of the SEC. But while the late Professor Cary and all his prodigious learning were unable to glamorize the topic of corporate governance, Boone Pickens and billions of dollars were. It's funny, but money has that effect. Perhaps we can expect the next definitive work on corporate law to come from the pen of Judith Krantz.

I bring these matters to your attention not to make you feel like characters from a prime-time soap opera, but to illustrate the point that what gets people's attention is more often the clash of interests than the clash of ideas. Indeed, ideas often are used simply as weapons in the battle of interests, to be discarded once they no longer serve material objectives. This is a notion the lawyers among you will no doubt understand.

The clash of interests that has heated up contemporary discussions of corporate governance is the contest between management -- whom its opponents call "entrenched" management -- and the uninvited bidder for corporate control -- whom management calls a "raider," a "fast-buck artist," or an "executioner." One of the philosophical issues that this contest raises about corporate governance is whether the corporation is to be viewed as a fundamentally contractual arrangement enabling large numbers of people to combine their wealth and efforts in a common enterprise, or whether it should be regarded as a kind of little commonwealth, whose structure is to be determined more by law than by contract, with due attention paid to each of the corporation's various "constituencies."

Raider advocates and manager advocates, however, make free use of arguments from both sides of the philosophical divide. Managers, not content to fight raiders with corporate charter amendments, call for public laws to hobble these troublesome outsiders. Raiders don't like laws like that, but some of them talk about laws to preserve shareholder voting and "shareholder democracy" as though business enterprises, which shareholders are in mainly for the money and which they can join and leave in a few seconds, were reasonably comparable to states and nations.

I lean toward the contractual view of the corporation, within limits.

In the next few minutes, I'd like to apply the idea of the corporate contract from two points of view: first, discussing the equities of the contract in light of the generally remote and impersonal relations between shareholders and their corporations; and second, touching upon several issues concerning the efficiency of the corporate contract for maximizing shareholder wealth, the incentives aligning the interests of management with shareholders', and means for realigning those interests where the discretion that the corporate contract typically delegates to management has been poorly used.

Just how genuine is the consent that shareholders give to the corporate charter, by-laws and other provisions governing their rights? Such judgments can move us into the trackless realm of the metaphysical, but the idea of consent is central to our way of life. General contract law is founded on the idea of consent; we speak of our government as one based on the consent of the governed; and indeed a free society can reasonably be characterized as one where societal relationships among adults rest upon mutual consent.

A stockholder consents to the corporate contract in the most basic sense that actual duress is rarely involved. Guns, threats against an investor's property, or members of his family, are business methods that generally have not found their way to Wall Street, at least not yet. More than this, investors rarely invest under the threat of extreme economic or personal hardship. Thus an argument sometimes made to justify, for example, regulating the relations between landlords and tenants or workers and employers is not available here. An investor not only may choose among different shares, but may choose bonds, mutual funds, certificates of deposit, real estate, gold and a host of other investment media; and he may decide to throw a party rather than invest in anything.

Few shareholders individually bargain the terms on which management is retained; but if this defeated their consent, most retail sales would have to be viewed as nonconsensual; as would most dealings of any kind between individuals and institutions.

A somewhat different angle of attack on the consensual nature of corporate relations holds that an investor should not always be saddled with the consequences of a corporate charter's terms because, in effect, he didn't know what he was getting into. This argument has some appeal because it is so often true. The fine print that is usually worth management's time to write is rarely worth the investor's time to read. Corporate governance is only one item among many that may be relevant to the investor, and he may be "rationally ignorant" if he concludes that it simply will not repay the time invested to learn the various contingencies to which his rights are subject under the corporate charter, given the relative unimportance of any particular stock to his portfolio, the relative ease of disposing of it, the probable existence of other shareholders with a larger stake in keeping track of these matters, and the relative infrequency of management misconduct that has a sudden and precipitous effect on share prices.

Since shareholders generally will not know every contingency to which their rights are subject, but will take shares on the common assumption that management is working for their best interest, shouldn't the law intervene when this appears not to be the case, whatever discretion the managers may claim under their contract?

One response is that ignorance was a risk the shareholder willingly undertook, and he should live with the consequences of his choice, rather than insist on something from the manager that the manager never agreed to. Where disclosure has been complete and compulsion absent, the equity in reforming contracts is questionable. However, I would give some weight to the fact that there is implicit in the relationship between a shareholder and a manager a certain degree of trust and confidence, and a minimum level of good faith that may reasonably be presumed. Accordingly, the further the departure from the general norm, the more specifically it and its implications need to be brought to a shareholder's attention. In the absence of such informed consent, there are limits that corporate law reasonably imposes on the discretion that managers may contract for. As long as dealings between a shareholder and a corporation are carried out on an impersonal basis, I doubt that any consent could be sufficiently informed to waive the minimum duties of care and loyalty provided in state corporation laws.

