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Institutional Investors Ante Portas: A Comparative Analysis of an Emergent Force in Corporate America and Germany

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In both the United States and Germany institutional investors hold a large proportion of the common stock of publicly traded companies. In the United States in 1990 institutional investors held 43 percent of all publicly traded common stock, 52 percent of the top fifty U.S. companies, and over 60 percent of eight of them with one outlier at over 75 percent.[1] Projections for the turn of this millenium foresee a further increase of institutional ownership in the magnitude of two-thirds.[2] The lion's share will likely be taken by the exponentially growing private and public pension funds.

In Japan the percentage is even higher. An empirical study in 1984 reveals that roughly 70 percent of the common stock of large Japanese enterprises is held by institutional investors and other companies.[3] In recent publication, the investment banking powerhouse Nomura Securities has predicted that during the next five years investment capital will more than double, accumulating to $1.2 trillion.

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1. *See* C. K. Brancato & P. R. Gaughin, The Growth of Institutional Investors in U.S. Capital Markets 21 (1988) (published in November of that year by the Institutional Investor Project, which was established by the Center for Law and Economic Studies at the Columbia University School of Law in collaboration with the New York Stock Exchange (NYSE)).

2. *Id.* at 20.

3. *See* Steven Barber, *A Close Circle of Friends*, Institutional Investor, Feb. 1991, at 35. For an in-depth analysis of the distribution of share capital in Japanese corporations, see Maeda, *Kabunushi no Kigyo Shihai to Kantoku [Management and Management Control by the Shareholders]*, 3 Genadi Kigyo Ho Koza [Lectures on Current Corp. L.] 191–95 (1985). A similar panoramic overview of what has occurred in France is provided by P. Collin, *Qui est l'actionnaire aujourd'hui et à quel mobile répond-il?*, Revue de Droit des Affaires Internationales [Rev. Dr. Aff. Int'l] 437–40. (1989).

In contrast, the role of institutional investors in the German stock market is of less significance. Some members of the financial community have deplored this phenomenon. They interpret it as proof of the underdevelopment of the German stock market.[4] Nevertheless, the fact is that an ever increasing trend towards concentration in the economy exists. Currently, between 150 and 200 truly multinational companies are competing in the world market. The world market also features a markedly growing tendency towards an institutionalization of corporate ownership. In this context it is apt to distinguish between national and foreign investors.

Within the first group, domestic public investment funds carry the lowest weight. A total number of thirty-one enterprises, which adhere to the Federal Association of German Investment Companies (Bundesverband Deutscher Investmentgesellschaften), manage 132 public funds with globally diversified portfolios. But fund capital amounts only to DM 16.6 billion; the big chunk lies with the insurance companies, the pension and death benefit funds, as well as professional benefit funds. For example, according to the quarterly released statistics of the Federal Commission for the Supervision of the Insurance Industry (Bundesaufsichtsamt für das Versicherungswesen), the insurance sector had amassed securities worth DM 667.4 billion at the end of 1989. Compared with the previous year the increase amounted to DM 53.7 billion. During the first six months of 1989, however, the size of new investments in corporate stock was rather modest. The life insurance companies that traditionally have the biggest need for investment opportunities, spent only DM 2.6 billion for the acquisition of stock. This figure breaks down to DM 1.5 billion for direct acquisitions and the remainder for indirect investments through special funds. Although, at first glance, this number appears to be a *quantité négligeable,* the amount gains a larger dimension when compared to the net growth of cash infusions in German corporations in 1989, which amounted to only DM 7.3 billion.[5]

Foreign institutional investors are on a much faster growth track. The Federal Bank of Germany (Deutsche Bundesbank) explains why:

> In light of the excellent profitability of German publicly traded companies, the, according to international standards, relatively low P/E ratio on this market and the continuously favourable macroeconomic prospects increasingly placed German corporate stock in the focus of attention of foreign institutional investors.[6]

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4. *See* Helmut Guthardt, *Pensionskassen und Börse,* 43 WERTPAPIERMITTEILUNGEN [WM] 1789–96 (1989); K. H. Schneider-Gädicke, *Die Börse im Umbruch,* 43 ZEITSCHRIFT FÜR DAS GESAMTE KREDITWESEN [ZfgK] 336, 340 (1990).

5. MONTHLY REPORT OF THE DEUTSCHE BUNDESBANK, June 1991, at 57. The same number for 1990 is DM 7.3 billion. *See* MONTHLY REPORT OF THE DEUTSCHE BUNDESBANK, July 1991, at 57. The total market capitalization of all issued common shares of German publicly traded corporations amounted to about DM 586 billion in June 1991. STATISTICAL SUPPLEMENT TO THE MONTHLY REPORT OF THE DEUTSCHE BUNDESBANK, SERIES 2, STATISTICS ABOUT THE SECURITIES MARKET, July 1991, at 41.

6. MONTHLY REPORT OF THE DEUTSCHE BUNDESBANK, March 1990, at 18. More recent development during the second half of the last decennium is summarized in MONTHLY REPORT OF THE DEUTSCHE BUNDESBANK, April 1991, at 26–27.

A second element was, of course, the growth of funds in the hand of foreign institutional investors searching for first-class investment opportunities.

Those two factors contributed to a major transfer of ownership from domestic to foreign owners, whereas the latter took part in new stock issues to a much lesser extent. The annual report for 1989 displays the concern with which the Bundesbank observes this development:

> In contrast to the growing readiness of national investors for long-term fixed income investments, the year 1989 was disappointing insofar as the private investor community could not be mobilized for long-term oriented stock purchases. In fact, the domestic nonfinancial segment reduced its holdings of German dividend yielding securities by net sales in the value of DM 18 billion.[7]

This statement, however, comes as no surprise to the experts of the German capital market. The decline of the private sector is an ongoing trend over at least the last two decades, which has not yet consolidated at a base level. Whereas in 1965, 27 percent of corporate stock was held by private investors, in 1985 the number shrank to only 17 percent.[8] On the other hand, the Bundesbank reports that under the lead of institutional investors foreign stock acquisition climbed to a new all-time high of DM 23.3 billion.[9]

In total, foreign institutional investors are alleged to hold close to a 20 percent stake in corporate Germany. However, this average figure is somewhat misleading because most of the holdings are clustered around a limited number of sixty to seventy corporations with a broadly dispersed share capital. In those companies, absent a predominating major shareholder, the aggregated institutional holdings are far above the average. It will only be a matter of time, if not already reality, before the institutional holdings add up to the majority.

When analyzing each company one must not be deceived by the impressive numbers of small shareholders. Commerzbank AG, Frankfurt/M., for example, which after the recently completed takeover of Vereins- und West-Bank AG, Hamburg, by Bayerische Vereinsbank AG, Munich,[10] fell back to the fourth

7. REPORT OF THE DEUTSCHE BUNDESBANK FOR THE YEAR 1990, at 4. This concern did not vanish in 1990, since the REPORT OF THE DEUTSCHE BUNDESBANK FOR THE YEAR 1990, at 58, is clouded with skepticism:

> Domestic non-banks took the opportunity of lower stock prices for large purchases, whilst at the same time foreign investors increasingly switched sides to the selling parties on the market. Whether the enhanced holdings express the macroeconomically desirable willingness for long-term investments remains to be seen. In the face of the active demand for option instruments in their various forms that is likely to be motivated by speculation, there are certain doubts as to drawing this conclusion.

8. *See* Michael Hauck, FRANKFURTER ALLGEMEINE ZEITUNG, June 13, 1987.

9. *See supra* note 6. This figure does not capture the increase of active investments which amounted to DM 4.3 billion in 1989.

10. *See* 43 ZfgK 830 (1990). For a survey of the ten biggest credit institutions in 1986 and 1988 see MONOPOLKOMMISSION, HAUPTGUTACHTEN 1988/1989. WETTBEWERBSPOLITIK VOR NEUEN HERAUSFORDERUNGEN. MONOPOLKOMMISSION, HAUPTGUTACHTEN 1991, at 161 (tbl. 8). Westdeutsche Landesbank Girozentrale (WestLB) which, in terms of total assets (DM 153.1 billion), holds the fifth position after Deutsche Bank AG (DM 274.2 billion), Dresdner Bank AG (DM 211.8 billion), Commerzbank AG (DM 168.8 billion) and Bayerische Vereinsbank AG (DM 153.9 billion) *(see id.)* has emerged from an amalgamation of the central transfer bank (Girozentrale) and the state bank (Landesbank) of the Federal State (Land) Northrhine-Westphalia in 1972. WestLB is publicly owned

position among the private universal banks, is proud to count 190,000 stock owners. Yet, when allocating the total outstanding share capital to institutional and private investors, it turns out that 42 percent are owned by the former group and 58 percent by the latter.[11] Deutsche Bank AG, Frankfurt/M., follows a similar pattern. 297,000 private shareholders share 56.4 percent of the bank's equity capital of DM 2.2 billion, whereas the remainder is kept in the deposits of 7,300 institutional investors. This apportionment shows a significant increase of institutional holdings by 4 percent, largely attributed to the enhanced demand for investment funds.[12]

An even more striking example is VEBA AG, Düsseldorf, a far-flunged conglomerate with interests in the energy and chemical industry as well as in retail business. Of the 543,000 shareholders, 97 percent are regarded to be private individuals. However, they own merely 30.5 percent of the common stock. Nearly 55 percent is held by domestic and foreign institutional investors. Particularly, the foreign quota has increased from 23 percent in 1986 to 43 percent in 1990 after the successive privatization of VEBA AG.[13]

The growing financial participation of institutional investors raises the question whether it has a symmetric impact on the corporate decision-making process. Particularly in the United States, institutions have been seeking a greater say in the affairs of companies in which they invest. The agenda consists of three essential issues where they claim the right both of consultation and codetermination: not only fundamental decisions, but also business policy and day-to-day operations; recruitment and promotion of key personnel; and the distribution of profits.[14]

The underlying thrust of the aforementioned list is the (partial) reunification of ownership and management. What was lauded by Berle and Means[15] more than half a century ago to be the genius of the firm is on the edge of being proved an anachronistic chimera under the modern circumstances of financial corporatism. Classical assumptions are called into question. The emerging owners of publicly held firms are now on equal terms with the incumbent management as regards size, power, and sophistication.[16] If properly channeled, this unique set of qual-

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by local authorities and the Federal State. The still prevailing business objective is to act as a house bank to the federal government, although a number of ventures were undertaken in the past to broaden the scope of activities. The most spectacular move was the recent conclusion of a cooperation agreement with London-based Standard Chartered Bank for the purpose of pooling the merchant bank activities. *See* 34 DIE AKTIENGESELLSCHAFT [AG] R 392 (1989).