Within these bounds, it is fair to hold the shareholder to his contract. Another question, however, is that of efficiency. Within limits applicable to anyone's pursuit of profit, social policy has usually assumed that the corporation's pursuit of profit is a good thing, causing it to behave in an economically rational way and thereby contribute to society's aggregate wealth. But does the managerial discretion that the corporate contract commonly allows encourage deviation from the pursuit of profit? Without providing definitive answers, let me remark upon a few related questions.

Separation of corporate ownership and corporate control is said to diminish profit incentives. Isolated, dispersed, and each having a small relative claim on profits, shareholders are poorly placed to effectively oversee management's efforts. This problem was given its classic statement by Professors Berle and Means in their 1932 work The Modern Corporation and Private Property. But old Adam Smith himself had realized that the directors of joint stock companies "being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnercy frequently watch over their own." [1]

And yet it seems to me that there is no shortage of "anxious vigilance" in board rooms today. The corporation has become a remarkably widespread form of business organization, especially as the laws restricting its governance loosened and the economic need for its capital collecting capabilities grew in the century before Berle and Means wrote.

One constraint on managerial inefficiency is the investor's "exit option." Managers need to raise money, and the era of full disclosure has made it easy for the investor to monitor the bottom line, possibly the simplest and most effective way of monitoring management. Financial markets, influenced by market professionals such as underwriters, securities analysts and money managers, decide whether the discretion offered to management represents a reasonable balance between flexibility and the risk of mismanagement. The institutional investor, moreover, will often be able to monitor management in a way that might be impractical for the smaller shareholder but can still benefit him.

Corporations also align the interests of managers with those of shareholders by compensating managers with stock options and other equity interests in the company. These usually form a major portion of the compensation for top executives. [2] Further incentive may be provided by an executive's career interest in leading a successful firm. Managers sometimes are said to have a bias toward organizational growth [3] that is not always consistent with profit maximization; even so, growth is usually a great deal easier with profits than without them. In short, there are a variety of mechanisms at work to spur the manager toward profit maximization. Three recent studies comparing manager turnover to stock-price performance all

[1] A. Smith, The Wealth of Nations 700 (Canaan ed. 1937).

[2] F. H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. of Comp. L. 540, 558-62 (1984)

[3] E. Herman, Corporate Control, Corporate Power (1981).

found a direct relationship between poor performance and turnover. [4]

When the incentives aligning the interests of managers and shareholders fail, there are alternatives. One is the shareholder derivative suit. Another is the corporate takeover.

Legal reform to further facilitate the use of the stockholder derivative suit has been questioned, and it is safe to say that the more exacting and manifold the managerial duties that are imposed by law, the more ground there will be for shareholder litigation. The role of plaintiffs' attorneys in these actions arguably skew incentives toward the recovery of fees rather than toward maximizing corporate wealth after litigation costs. One study showed that news of success by shareholders suing derivatively doesn't help share prices despite the theory that this will benefit all shareholders. [5] Whether this means shareholders would prefer fewer such suits or just that their confidence in management has been shaken is another question. Moreover, the role of such suits in deterring managerial misconduct is probably not reflected in price reaction to any particular suit. On the other hand, the deterrent effect itself is complained of as a costly inhibitor of management's willingness to innovate or take risks.

A third consideration in assessing the impact of such litigation against managers is the effect of indemnification for legal costs and insurance against recovery. On one view, the widespread insistence on these protections indicates that the law has become too hazardous to managers, while the adoption of them ameliorates the discipline and deterrence that are supposed to justify legal liability and its attendant litigation costs. But it has also been argued that, since insurers may be better

[4] J. Warner, R. Watts, K. Wruck, "Stock Prices, Event Prediction and Event Studies: An Examination of Top Management Restructurings," Working Paper, University of Rochester, 1987; M. Weisbach, "Outside Directors, Monitoring, and the Turnover of Chief Executive Officers: An Empirical Analysis," Working Paper, MIT, 1987; A. Coughlan, R. Schmidt, Executive Compensation, Management Turnover and Firm Performance: An Empirical Investigation, 7 J. of Accounting and Econ. 43-66 (1985).

[5] D. Fischel and M. Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 Corn. L. R. 261 (Jan. 1986).

situated to monitor management than are shareholders, the insurance not only spreads the risk of misconduct but reduces it as well. [6] Finally, the effect of insurance is limited by deductible amounts, by the exclusions usually found for fraud and other bad faith conduct, and by availability.

Possibly the most feared and currently controversial check on managerial performance is the market for corporate control. If, for example, the incumbent managers' bias toward growth has gotten the better of them and caused share prices to fall, this will attract a bidder who can restore value by spinning off any improvidently added operations.