11. *See* 35 AG R 74 (1990).

12. 36 AG R 242 (1991).

13. *See* Uwe H. Schneider, *Auf dem Weg in den Pensionskassen—korporatismus*, 35 AG 317, 320 (1990).

14. *See* Ruder, *The Impact of Institutional Investors on Large Corporations*, SEC News Release, Oct. 11, 1987, at 2.

15. A. A. Berle & G. C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY 1932 (rev. ed. 1967).

16. Richard M. Buxbaum, *Institutional Ownership and the Restructuring of Corporations*, *in* FESTSCHRIFT FÜR ERNST STEINDORFF ZUM 70. GEBURTSTAG AM 13. MÄRZ 1990, at 7, 23 (Jürgen F. Baur, Klaus J. Hopt, Peter Mailänder eds., 1990).

ifications provides a lever to make management more respondent to the needs of shareholders and other corporate constituencies, such as, employees, customers, suppliers, and local communities.[17]

The emerging power, and already demonstrated ability of institutional investors to exercise it, inevitably triggers dissonances in the fine-tuned triad of ownership, finance, and control. Part I of this article serves to exemplify the discord by reviewing the highlights of the 1990 proxy season, which could be the alarm signals of what may become an electoral upheaval—early stirrings that could lead to the creation of the republic of corporate America. Part II attempts to explain why fund managers cannot evade the corporate governance debate like individual shareholders by simply "taking a dollar today, in lieu of waiting for tomorrow."[18] Part III appraises a number of proposals that have been advanced to restore shareholder rights and the accountability of corporate managers to shareholders. Part IV analyzes the possible implications and challenges of the paradigmatic change in corporate governance originated in the United States for corporate Germany. A summary and concluding remarks are presented in part V.

I. Canvassing Institutional Investors

The basic dynamics of the 1990 proxy solicitations that bombarded shareholders with persuasive pleas until the very day of a company's annual general meeting had a great deal in common. Usually, the financial returns and the growth of the company under attack fell short of the average indices for the Fortune 500 corporations or, as a more specific benchmark, for the industry in question. Therefore, incumbent management was blamed for having failed to create value for the owners. Further, and the focal point of criticism, was the creeping disenfranchisement of the shareholders by means of barriers to potential corporate control transactions such as the introduction of shareholder rights plans (poison pills), staggered board terms, and fair price provisions.

The isolated and, a fortiori, the combined effect of those defensive efforts has had an adverse impact on institutional investments, particularly since in the late 1980s courts have shown a greater degree of receptivity to strategies aimed at the preservation of corporate independence rather than mediatization.[19] And this is only one facet of the apocalyptic writing on the wall. State legislators have increasingly enacted antitakeover laws,[20] banks as the indispensable financial

17. Martin Lipton, *Corporate Governance in the Age of Finance Corporatism,* 136 U. PA. L. REV. 1, 6 (1987).

18. Statement ascribed to T. Boone Pickens, Jr., Chairman of the Board of Mesa Petroleum. Louis Lowenstein & Ira M. Millstein, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad?: Introduction,* COLUM. BUS. L. REV. 739, 745 (1988). *See also* Warren A. Law, *A Corporation Is More Than Its Stock,* HARV. BUS. REV., May–June 1986, at 80, 83.

19. *See* Leo Herzel & Richard W. Shepro, *Delaware Supreme Court Boosts Powers of Takeover Target Boards,* FIN. TIMES, Mar. 22, 1990, at 16.

20. *Contempt for Shareholders,* THE ECONOMIST, Apr. 28, 1990, at 16. An overview of the most recent legislative history is provided in Stephen Mahle, *Proxy Contests, Agency Costs, and Third*

intermediaries have shown less enthusiasm for putting up their own monies on the line in takeover situations, and the junk bond market has fallen into a coma.[21]

In the face of such a bleak outlook, the following scenario emerges: The largest shareholder takes the initiative and urges corporate management to adopt a far-reaching restructuring program. However, his venture is an empty threat if he does not find allies among the other shareholders. Addressing the limited number of institutional investors with their extraordinarily great voting power is evidently the most efficient way of forming an allied reform bloc. As this is an open secret for the incumbent management, it also begins courting institutional investors. Which competitor will finally succeed hinges on the bargain each has to offer. However, it appears as if incumbent management enjoys a competitive advantage in drawing on its possession of the current list of shareholders,[22] its full access to corporate assets to finance its solicitation,[23] and its bonus of power. Just like every human being, fund managers cannot exempt themselves from the psychological bias of staying with people to whom they have accommodated over the years. They are afraid of the uncertainties of new characters who may disturb the routine: *Semper ita fecerunt!*

A. Harold Simmons' Crusade for Shareholder Democracy

1. *Setup*

Houston-based NL Industries Inc. (NL) bought under Dallas investor Harold C. Simmons' aegis an 18.95 percent stake in Lockheed Corp., which equaled an investment of $550 million. From the first acquisition of Lockheed shares by NL on August 29, 1988, to February 14, 1990, Lockheed's stock price dropped by nearly 40 percent from $54-¾ to $37-⅜—a decline in aggregate market value of over $1.3 billion that wiped out $100 million of Simmons' initial cumulative investment.

Based on the obvious perception that Lockheed management was failing to deliver adequate return on its shareholders' investment, Simmons met with Daniel M. Tellep, Lockheed's chairman of the board and chief executive officer, and requested that NL be given up to six of the fifteen seats on Lockheed's board of directors. Although Tellep and his fellow directors owned in aggregate less

Generation Antitakeover Statutes, 15 J. Corp. L. 721, 750–55 (1990). The nation's newest and toughest antitakeover statute was passed by the Pennsylvania legislature on April 23–24, 1990. For a more complete discussion, see *infra* notes 32–33 & accompanying text.

21. *See* Louis Lowenstein, *Market Sees That Junk Bonds Are What They Are, Well, Junk,* N.Y. Times, May 13, 1990, at 18.

22. Under the so-called "disclose or mail" principle laid down in SEC-Rule 14a-7, management may elect to mail an insurgent's proxy materials to stockholders rather than supplying the insurgent with the current shareholder list. 17 C.F.R. § 240.14a-7 (1991).

23. *Cf.* Bernard S. Black, *Shareholder Passivity Reexamined,* 89 Mich. L. Rev. 520, 536 (1990); James E. Heard, *Institutional Investors and Corporate Governance: The U.S. Perspective, in* International Corporate Governance 245, 252 (J.C.F. Lufkin & D. Gallagher eds., 1990).

than 1 percent of the common stock, they declined Simmons' request for board representation. On February 21, 1990, NL amended its Schedule 13D filing to disclose its determination to commence soliciting proxies in support of the election of fourteen nominees of NL to Lockheed's board of directors. Less than two weeks later, the company announced it had moved up the annual meeting from mid-May to March 29, 1990.

Simmons recognized from the outset that his most important audience were the institutional investors, of whom a relatively small group of 120 owned over 25 percent of Lockheed's outstanding stock. The collective holdings of all institutions amounted to 60 percent. Simmons courted them vigorously by traveling around the country and discussing issues related to shareholder democracy such as confidential voting, removal of Lockheed's poison pill, placing restrictions on greenmail, and opting out of the Delaware antitakeover law. He also assembled a slate of board nominees with close ties both to the aeronautics industry and the military, reflecting Lockheed's position as the sixth largest defense contractor within the United States. The most prominent candidates were former Republican Senator John Tower of Texas, who had chaired the Armed Services Committee from 1981–85 and President Ronald Reagan's Special Review Board on the Iran-Contra affair, and Admiral Elmo R. Zumwalt, Jr., the former Chief of Naval Operations. Provided the members of his slate were elected, Simmons promised that he would commission an in-depth analysis of Lockheed's business policy and attempt to transform Lockheed into a high-tech manufacturer with competencies in the nonmilitary product market. Hence, his takeover strategy was to gain control over Lockheed through a proxy fight without making a concurrent cash tender offer.

In supporting confidential voting Simmons picked up a proposal advanced by Harrison J. Goldwin, then Comptroller of the City of New York and, as such, trustee of the New York City Employees' Retirement System, to require all proxies, ballots, and voting tabulations that identify shareholders to be kept secret. The suggestion was congenial because its objective was to avoid real or perceived coercion of individual shareholders (for example, subscribers to an Employee Stock Ownership Plan) and institutional money managers by business management. Both groups have to fear retaliation in case of nonobservance of management's recommendations by losing either their jobs or lucrative business opportunities.

Standing up for opting out of section 203 of the Delaware General Corporation law[24] happened to coincide with a criticism of another major institutional shareholder. The California Public Employee's Retirement System, a $56 billion public pension fund with a 500,000-share interest in Lockheed, had repeatedly asserted that Lockheed's reincorporation in Delaware (from California) in 1986 was for the mere purpose of taking the company "out of play." Opting out would

24. DEL. CODE ANN. tit. 8, § 203 (1990).

partially reverse this allegedly selfish managerial decision by allowing takeovers with the reasonable expectation for the shareholders of cashing in a corporate control premium. After all, the power to decide whether to accept or reject an acquisition proposal would be removed from the board level and shifted to the general, or in case of emergency, to a special shareholders' meeting.

2. *Outcome*

The canvassing of the institutional investors whose goals dovetailed with Simmons' proved to be a sweeping success, including to everybody's surprise the detoxification of the poison pill. Although all the incumbent board members were reelected by a margin of 62 percent to 38 percent,[25] Lockheed had agreed up front to enlarge the board by three seats specifically reserved for representatives of the institutional investors' clientele.[26] The demand both for the prohibition of greenmailing and for the introduction of confidential voting put Lockheed's management under duress. After stalling tactics in the run-up phase, management rapidly gave in as the annual meeting approached and the likelihood of a close election appeared. In another last-minute effort to lure large shareholders who were leaning toward support of Simmons, Lockheed announced that it would subordinate to the shareholders' will and opt out of section 203 of the Delaware General Corporation law on the condition that a significant minority of shareholders voted in favor of such action.

As would be expected, on the day of the annual meeting the New York Times trumpeted in bold letters: "Lockheed Gives in to Big Holders—Concession Made to Thwart Simmons."[27] Simmons himself was quoted with the euphoric statement: "We've achieved a lot here. We focussed them on profits, and we gave them an education in shareholders' rights."[28]

3. *Critical Evaluation*

Without doubt, Simmons' proxy fight generated a major shake-up within the entrenched Lockheed organization. For a neutral observer, however, the conclusion is nearly irrefutable that the institutional investors came off best from this continually headline-hitting corporate brawl. Simmons won a Pyrrhic victory, being left with a paper loss of $100 million on his one fifth stake in Lockheed and an additional $6 million in out-of-pocket expenses for his proxy fight campaign without having achieved his cardinal goal of direct board representation. On the

25. *See* Michael Lev, *Lockheed Claims Victory over Simmons,* N.Y. TIMES, Apr. 11, 1990, at D1, D4; Rick Wartzman & Karen Blumenthal, *Lockheed Wins Proxy Battle with Simmons,* WALL ST. J., Apr. 11, 1990, at A3.

26. *See* Karen Blumenthal & Rick Wartzman, *Lockheed Corp. Refuses to Give Simmons 3 Seats,* WALL ST. J., Mar. 28, 1990, at A3; Richard W. Stevenson, *Institutional Investors to Get a Seat on Lockheed's Board,* N.Y. TIMES, Mar. 28, 1990, at D1, D8.

27. Richard W. Stevenson, *Lockheed Gives in to Big Holders,* N.Y. TIMES, Mar. 30, 1990, at D1.

28. *Id.* at D4.

other hand, the incumbent management was stigmatized as a group of appeasers. In the beginning they took up a bold stance, but their verbal shows of strength were not followed by any energetic opposition when the real battle took place in the assembly hall of the general shareholders' meeting. Management preferred to shy away from an open confrontation with Simmons that could have jeopardized their job security.

B. THE BELZBERG BROTHERS' SIEGE OF ARMSTRONG WORLD INDUSTRIES, INC.

1. *Setup*

The target company of this takeover battle was Armstrong World Industries, Inc. (Armstrong), a fully vertically integrated flooring and building products company based in Lancaster, Pennsylvania. Since 1989, Armstrong's management had carried out a business plan aiming at organizational restructuring and salaried work force reduction. "Back to core business" and slashing overhead costs was incumbent management's hasty reaction after it had learned of a rapid accumulation of a large block of shares in the sphere of influence of the Belzberg brothers, then one of Canada's wealthiest family clans, based in Vancouver, British Columbia. Their deliberate successive buying of Armstrong's stock was mainly engineered through three corporate affiliates. As of April 2, 1990, they owned an aggregate of 4,780,400 common shares, constituting approximately 11.51 percent of the outstanding common shares and 10.14 percent of the outstanding securities entitled to vote at the annual meeting.

In the meantime, in April 1989, the Belzbergs had examined in vain the possibility of a business combination with Armstrong on a negotiated basis. In response, Armstrong's board of directors turned the tables and instituted an employee stock ownership plan (ESOP). On June 26, 1989, Armstrong inquired with the Belzberg affiliates whether they were willing to sell their stakes in light of this development. The Belzbergs declined outright. As of April 2, 1990, the Mellon Bank, the trustee of the ESOP, held beneficial ownership of 5,623,358 shares of a new series of convertible preferred stock equivalent to 11.74 percent of the outstanding common stock.

On February 1, 1990, one of the affiliates of the Belzberg concern retained the investment banking firm Donaldson, Lufkin & Jenrette Securities Corp. to act as its exclusive financial advisor with respect to its involvement in Armstrong. On March 2, 1990, the Belzbergs announced publicly that, "in view of developments at and pertinent to Armstrong, and financial markets, as well as general economic conditions," they had asked their investment banker to approach third parties to discuss the possibility of acquiring all or part of Armstrong's business, either alone or in conjunction with them.[29] This abrupt shift from a determined

29. Peter Cooney, *Belzbergs Seek to Enlist Third Parties in Pursuit of Armstrong*, REUTER BUS. REP., Mar. 5, 1990.

go-strategy to a half-hearted partial go- or even no-go-strategy was hardly persuasive because cloudy factors were already looming before the March 2nd announcement.

First, Armstrong's stock price had not shown any significant appreciation since April 27, 1987, when the reign of the four directors presently standing for reelection began. The price then was $33.5; on February 2, 1990, it amounted to $35, and by March 30, 1990, the closing price of a common share was $33.125. Taking further into consideration the aggregate dividends of $2.96 per share paid during the almost three-year period, the investors in Armstrong shares were left with an annual yield of approximately 3 percent, well below the inflation rate during the period.

Second, under the heading of developments related to Armstrong's product markets, came the sharp downturn in the housing and construction industry. Consequently, the demand for Armstrong's durable goods was slack.

Third, the extinction of the junk bond market was already a fait accompli following the collapse on October 7, 1989, of the management-led takeover bid for UAC Corp. This collapse severely pinched not only the Belzbergs' but also other corporate raiders' financing options. Likewise, the nebulous reference to the "general economic conditions" was an empty shell.

As a result, the Belzbergs were left with a $31 million paper loss in an unsuccessful hostile takeover attempt.[30] However, instead of giving up and liquidating their stock position,[31] the Belzbergs decided to pursue their original goal of obtaining corporate control over Armstrong by waging a proxy fight at the annual meeting scheduled for April 30, 1990.

To rectify the dismal state of affairs, the affiliates pertinent to the far-flung financial concern of the Belzberg family formed the Shareholder Committee for Responsible Corporate Governance of Armstrong World Industries, Inc. (the Committee). Its agenda was twofold. First it asked shareholders to support the election of a slate of four board nominees to fill the vacancies of Armstrong's staggered board that were to expire at the 1990 annual meeting. Second, the Committee proposed five amendments to Armstrong's articles of incorporation that were designed to make it harder for Armstrong's board to ignore the shareholders' readiness for a sale or a merger. The general thrust was to opt out of several provisions in the Pennsylvania Business Corporation Law (the PBCL)[32] that were endorsed by Armstrong's top management and sponsored by State Senator Noah Wenger, whose constituency was in Lancaster, the site of Armstrong's

30. *See* Vindu P. Goel & Gary Lamphier, *Samuel Belzberg Plays Down Reputation as a Raider in Armstrong Proxy Fight*, WALL ST. J., Apr. 27, 1990, at 7C.

31. This is what most of the securities analysts expected to happen. *See* Cooney, *supra* note 29 (quotations cited therein).

32. 15 PA. CONS. STAT. ANN. § 2541 et seq. (1991) (originally passed in the General Assembly of Pennsylvania as Session Bill No. 1310 *amended on third consideration*, 1989 Sess. (Dec. 12, 1989, printer's no. 1824)).

headquarters. The PBCL came into effect on April 27, 1990, when Pennsylvania Governor Robert B. Casey signed it so as to protect Armstrong from the Belzbergs' proxy fight scheduled for the annual meeting on April 30, 1990.[33]

The Committee placed emphasis on the 1990 annual meeting as the only chance for the shareholders to act in their self-interest to restore the rights of which the new legislation had deprived them.[34] Afterwards, the Committee explained, the right of initiative would shift to the board of directors. That body would decide in its own discretion which amendments to propose to the shareholders. Accordingly, the Committee submitted the following five proposals to shareholder voting: (1) the right to call a special shareholder's meeting; (2) the right to propose amendments to the articles of incorporation; (3) opting out of the five-year prohibition of business combinations under subchapter F of chapter 25 of the PBCL; (4) immediate effect of the derogation of subchapter F; and (5) permission of majority decisions by written consent.

2. *Outcome*

According to the final tally of the 155 million proxy votes cast, board nominees received about 105 million votes and Belzberg nominees about 50 million. Under the complicated cumulative voting system, which allotted each shareholder four votes per share and the right to divide those votes among the eight candidates in any way he or she chose, including leaving them to proxy solicitor's discretion, incumbent management decided to cumulate its proxy votes to reelect three directors. The Belzbergs cumulated their votes to elect Harvard Business School professor Michael C. Jensen.[35] The binding shareholder vote on the five proposed amendments to Armstrong's corporate charter was deleted from the agenda because a federal trial on their validity was still pending.[36]

Although the Belzbergs averred on the day of their electoral defeat that they would not lift the pressure from Armstrong's incumbent management to constantly explore the possibility of a business combination with another company,[37]

33. *Anti-Takeover Law Takes Effect,* CHI. TRIB., Apr. 28, 1990, at sec. 2, 1-2; *Anti-Takeover Law Signed,* N.Y. TIMES, Apr. 28, 1990, at 34. For an elaborated analysis of the constitutional objections to and the economic implications of the so-called "Armstrong Law" see Thomas C. Paefgen, *Alle Macht dem Management. Das Paradoxon der US-amerikanischen Anti-Takeover-Gesetzgebung am Beispiel von Pennsylvania,* 36 AG 41, 49 *et seq.*, 54 *et seq.* (1991).

34. The freedom of choice to opt out of all or part of the provisions of the Pennsylvania Business Corporation Law (PBCL) was limited to a window of ninety days after coming into force. More than sixty-five companies, equivalent to about 21% of Pennsylvania's publicly traded corporations, including Westinghouse Electric Corp. and H. J. Heinz Co. have made timely use of the exemption. *Cf.* Black, *supra* note 23, at 574; Vindu P. Goel, *Many Top Pennsylvania Firms Opt Out of Provisions and State Anti-Takeover Law,* WALL ST. J., July 27, 1990, at A5.