This market has obvious benefits for shareholders in target companies. No one rejects a stock recommendation because he suspects the company is about to become a takeover target.

There is, moreover, not much evidence that premiums paid to target shareholders accrue at the expense of others rather than from efficiency gains. The studies done on bond prices to date do not, for example, indicate that takeovers represent simply a redistribution of wealth from debt-holders to the holders of the target's equity. [7]

Another common criticism is that the market for corporate control reduces efficiency by forcing managers to concentrate exclusively on quarterly profits rather than taking the long view. Long-term investments, such as research and development, are discouraged.

But the fact that some stocks sell at higher price/earnings ratios than others suggests that securities markets quite regularly take the long term point of view. Moreover, a 1985 study by the Commission's Office of the Chief Economist -- which looked specifically at takeover targets and firms spending large amounts on research and development -- concluded that research-oriented firms were not more vulnerable to takeovers. Indeed, when in reases

[6] C. J. Goetz, A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven, 71 Corn. L. R. 344, 349 (1986).

[7] _See_, G. Jarrell, J. Brickley, J. Netter, The Market for Corporate Control: The Empirical Evidence Since 1980 (forthcoming, J. Econ. Perspectives) summarizing studies to date, (1987).

in research and development were announced, stock prices tended to go up, not down. [8]

The discipline provided by the market for corporate control is reduced by various antitakeover measures. The issue for investors and perhaps for the law of corporate governance is whether the added discretion these measures provide to management is worth the risks inherent in allowing management to gauge its own performance. While some antitakeover measures, such as so-called fair-price amendments, seem to have no significant negative impact on share prices, others, like the poison pill, do. [9] The poison pill, as you know, is a device that may, for example, allow target shareholders, when a hostile change in control is threatened or accomplished, to purchase additional shares from or sell shares to the target at very advantageous prices. However, the pills can generally be redeemed cheaply by incumbent management. Pill advocates say they permit management to hold out for a better price or to attract other bidders and create an auction for control. But as often as not the pill's adoption does not get a better bid but defeats all bids. Instead of an allegedly inadequate premium, shareholders receive none. A study to be published this year shows poison pills had a small but statistically significant negative impact on the price of the affected stocks. [10]

But I hesitate to condemn antitakeover devices uniformly, at least to the extent of recommending legislation against them. They represent an extension of managerial discretion; but not every extension of discretion is adopted by every corporation in a "race to the bottom." Delaware has long been known as a state where management could contract for a high degree of discretion, yet corporations do not all incorporate in Delaware. And those that do do not appear to bring their investors a lower rate of return. On the contrary, a 1980 study

[8] Office of the Chief Economist, S.E.C., "Institutional Ownership, Tender Offers and Long-Term Investments" (1985).

[9] See, Office of the Chief Economist, S.E.C., "Shark Repellents and Stock Prices: The Effect of Antitakeover Amendments Since 1980" (1985) and "The Effect of Poison Pills on the Wealth of Target Shareholders" (1986).

[10] M. Ryngaert, "The Effect of Poison Pill Securities on Shareholder Wealth," (forthcoming in J. of Fin. Econ.) 1987. See also Office of the Chief Economist, S.E.C., "The Effects of Poison Pills on the Wealth of Target Shareholders" (1986).

indicated that share prices increased after firms reincorporated in Delaware. 11/

Or consider dual-class recapitalization and other disparate voting rights measures. These tend to dampen the discipline of the corporate control market, but a study by the Commission's Office of the Chief Economist showed that their effects on stock prices when announced were insignificant, and even positive over a longer period of time. 12/ In some situations the market may regard these measures as enhancing corporate earnings prospects, despite the marginal sacrifice of managerial accountability. If this is the case, then the issuance of such stock cannot necessarily be regarded as an abuse of discretion.

Managerial discretion or control is part of a package that the corporation offers to the capital markets. I don't believe that evidence supports the proposition that certain measures insulating managers enhance the earning prospects of the corporation. Some of them may even brush the line between good faith business judgment and self-dealing. However, there are many, perhaps many in this room, who vehemently disagree with that judgment. I am willing, within the bounds of a manager's basic duties of care and loyalty, to give them their opportunities in the market. If experience shows, as it has not thus far, that such job tenure arrangements do payoff for investors, then investors' funds will flow toward corporations that provide them. Otherwise investors will find better alternatives.

11/ P. Dodd and R. Leftwich, The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation, 53 J. of Bus. 259-80 (1980).

12/ Office of the Chief Economist, S.E.C., "The Effect of Dual-Class Recapitalizations on the Wealth of Shareholders" 1987.