35. *Management Wins 3 of 4 Contested Seats on Board,* WALL ST. J., May 18, 1990, at C14.

36. Vindu P. Goel, *Armstrong Wins 3 of 4 Contested Seats for Company's Board,* WALL ST. J., May 15, 1990, at A4.

37. In the same vein, Samuel Belzberg's later statement that he regarded the stake in Armstrong as a "long-term" investment. See Gary Lamphier, *Belzberg Says First City Might Drop Risk Arbitrage,* WALL ST. J., May 21, 1990, at C1.

it took them less than four weeks to break their word. On May 30, 1990, the affiliated companies sold all their shares at an estimated $18 million loss, which was partially made whole by a settlement fee of $4.4 million. Under the agreement the Belzbergs dropped all litigation against Armstrong, including a challenge to the constitutionality of the PBCL and a lawsuit seeking a binding vote on the five corporate governance amendments. A nonaggression pact was also accorded for a period of ten years.[38]

3. *Critical Evaluation*

At first sight one is tempted to say that the Belzbergs blooded their collective nose in their raid on Armstrong. A cash outlay of $13.6 million and the additional losses on the invested capital certainly were a dear price for one board mandate in return. Moreover, not only was Armstrong as the specific target company "put out of play" for a decade; the whole market for corporate control in the state of Pennsylvania practically dried up after the enactment of the management-friendly PBCL—which has already gone into the legislative annals as the "Armstrong" bill.[39]

However, one must not overlook the peculiarities of this specific takeover battle. First, the cumulative voting system and the staggered board terms made it easier for incumbent management to wear the Belzbergs down. Second, the Belzbergs fell easy prey to propaganda to damage their self-depicted image as protagonists of shareholder democracy.[40] It only sufficed to recall their aggressive bid for Ashland Oil Company (Ashland) in 1986. Furthermore, their credibility was undermined by a criminal conviction of a member of the Belzberg family because of a violation of section 13(d) of the Securities Exchange Act of 1934[41] in connection with illegal "parking" of stock with an investment bank during the Ashland raid.[42] The personalization of the proxy contest was an ingenious move to drive a wedge between the Belzberg brothers and the other shareholders. The legitimate business concerns were cleverly pushed into the background. It was simple for Armstrong's management to brand the Belzbergs as a pack of greedy wolves in sheep's clothing.

C. BTR's Proxy Contest for Norton Thwarted with Saint-Gobain's Deep Pockets

1. *Setup*

ER Holdings, Inc. (ER) an indirect wholly owned subsidiary of the British conglomerate BTR P.L.C. (BTR) launched a $75 all-cash/all-shares ($1.64 bil-

38. *See Armstrong Sets Pact with Belzberg Firms to Resolve Disputes,* WALL ST. J., June 7, 1990, at B4.

39. Leslie Wayne, *Anti-Takeover Proposal Gains in Pennsylvania,* N.Y. TIMES, Apr. 4, 1990, at B2.

40. A "fighting ad" was placed by Armstrong's management in WALL ST. J., Apr. 25, 1990, at C23.

41. 15 U.S.C. § 78 (1990).

42. Securities and Exchange Commission v. First City Financial Corporation Ltd., 688 F.2d 705 (D.D.C. 1988), *aff'd,* 890 F.2d 1215 (D.C. Cir. 1989).

lion in aggregate) hostile tender offer for Norton Co. (Norton) on March 16, 1990. ER, a Delaware corporation, beneficially owned 325,000 shares (1.7 percent) of Norton common stock as of March 30, 1990. Norton, a manufacturer of abrasives, superabrasives, ceramics, and other engineering materials, was incorporated in Massachusetts.

The $75 per share offer was generally viewed favorably, considering its market price was $58-¼ per share before the offer and the Norton share price had never exceeded $64 since the company's foundation in 1885. Wall Street analysts raised serious doubts as to whether a white knight would come forward, given the depressed state of Norton's markets and the relative generous level of BTR's offer at nineteen times historic earnings.[43] As one analyst observed, "[t]he BTR offer looks like a fair one. To top that price you'd have to have pretty fancy plans."[44]

Nevertheless, Norton's board turned BTR's "inadequate" offer down. Relying on its financial advisor, management came to the conclusion that remaining an independent entity would be a superior alternative to BTR's proposal.[45] Accordingly, Norton established a vigorous defense system. Opposition to the offer was encouraged among employees and local residents, who then for their part lobbied for legislation to thwart the offer. Governor Michael S. Dukakis hastened to sign into law an antitakeover bill that prohibited companies incorporated in Massachusetts from electing more than one-third of their board members each year. The boards were allowed to opt out of the staggered election requirement at any time, but shareholders were not allowed to undo the provision until January 1, 1992, and then only by a two-thirds vote. Thus, BTR could win only three seats of the board out of a total of eleven seats at the annual meeting on April 26, 1990.[46]

2. *Outcome*

Although more than half of Norton's common shares had been tendered, which would have enabled BTR's slate of three directors to take up their seats in the boardroom, Norton abruptly forestalled BTR's progress by concluding a negotiated merger with Compagnie de Saint-Gobain S.A. (Saint-Gobain), a French conglomerate, for $90 a share or about $1.9 billion in cash. Saint-Gobain agreed that Norton's principal business would continue to operate in Worcester. The conclusion of long-term employment contracts with a number of Norton key executives ensured continuity of management.[47]

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43. Martin Dickson, *Changing the Rules of the Ball Game,* FIN. TIMES, Apr. 20, 1990, at 25.

44. William M. Bulkeley et al., *Norton Co. Could Face a Proxy Battle if It Doesn't Accept BTR Takeover Bid,* WALL ST. J., Mar. 19, 1990, at A3.

45. *Norton Rejects Offer by BTR as "Inadequate,"* WALL ST. J., Mar. 30, 1990, at A1.

46. Richard D. Hylton, *Talking Deals: No End in Sight in Norton Battle,* N.Y. TIMES, Apr. 19, 1990, at D2; *New State Law Aids Norton in Bid to Block Takeover,* CHI. TRIB., Apr. 19, 1990, at 3C.

47. Richard D. Hylton, *$1.9 Billion Bid Taken by Norton,* N.Y. TIMES, Apr. 26, 1990, at D1; David Stipp, *Norton Agrees to Be Acquired by Saint Gobain,* WALL ST. J., Apr. 26, 1990, at A3.

Immediately after learning of this surprise bid, BTR reversed itself, sold its 325,000 Norton shares for a $13 million profit, withdrew its board nominees, and told Norton's stockholders who had already tendered their shares they could pull them back.[48] John C. Cahill, BTR's chief executive officer, had always declared that he regarded the Norton offer as fair and final and was only willing to consider increasing it if confidential information initially withheld by Norton showed that a higher price was warranted.[49] He was loathe to be involved in an overreaching price battle.

3. *Critical Evaluation*

Norton's board strategy shows a striking similarity with Armstrong's mode of operating. Both successfully lobbied state legislators for support. The comfortable coalition between politicians and local corporate citizens not only put the out-of-state intruders to flight, it also erected new legal obstacles on the free market for corporate control. After the strengthening of the state antitakeover law, the onus to lobby the institutional investors shifted to the bidding companies. In the Belzberg case, low public opinion created an unbridgeable credibility gap, whereas BTR failed because of its self-discipline in not going beyond its standards of financial reasonableness. In both situations institutional investors were not confronted with a dilemma because each bid lacked a key success factor in financial markets: credibility or superlative terms. American xenophobia was at best, if at all, a marginal issue, as can be easily exemplified by Norton's white knight, Saint-Gobain.[50]

D. American General Wins the Proxy Battle against Torchmark but Loses the Independence War

1. *Setup*

On March 26, 1990, Torchmark Corp. (Torchmark), an insurance and financial services company, made an unsolicited offer of $50 per share, or about $6.3 billion in cash and stock, for American General Corp. (American General). One week later Torchmark withdrew the bid, saying American General had not responded to its offer in time.

Simultaneously, however, Torchmark proposed its own slate of five independent nominees for American General's board, indicating that it would halt any further acquisition attempts in the event of defeat at the latter's annual meeting on May 2, 1990. Moreover, it introduced a nonbinding resolution seeking to force American General's board to put the company on the auction block.[51] Having established

48. *BTR Has Sold Its 1.7% Stake in Norton Co.*, WALL ST. J., Apr. 27, 1990, at B9A.

49. *See* Lawrence Ingrassia, *BTR PLC Begins Proxy Fight in Bid for Norton Co.*, WALL ST. J., Apr. 13, 1990, at A2.

50. *See* David Duffy, *Norton Backlash "Not Xenophobic,"* FIN. TIMES, May 2, 1990, at 23.

51. *See* Rick Christie, *Torchmark Bid to Be Dropped if Slate Fails*, WALL ST. J., Apr. 16, 1990, at A3.

its position, Torchmark conducted an intensive election campaign focusing on American General's institutional investors, who controlled about 69 percent of the latter's common shares. Interestingly enough, about 30 percent of the stock was owned by institutions that also owned 8 percent of Torchmark shares.

2. *Outcome*

On May 2, 1990, Torchmark emerged victorious. Although General American won the proxy vote by a margin of 60 percent to 40 percent, Harold S. Hook, the chairman of the board and chief executive officer, stunned the shareholders by saying that American General was up for sale. Once the company had been "put into play," he felt compelled to take the appropriate steps, particularly in light of the increased vulnerability of the company due to reduced earnings per share during the last three years and the accordingly depressed stock price. By initiating the action, American General's chieftain hoped to have a better control over the auction process and to extract the maximum shareholder profit.[52]

3. *Critical Evaluation*

General American's unconditional surrender was prompted by mounting pressures within the life insurance industry for consolidation and cost cutting. Incumbent management came to the inevitable conclusion that it could not achieve the turnaround without external help. The chronic lag behind the industry average made the shareholders increasingly impatient and more susceptible to a corporate control transaction, be it in whole or piecemeal. Fending off Torchmark would only have allowed some breathing time before the next contender would have caused trouble anew.[53] Hence, management would have been nearly constantly distracted from its genuine task of running the company. Therefore, it chose pragmatically to get the unpleasant matter over and done with.

Institutional investors were actively relieved of a looming clash of interests that probably sooner or later would have cost incumbent management its position in any event. Judged from this perspective, the 1990 proxy contest only accelerated a development that had its roots in the company's dissatisfying past performance. Management knew that its resistance against Torchmark was useless after roughly 50 percent of the shareholder votes were cast in favor of the nonbinding referendum that American General be put up for sale.[54]

52. *Cf.* Thomas C. Hayes, *American General Up for Sale*, N.Y. TIMES, May 3, 1990, at D1 ("We wanted to be in control of the process and not be pecked to death by ducks.").

53. *See* Randall Smith & Michael Allen, *American General Proxy-Vote Victory Wouldn't End Pressure to Lift Stock Price*, WALL ST. J., May 2, 1990, at A3.

54. The outcome of the election was kept secret by the defeated management. Randall Smith, *Storming Barricades with a Proxy*, WALL ST. J., May 10, 1990, at C1, C17. Their subsequent process of deduction was in line with recent empirical evidence suggesting that management may win the battle in proxy contest, but insurgent shareholders win the war. A 1989 study of sixty major proxy contests revealed that while management prevailed in proxy contests 70 percent of the time, in most cases a new management team was in place within three years of the contest.

E. Carl C. Icahn versus USX Corp.: Breaking Up Is Hard to Do

1. *Setup*

In the summer of 1986 Carl C. Icahn started to buy stock of USX Corp. (USX). He stopped his purchases at a 13.3 percent stake, making him the largest individual shareholder, in order not to trigger a poison pill provision that prevented anyone from acquiring more than 15 percent of USX stock without its becoming prohibitively expensive.

Rather, in spring 1990 he submitted a spin-off proposal to the shareholders aiming at a de-diversification of USX. The separation into two distinct stockholder-owned companies, that of Marathon Oil Company and all other energy-related USX business units on the one hand and former U.S. Steel Corp. on the other hand, would in Icahn's view have yielded an aggregate value of $48 a share instead of the current stock market price oscillating in the low $30s. According to Icahn's calculations, with its appreciation of 8.4 percent in the last fifteen years, USX had failed to keep pace with the market price increases recorded by either pure oil or steel companies, let alone with the 308 percent increase in the S & P 500 stock index during the same period.

According to the terms of the proposal, USX would have distributed as a dividend to all shareholders a common stock interest of not less than 80 percent of the equity of U.S. Steel, which would have consisted of all assets and liabilities (not to include more than $1.5 billion of long-term debt) associated with USX's steel business. Stockholders would have retained their common stock interest in USX, which would have then primarily consisted of Marathon Oil Company and the minority interest, if any, in U.S. Steel Corp. The implementation of the spin-off plan was alleged to be tax-free both to USX and its shareholders and would retain USX's existing tax-loss carryforwards.

Icahn based his proposals on three arguments:

- If and when unrelated businesses are separated, investors and financial analysts are able to price each of the separate entities more accurately by taking into consideration their independent prospects and strategic orientations.
- The management of each separate business unit can be held more accountable for its performance as each business stands on its own without the benefit of cross-subsidization.
- The creation of distinct publicly traded companies provides a wider choice of investment opportunities, thus leading to more efficient capital formation.[55]

55. For a critical assessment of those popular explanations for the empirically established positive stock market reaction to spin-offs see Katherine Schipper & Abbey Smith, *The Corporate Spin-Off Phenomenon*, Midland Corp. Fin. J., Summer 1984, at 27–34. *See generally* Lindley H. Clark, *De-Diversification Aid to Productivity*, Wall St. J., May 14, 1990, at A1.

On April 25, 1990, Icahn went a step further by announcing plans to acquire additional $800 million of USX stock, provided, however, that his spin-off proposal met with shareholders' majority approval at the firm's forthcoming annual meeting and the poison pill provision was abolished.

2. *Outcome*

On the day after USX's general shareholders' meeting on May 8, 1990, Mr. Icahn conceded that his highly visible campaign with a $10 million budget for mass media advertising had come to nothing. Although some institutional investors were sympathetic to Icahn's plan, they chose to support the incumbent management, which had signaled that it too would consider the merits of Icahn's plan at some future date when the steel market was in less turmoil. Apparently, institutional investors shrank away from the risk of further change after USX's management had initiated a massive, painful restructuring, which had begun to pay off with improving financial results. Hence, Icahn faced an uphill battle against a winning board team. He failed to persuade the institutional investors that his superior managerial skills could generate even higher value for USX's pool of assets.[56]

3. *Critical Evaluation*

Icahn's proxy contest is to be distinguished from the Torchmark versus American General proxy battle insofar as it was not intended also to resolve a power struggle. Rather, it only asked for the adoption of a nonbinding shareholder resolution on a fundamental corporate decision. More precisely it revolved around a substantive disagreement over corporate strategy, whether or not USX would function more effectively if it spun-off its steel-making unit from its oil and gas operations. Although in all likelihood Icahn had made his initial USX investment with a takeover in mind, the complex debate over corporate strategy in the proxy arena never escalated into a shadow takeover attempt as could be observed with the Belzbergs. Furthermore, the USX election had just as little in common with the Lockheed case, since no shareholder rights were at stake that called for a resolute defense action against further erosion.

In the light of these particular circumstances institutional investors did not regard it as opportune to flex their muscles because Icahn's constant presence provided them with greater leverage for putting pressure on management to improve USX's share price than could a single warning shot that incumbent management might possibly ignore. In fact, USX's board of directors resorted to

56. Jonathan P. Hicks, *Icahn Seen Failing in USX Vote,* N.Y. TIMES, May 8, 1990, at C1. It should be noted that USX's management let pass a waiting period of less than one year before it recognized Icahn's business acumen as being sound and convincing enough to carry out the restructuring he had sought in 1990. *See* Jonathan P. Hicks, *USX to Issue Stock Linked to Steel Unit,* N.Y. TIMES, Feb. 1, 1991, at C1.

Lockheed's successful strategy of compromising.[57] They adopted the idea of a corporate spin-off so that Icahn's competitive advantage was neutralized. In addition, the tactic of denigration that occurred in the Belzberg case came into play. The subtle allusions to Icahn's past as a corporate raider shrilled the alarm bells within the financial community. Icahn's profession that he had seen the light in the meantime was widely interpreted as an opportunistic dissimulation.

II. The Inapplicability of the "Wall Street Rule" to Institutional Investors

With rare unanimity, the statements of the 1990 proxy season articulated the categorical appeal for increased shareholder participation in corporate governance as opposed to deference to corporate decision-making. From the institutional investors' (pension funds not subject to the Employee Retirement Income Security Act (ERISA),[58] banks, insurance companies, mutual funds) perspective the question arises whether there is any compelling reason why they should interfere with managerial actions criticized for being contrary to shareholder interest. In contrast to Albert O. Hirschman's[59] more complex exit-voice-analysis, Daniel R. Fischel[60] has accentuated that the availability of the exit option stands in a reciprocal relationship to the importance of voice and voting. Since interference entails the expenditure of time, effort, and money to make an informed opinion about the legitimacy and validity of the competing proposals, the more rational plan for the canvassed institutional investors would be to sell their stock instead of dedicating more resources to voting. The liquid market in publicly traded shares is claimed to be a superior alternative over participation in corporate governance. Management's departure from the shareholder interest will be punished by the market for capital and corporate control as well as for managerial services. Each market, after all, is a mirror of the available information about its participants and goods. Yet unresolved is the crucial question

57. *See* Richard W. Stevenson, *Talking Deals: Lockheed's Moves in Proxy Fight*, N.Y. TIMES, Apr. 5, 1990, at D2.

58. Pub. L. 93-406, 88 Stat. 832 (1974) (codified as amended at 29 U.S.C. §§ 1001–1168 (1990)). As to the widely unknown responsibilities under ERISA (§§ 401–14), see the enlightening comments of J. E. Heard & J. C. F. Lufkin, *ERISA and Proxy Voting*, *in* INTERNATIONAL CORPORATE GOVERNANCE, *supra* note 23, at 5 *et seq. See also* Eugene Maloney, *Proxy Voting Responsibility under ERISA*, 7 ANN. REV. BANKING L. 259–63 (1988).

59. ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 46 (1970).

60. Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1277–78 (1982). The potential costs and the set of possible regulatory measures at hand to strike a balance between the "voice" and the "exit option" are discussed in John C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 277, 1328 *et seq.*, 1336 *et seq.* (1991).

whether or not the so-called "Wall Street Rule"[61] applies with the same rigidity both to private and institutional investors. At least one economic and one legal argument suggest that the answer is in the negative.

A. Too Big to Vote with the Feet

As already touched on at the beginning, one of the salient features in the evolution of the U.S. capital markets over the last six decades has been the dramatic shift of ownership of securities from individual to institutional investors. Starting in 1950 with assets worth $107 billion and ownership of 8 percent of outstanding corporate equity, in the period from 1981 to 1987 the value of total assets managed by institutional investors more than doubled from $2.1 trillion to $4.46 trillion. In 1986, not less than 42.7 percent of the total stock outstanding was in the hands of institutional investors. Today institutions control assets worth $6 trillion—more than the GNP of the United States—and account for nearly 20 percent of all financial assets and 45 percent of all outstanding equities.

Among them pension funds take the major share of approximately 21 percent of all outstanding U.S. equities. This number translates into holdings of institutional total assets in 1981 of 42.5 percent and in 1987 of 43.5 percent.[62] Hence, pension funds could strengthen their leading position and are likely to continue growing.[63]

A brief glance at publicly listed common stocks elucidates the unbroken trend towards concentration of ownership in corporate America. When the Securities Act of 1933 came into force, institutions owned about 8 percent of the outstanding NYSE quoted securities. When in the 1950s, the driving out of private and nonprofessional investors gained momentum so that by 1987, 45 percent of the almost $3 trillion of public company stocks were held in institutional portfolios. The concentration ratio is even higher in the upper segment represented by the companies included in the prestigious S&P Stock Index which, above all, warrants for a higher degree of fungibility and liquidity. In 1987, forty-seven out of

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61. The glossary in Louis Lowenstein, What's Wrong with Wall Street Short Term Gain and The Absentee Shareholder 256–57 (1988) sums up its substance as follows:

> If one shareholder turns activist, investing time and talent in overseeing an otherwise indolent management, the benefits accrue in full measure to all the other shareholders, even if they sit on their hands. Hence the rule that investors should not bother to become thoughtful, active shareholders. If they lose confidence in management, the only sensible course is to sell out. What is good advice for any one investor, however, is bad for them collectively, since they cannot all sell out. Even those who do will often have sold at an unnecessarily depressed price. While almost everyone recognizes the dilemma, no one seems much inclined to consider changes.

62. Dennis J. Block & Jonathan M. Hoff, *Emerging Role of the Institutional Investor,* N.Y.L.J., Apr. 12, 1990, at 5; Buxbaum, *supra* note 16, at 16–17; Brancato & Gaughan, *supra* note 1, at 6; Jay O. Light, *Privatization of Equity,* Harv. Bus. Rev., Sept.–Oct. 1990, at 62, 63; William Taylor, *Can Big Owners Make a Big Difference,* Harv. Bus. Rev., Sept.–Oct. 1990, at 70, 71.

63. According to an estimation by the Federal Reserve Board this share will climb to 50 percent by the year 2000. *See* Bruce Nussbaum & Judith H. Dobrzynski, *The Battle for Corporate Control,* Bus. Week, May 18, 1987, at 102, 103–104.

the fifty largest corporations had institutional ownership that exceeded 33 percent of their total outstanding stock. Forty-one of these fifty corporations had institutional holdings in excess of 40 percent of their total outstanding stock, and twenty-seven of them had institutional holdings in excess of 50 percent of their outstanding stock.[64]

A 1986 staff report from the House of Representatives' Subcommittee on Telecommunications, Consumer Protection, and Finance sheds some light on the increase in institutional holdings:

> While there was a significant increase in pension fund holdings of corporate stock and other financial assets in the 1950s when many companies joined industry leaders such as General Motors in forming pension plans, much of the recent high level of growth reflects the impact of the enactment of the Employee Retirement Income Security Act (ERISA) in 1974. From the perspective of securities markets, the enactment of ERISA was landmark legislation in two respects.
>
> Because it required the liabilities of pension fund sponsors (employers) to beneficiaries (employees) be funded, it resulted in a substantial increase in purchases of long-term financial assets—particularly corporate stocks and bonds—and thus a higher level of capital formation than would have otherwise occurred. Because it increased the amount of saving through deferred compensation, it contributed to a shift in savings patterns that reduced the amount of direct savings by individuals (and thus the share of outstanding corporate stocks held by individual investors) while increasing the share of financial assets controlled by institutional investors.[65]

The drawback of the steady flow of cash from new contributions on the one hand and capital appreciations of stock and bond holdings, sweetened by dividend and interest payments on the other hand, however, is the growing restriction of maneuverability of the accumulated assets. It becomes increasingly difficult to unload huge blocks of securities and funnel the proceeds to tentatively more efficient and profitable ventures. Harrison J. Goldwin, former comptroller of New York City and co-chair of the Council of Institutional Investors, describes the paradoxical situation he and his brethren at pension funds are confronted with: ''We're not in a position to sell our stock. We own stock in 1,350 corporations. We could sell a given company here or there. But we've got to reinvest the money.''[66]

Although the financial services industry developed the block trading mechanism to alleviate the threatened loss of salability of large holdings in securities,[67] the problem still remains that an immediate oversupply of a certain stock or bond

64. LOWENSTEIN, *supra* note 61, at 58.

65. Memorandum from T. E. Wirth, chair, to the members of the U.S. House of Representatives, Subcommittee on Telecommunications, Consumer Protection and Finance (Mar. 17, 1986) (regarding hearing on pension funds in the capital markets: the impact of corporate governance, trading activity, and beneficiaries).

66. *Quoted in* Nussbaum & Dobrzynski, *supra* note 63, at 104.

67. LOWENSTEIN, *supra* note 61, at 59–60.

depresses its market value and generates unnecessary losses for the holder. Thus, restructuring a diversified portfolio with massive positions is a delicate task that cannot be executed all at once. Rather it needs careful foresight and patience to complete a (creeping) series of market transactions. A recent empirical study has particularly proven that erratic churning is consistently inferior to a low-turnover investment strategy.[68]

B. FIDUCIARY DUTY OF "LONG-TERMISM"

In the face of the aforementioned pocketbook constraints that bond the institutional investor to the assets in its portfolio, it is no accident that fund managers resort to the alternative to invade the exclusive policy purview of management. Accordingly, Robert A. G. Monks, head of Institutional Shareholder Services —a pension fund consulting firm in Washington, D.C.—and former administrator of ERISA formulates the objective and the action plan in the same breath: "We use the proxy machinery reluctantly, to get management's attention. But we really look forward to a cooperative long-term arrangement between management and owners."[69] The proxy voting system is designed to be administered as a stimulant to cure the much discussed managerial disease of "short-termism," with adverse consequences for corporate stability, business planning, and the long-range viability and competitiveness of the corporation.[70]

However, the practice to date appears to belie the merits of such an approach. The ultimate question is how to reconcile the increasing mismatch of two competing sets of equally valid and more than often incompatible objectives.[71] On the one hand, the corporate managers must carry out their duty of care to identify and implement positive not present value projects to further the company's growth and prosperity. However, the professional institutional investors, on the other hand, are charged with fiduciary responsibility to maximize profits for their

68. The study, undertaken by SEI Corp., captured the time frame from 1981 to 1986. The average ROI for low-turnover portfolios was 15.2 percent, while volatile portfolios averaged 13.5 percent. But it is noteworthy that neither strategy could consistently outperform the S&P 500 Index that boomed within the same period at an 20 percent annual rate. *See* Nussbaum & Dobrzynski, *supra* note 63, at 104.

69. *Quoted in* Nancy J. Perry, *Who Runs Your Company Anyway?*, FORTUNE, Sept. 12, 1988, at 140, 142.

70. Lowenstein & Millstein, *supra* note 18, at 741. That competition among many managers leads each to seek "a short-term premium for a portfolio stock," even though they recognize that they forgo a significant profit potential inherent in a buy-and-hold policy is a common theme in corporate law doctrine. *See* Martin Lipton & Stephen A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 207 (1991) (citing other authorities).

71. Statement of J. C. Wilcox on the occasion of a roundtable discussion about *The Proxy and the Institutional Investor: Examining Problems of Present and Blueprint for Future*, PENSION & INVESTMENT AGE, Mar. 19, 1990, at 17.

beneficiaries.[72] This market-oriented agenda has precipitated accusations by management that institutional investors are not "owners" of the corporation in any traditional sense, since their nearly uniform decisions to sell in tender situations evince short-term "speculation."

When looked at more closely, this line of reasoning deserves skeptical consideration because it rests on the almost axiomatic assumption of passivity as the capital supplier's first duty: "If it ain't broke, don't fix it!" Specifically, the wave of takeovers that began in the late 1970s requires a rethinking of the covenant that exists between investors and corporate management. The phenomenon of bid premiums of on average 80 percent[73] ineluctably implies profit potential above the bid price, since investors are supposed to behave in an economically rational manner. If the future cash flow to recoup the cost of capital and an individually determined profit margin can be ascertained by the greenmailers and the arbitrageurs, it is likewise an opportunity that can be seized by institutional investors. They have the economic muscle to spot the intrinsic potential and to alert the board of directors so as to bring in the new management talent needed to realize this potential.

Overall, however, institutional investors perform their fiduciary duty better by retaining their stake in a corporation and helping to secure genuine improved performance of the corporate assets rather than abandoning one short-term investment in pursuit of another. For this concept of "relationship investment"[74] to be implemented effectively, it is of crucial importance for the shareholders that the following two parameters are met. First, regular, and when necessary, prompt satisfaction of the need of adequate information as to the operation and the financial status of the company should be made;[75] and second, shareholders should be allowed unhindered judgment of the board's responsibilities to keep abreast with the product market and to rejuvenate itself timely.[76] Whether to

72. *Cf.* Morton Klevan, *Fiduciary Duty and Proxy Voting,* 7 ANN. REV. OF BANKING L. 229-36 (1988); Ronald M. Machold, *Fiduciary Prudence: A Practical View,* 7 ANN. REV. BANKING L. 275–80 (1988).

73. LOWENSTEIN, *supra* note 61, at 121.

74. This concept is spelled out in more detail in Jonathan Charkham, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad?: Hands Across the Sea,* COLUM. BUS. L. REV. 765, 770–72 (1988). For recent refutation, see Taylor, *supra* note 62, at 80–82 who argues that the expertise gap renders it almost impossible to realize a direct communication with large shareholders and corporate managers. In order to close the gap he advocates the idea of hiring knowledgeable agents acting on behalf of the institutional investors. The idea of creating a core of professional directors is also advocated in Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors,* 43 STAN. L. REV. 863, 883-92 (1991), and Coffee, *supra* note 60, at 1359–62. The pertinent counterarguments against this model of collegial monitoring are offered *infra* notes 101–05 & accompanying text.

75. LOWENSTEIN, *supra* note 61, at 211.

76. This implies a reinternalization of the "pruning deadwood" effect that until recently fell within the domain of the (external) market for corporate control. *See* LOWENSTEIN, *supra* note 61, at 124–25. The "pruning deadwood" theory is based on the efficient capital market hypothesis. It argues that hostile takeovers systematically increase productivity and managerial efficiency. "Bidders pay large premiums for target companies, and since in an efficient market everything else is

sponsor specific proxy resolutions has to be decided according to the degree of congruence with those two criteria.

III. The Four Cornerstones of the Legal Framework of the Interaction between Institutional Investors and Corporate Management

A. Corporate Dialogue

The first step to overcome the apparent chasm between owners and managers is the establishment of profound and continuing channels of communication. What is urgently needed is the forum and the occasion—the time and the place—for such dialogue. These are the procedural prerequisites to gradually reducing the current prevailing distrust on both sides, which causes a considerable amount of social cost.[77] Being familiar with each other's needs and interests helps to mitigate much of the conflict that David Walker, formerly the executive director of the Bank of England and presently the head of the U.K.'s Securities and Investments Board, summed up as follows:

> The point is obvious enough that a major investor cannot take a mature view about the future of a company unless he has some first-hand knowledge of the quality of the Board. . . . Equally, it is very unsatisfactory for a Board to labour under the impression that major shareholders would not support long-term projects when the matter had not been discussed with them.[78]

Thus, fund managers have not only the right, but also the obligation vis-à-vis their beneficiaries, to be sufficiently well informed about the corporation's business plan to ensure that substantial changes in the firm's investment strategies, for example, expansion of the production capacity, or the allocation of the research and development budget, which might depress the earnings per share ratio are communicated in a timely fashion.[79] Ongoing exchange of information instead of polarization becomes an inevitable necessity for investors and corporate managers once both parties become aware of their mutual interest in the performance of the underlying business operations. In the long run and for the economy as a whole, financial profits are not worth the paper they are written on if they were not preceded, or at least will be succeeded, in the foreseeable future by business profits.[80]

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already reflected in the price of the shares, the bidders must be contemplating improved management, better use of resources, or some useful synergies." *Id.* at 251 (glossary); *see also* Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 306 (1983) (arguing that "the tender offer process resembles more a random selection process than the disciplined pruning . . .").

77. Statement of A. Oliver on the occasion of a roundtable discussion in *The Proxy and the Institutional Investor: Examining Problems of Present and Blueprint for Future*, *supra* note 71, at 17.

78. *Quoted in Company Boards: Wanted: A Cure for Board Stiffness*, THE ECONOMIST, Dec. 20, 1986, at 126.

79. Lowenstein & Millstein, *supra* note 18, at 748.

80. *Id.* at 745.

B. SECRET BALLOTS

The second step on the procedural level is the contractual or statutory imposition of confidential voting in proxy contests. This will place institutional investors and activist groups on a more equal footing with corporate management.[81] Apart from alleviating the present bias of the proxy machinery in management's favor, it will protect the shareholders against coercive pressure to take sides in critical voting questions and the integrity of their individual privacy rights.[82] Although it can be argued that due to the size and diversification of their portfolios, money managers are much less vulnerable to the threat of retribution than employee shareholders,[83] it can also be seen that fund managers are considerably diverted from their genuine asset management task by being flooded with written and oral proxy solicitations. Confidential voting will avoid this kind of negative externality.

Another false objection put forward is a textbook example of the so-called "nirvana fallacy."[84] While the confidential voting process undoubtedly entails a certain probability of error and mischief,[85] it does not follow that this proposal should be jettisoned in favor of independent shareholder nominated directors.[86] The proper comparison is between the costs and benefits of both proposals for reform.[87] Whereas confidential voting increases the administrative costs generated by complicating the proxy machinery, the recruitment of suitable board members creates a new bureaucratic layer with increasing agency costs, let alone ex ante incurred information and transaction costs, which taken together, are deemed to exceed the relatively easily ascertainable costs of the voting tabulation process by a specialized private firm.[88]

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81. The unfair advantages over the shareholders were enumerated by James Heard, like Michael C. Jensen, director of Analysis Group, Inc., which, en passant, had been retained by one of the Belzberg affiliates to provide advice both in respect to SB No. 1310 and the proxy fight against Armstrong. Heard listed: (i) management's complete control of the voting system; (ii) management's unlimited access to corporate funds in soliciting proxies; (iii) restricted shareholder access to the proxy statement; (iv) no original nomination right for dissident shareholders; (v) no reimbursement of shareholder expenses associated with their own proxy solicitations; and (vi) no shareholder right to confidential voting or to independent tabulation of voting results. *Securities, Witnesses at Hearing Split Over Confidential Proxy Voting,* Daily Report for Executives (BNA) No. 148, at A-5, A-6 (Aug. 3, 1989) [hereinafter *Securities, Witnesses].*

82. *Id.*

83. *See id.* (statement of Richard Foley while representing the United Shareholders Association, which had been founded by T. Boone Pickens, Jr.).

84. The "nirvana fallacy" is discussed in Harold Demsetz, *Information & Efficiency: Another Viewpoint,* 12 J. L. & ECON. 1-22 (1969).

85. *See* the quotation of Roderick Hills (former SEC chairman and now managing partner of Donovan, Leisure, Newton & Irwin, Washington) in *Securities, Witnesses, supra* note 81.

86. *See* Gilson & Kraakman, *supra* note 74, at 880-82; LOWENSTEIN, *supra* note 61, at 205-14.

87. Fischel, *supra* note 60, at 1272.

88. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law,* 26 J. L. & ECON. 395, 425 (1983).

C. Shareholder Approval of Specific Corporate Investment Decisions

Shifting the focus on the substance of monitoring rights for institutional investors, the eye falls on section III of the so-called "Shareholder Bill of Rights" (the Bill).[89] The Bill was promulgated by the Council of Institutional Investors (the Council) in April 1986. The Council is an association of employee benefit plans, state and local agencies that oversee such plans, and not-for-profit foundations and endowments. It is grounded on the belief that more powerful investors can effectively orchestrate the voting of proxies in concert and, as a result, the benefits from improved performance will inure to each investor according to the size of its investment (positive externality).

In essence, the provisions of section III of the Bill draw a distinct line between financial and operational decisions. The latter are outright acknowledged as the prerogative of corporate management.[90] From the former segment is extracted an enumerative and exhaustive catalogue of five specific decision-areas that are declared to be subject to approval by a majority shareholder vote: greenmail, poison pills, golden parachutes, disposition of certain assets (crown jewels), and incurrence of excessive debt (junk bonds).[91]

A sixth reserved decision-area is a blend of procedural matters, i.e., the election and removal of directors, convocation of special meetings on shareholders' request, and procedure for fixing a record date. Clearly, it does not fit in the given systematic order. Notwithstanding this inconsistency, it gives expression to and underscores the fundamental insight that substantive right concessions have to be balanced with procedural safeguards to develop their optimal effect.

The list of veto transactions deserves approval. It avoids abrupt distortions of the stock price precipitated by unexpected financial and investment decisions. Thus, the volatility of the normally concerted, short-term myopic institutional buying and selling is smoothly leveled out and the unwinding of large holdings can be stretched out over a longer period of time.[92]

Furthermore, an intervening control of the equity and debt structure of the firm grants the shareholders a disciplining influence on the risk-taking propensity of the business managers. This need to monitor the financing and investing activities follows from the economics of moral hazard in the absence of the "Wall Street Rule."[93] The managerial incentive to pursue, in the eyes of the shareholders, overly risky projects is decreased by a contractual veto power. The

89. *Appendix: Shareholder Bill of Rights,* (Revised as of Sept. 7, 1988) Colum. Bus. L. Rev. 759–64 (1988) [hereinafter *The Bill*]. Heard, *supra* note 23, at 246–47.

90. *See The Bill, supra* note 89, at 761 (explanatory notes).

91. *Id.* at 760–61.

92. Robert S. Waill, *From Weak Hands in Strong Hands,* Trusts & Estates, Jan. 1981, at 52, 53.

93. *See* the extensive discussion *supra* notes 61–68 & accompanying text.

economic savings of bankruptcy costs are more than worth the administrative costs and costs of error associated with this specific direct monitoring device.[94]

D. "BOARDMAILING"[95]

Instead of conceding institutional investors the right of consent in any corporate decision that will have a significant financial effect upon a corporation and its shareholders, one might be inclined to take the idea of shareholder democracy a step further and reverse the modern theory of a firm as an agency relationship with a strict separation of investment and management[96] in revitalizing the classic shareholder-as-manager model. Representatives of institutional investors would be elected as members of the board and, as a result, enjoy the authority to effect corporate business decisions. In drawing a parallel to the ancient Greeks who regarded the citizens' full-time dedication to participation as a *conditio sine qua non* for the success of democracy, Nell Minow, general counsel of Institutional Shareholder Services, Inc. and executive director of the Samuel and Ronnie Heyman Center on Corporate Governance at Yeshiva University's of Cardozo Law School, has recently proclaimed the species of pension fund managers as the "ideal stewards of America's corporations," since they "could devote their entire working hours to their equivalent of citizenship—corporate governance."[97]

Such a metaphoric statement, of course, flatters the ego of fund managers. In practice the idea that any of them will seriously consider doing the job of corporate managers is hardly conceivable. This has little to do with the widely accepted psychological insight that most people tend to shy away from power.[98] Even if this were not true for the generic group of money managers, the assumption of corporate leadership would still run afoul of the fundamental economic principle of division of labor. The strength of the corporate form is that it enables individuals who can supply capital but lack managerial ability to invest while simultaneously allowing professional managers who lack personal wealth

94. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 94, 114 (1985).

95. Quotation ascribed to Carl C. Icahn when he acknowledged defeat in the spectacular Texaco proxy fight after the board of directors, bowing to necessity, had secured support of institutional investors by making the until then unprecedented concession of granting them a greater role in electing directors. Stratford Sherman, *Pushing Corporate Boards to Be Better*, FORTUNE, July 18, 1988, at 58.

96. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310-11 (1976); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301-25 (1983).

97. Nell Minow, *Shareholders Awakening to Their Power; Institutional Investors: Sleeping Giants?*, LEGAL TIMES, Apr. 25, 1988, at 16.

98. This critical issue was rightly pointed out by E. Regan, New York State Comptroller and sole trustee of New York's state and local fund, on the occasion of a roundtable discussion. *The Proxy and the Institutional Investor: Examining Problems of Present and Blueprint for Future*, *supra* note 71.

to start and operate enterprises.[99] Investors would be hurt rather than helped if they interfered with corporate governance that does not fall in the domain of their genuine expertise.[100] Moreover, wearing two hats as money and industrial manager exposes the investor to the reproach of self-contradictory behavior. The guiding managerial principle to focus on core businesses is in no way unique to enterprises but is inherent in any agency relationship where the agent has less incentive to maximize wealth than if he himself were the principal.

From the perspective of the institutional investors, the key issue is effective monitoring. They have to reassert their original right as a function of ownership to elect qualified directors to the board, which is one of the most vexing problems of corporate governance.[101] Since the latter are entrusted with the efficient coordination of the various production inputs, such as capital, labor, and raw materials, "[t]he corporate managers of today must be as sophisticated in managing their debt and equity capacities as they are managing their plant capacity. There would in fact be no room for corporate raiders and arbitragers"[102] if a screening, monitoring, and incentive system were developed that retained corporate managers committed to the increase of shareholder value and, conversely, punished shirkers with a tendency to appropriate perquisites out of the firm's treasure house for their own consumption. To achieve this goal institutional investors do not need a voice in the boardroom. On the contrary, direct representation could import additional agency problems ("Who monitors the monitors?")[103] and conflicts of interest because of legally, politically, socially, or ethically imposed divergencies from the economic theorem of wealth maximization.[104]

In application of the Pareto principle of welfare economics, investors' welfare is maximized by a corporate governance structure that permits unequal distribution of gains from business decisions, subject to the constraint that no investor be made worse off by the action. Reliance on the fiduciary principle, as refined above,[105] appears to be socially superior to direct monitoring since its deterrent effect, combined with the various market forces, preserves the gains resulting from the delegation of the decision-making authority and the division of labor,

99. M. Dooley, *Controlling Giant Enterprises: The Question of Legitimacy, in* CORPORATE GOVERNANCE: PAST AND FUTURE 28, 38 (Henry G. Manne ed., 1982).

100. This fear of a boomerang effect is the reason why institutional investors have traditionally shown a lack of enthusiasm for a more active role in corporate governance. *See* J. A. C. Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights,* 8 HOFSTRA L. REV. 183, 184–88 (1979).

101. Sherman, *supra* note 95, at 64.

102. Ronald M. Machold, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad?: A Domestic Perspective,* COLUM. BUS. L. REV. 751, 757 (1988).

103. Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions,* 91 YALE L.J. 698, 701 (1982).

104. LOWENSTEIN, *supra* note 61, at 215–16 also refers to the possible exposure to lawsuits.

105. *See supra* part III.C. In the terminology of Easterbrook & Fischel, *supra* note 103, at 702 this is a practical example of "re-contracting" the standard legal terms of the fiduciary rule.

while limiting the ability of incumbent management to further their own interests at the expense of the investors.

IV. Implications for the Players and Dynamics for Corporate Germany

A. Reapportionment of Stock Property Due to Divergencies between the National Old Age Pension Schemes

1. *The Heavy Hitters*

It is common knowledge that the savings behavior of people varies from country to country. People prefer different forms of investments and each country has its own system of how to finance the provision for old age and the corresponding pension schemes. Against this background, Anglo-American, as well as Japanese and Swedish pension funds, stand out with a spectacular growth record. Among this leading quartet, the U.S. pension funds have the deepest pockets of the world, with more than $2.6 trillion in 1989. This number corresponds to the gross national product (GNP) of Japan. The vast investment-seeking capital has substantially contributed to the rise of the global stock markets in the 1980s because a major part was used for stock purchases, and the higher demand forced up prices.

2. *The German Stock Market: Cockaigne of Arbitrage Opportunities*

In the meantime, U.S. and other institutional investors had discovered the German stock market.[106] They discovered that the stock quotations were an inadequate measure both of the liquidation and the going concern value of the underlying corporate assets. By way of example, the College Retirement Equities Fund (CREF), which operates the old-age pension scheme for 200,000 college teachers and professors, beneficially held shares of German companies at the end of 1989 worth nearly DM 1 billion, the largest portion of which was tied up in shares of Allianz AG, Munich, the largest European insurance company, representing a market capitalization of nearly DM 110 million.[107]

Put differently, U.S. pension funds do not restrict the geographic spread of their portfolio strategy to companies in their home country like IBM, Hewlett & Packard, General Motors, Ford, Johnson & Johnson, and Philip Morris, which are also competing on the German product market through significant subsidiaries. Rather, they make direct investments in publicly traded companies incorporated in Germany. Thus, the returns on those investments flow in the distribution to the beneficiaries of the U.S. pension funds.

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106. *See* Heard, *supra* note 23, at 248; S. Ulrich, *Shareholder Power,* Manager Magazin, May 1991, at 121, 128.

107. *See* Annual Report 1989, at 41 *et seq.; see also* W. Wilhelm, *Manager unter Druck,* Manager Magazin, May 1991, at 100, 115.

It may be supposed that the capital interest of foreign pension funds in German blue chips will grow, because the number and size of share issues on the U.S. stock market does not match the rapidly rising investment needs of the institutional investor clientele. What is of utmost importance is the invention and innovation of new financial products.

3. *Legal Fragmentation of the Globalized Capital Markets*

The enhanced interest of foreign institutional investors in the German stock market is consistent with the globalization of the economy, which is, among other things, reflected in the globalization of the ownership. Multinational companies with a corresponding multinational dispersion of their share capital enjoy the benefit of a better local acceptance. At the same time, the phenomenon of globalization opens new avenues for equity and debt financing. What must not be overlooked, however, is that the factual investment policy of and the legal framework for the institutional investors are still disparate. While in the United States, Japan, and the United Kingdom, the formation and allocation of capital for retirement benefit purposes is mainly channeled through insurance companies and pension funds, which invest a large proportion of the capital in stock, Germany has no equivalent group of institutional investors.[108] Certainly, the local insurance companies have significantly increased their stock holdings in the past. In the same vein, it must be acknowledged that more private savings are devoted to investments in shares and other forms of securities to provide for retirement. To this end pension reserves might not only be used for the self-financing of the company, but also for the implementation of employee stock ownership plans. The fundamental difference, however, is the financing of the German social security system, where no reserves are created. Instead, the future generation bears the burden of financing the old-age benefit scheme. The central issue then is how to reconcile the growing impact of the foreign pension funds with the traditional concepts of corporate governance in Germany.

B. Erosion of Power of General Shareholders' Meeting

The number of complaints about the nonexercise of voting rights at general shareholders' meetings is steadily on the rise.[109] For example, when Deutsche Bank, Germany's preeminent universal bank, held its general meeting, only 41 percent of the total outstanding share capital was represented and when the vote

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108. *See* Michael Hauck, *in* GELDVERFASSUNG UND ORDNUNGSPOLITIK 43 (Hahn ed., 1989); Michael Hauck, *in* PENSIONSKASSEN UND BORSEN 36 *et seq.* (Arbeitskreis der Deutschen Wertpapierbörsen ed., 1989); Hans J. Mertens, *Förderung von, Schutz vor, Zwang zu Übernahmengeboten,* 35 AG 252, 254 (1990).

109. Dirk Schmalenbach, *Federal Republic of German, in* INTERNATIONAL CORPORATE GOVERNANCE, *supra* note 23, at 109, 122. A similar development was observed in Japan until the reform act in corporations law in 1981. *See* Maeda, *supra* note 3: "The general shareholders' meeting of the big enterprises were only poorly attended, extremely short and nothing but mere formalities."

to lift the 10 percent ceiling of the voting power came, the relative number fell to only 37 percent. Similarly, disappointing numbers were recorded at the 1989 annual meetings of Deutsche Babcock AG, Oberhausen and Continental AG, Hannover with 41.98 percent and 43 percent respectively. Hoesch AG, Dortmund surpassed every other company with a disastrous 27 percent.[110]

The decline at annual shareholders' meetings has a host of reasons. First of all, small shareholders have evidently lost any interest in "their" company and are content with themselves in the role of coupon cutters. The shareholders' associations can compensate for this deficiency of representation only to a limited extent. Second, in contrast with their domestic counterparts, foreign institutional investors often abstain from using the proxy voting machine. Domestic capital investment companies are normally represented by subsidiaries of affiliated companies of commercial banks or insurance companies. Under those circumstances the lack of representation does not pose a problem as in the case of all other domestic institutional investors.

The picture is less happy when looking at the group of foreign institutional investors. Why they give a wide berth to general meetings even though their property interests are directly affected by the shareholders' resolutions is open to speculation. The possible explanations span from a lack of interest in the problems in the context of the deposit of shares,[111] the preservation of the unrestricted right of disposal in light of the temporary impediment that the deposit of shares is a prerequisite for the voting power at the shareholders' meeting,[112] to the intentional disguising of the stock ownership.

The massive shareholder absence produces random majorities. Even worse, it allows organized minority groups an inadequate influence. In the past, proxy voting initially enabled commercial banks to bundle the dispersed interests of small shareholders. Second, it facilitated the treasuring of profits for internal financing of future growth opportunities,[113] which met with the long-term orientation of the capital owners. Third, proxy voting ensured an adequate counseling and monitoring of management through representation on the supervisory board. Fourth, the proxy voting system warranted solid majority decisions.

Particularly, this last function cannot be accomplished under the above described changes in the distribution of corporate ownership. Nowadays we have to ask the question: who will substitute for the shareholders in monitoring the business managers given that the former are not able to overcome their lethargy

110. The then chairman of the executive board, Detlef Karsten Rohwedder, commented laconically that he could make neither heads or tails of the low attendance. He suspected that one-third of Hoesch's share capital was in the hands of foreign investors who naturally (sic!) would not allow any voting authorization. *See* DAS WERTPAPIER 783 (1989).

111. *But see* the sharp criticism by Otto Graf Lambsdorff, DAS WERTPAPIER 1346 (1989).

112. F. Wilhelm Christians, *Der Aktionär und sein Stimmrecht*, 35 AG 47 (1990).

113. *See* Klaus Piltz, *Gewinnverwendungspolitik der Aktiengesellschaft*, *in* FINANZIERUNGSHANDBUCH 627 (F. Wilhelm Christians ed., 2d ed. 1988).

and willingly or unwillingly have to resign from their responsible position as "watchdogs of last resort"?[114] Beyond any doubt, the shareholders' meeting as the ultimate decision-making and supervising organ is currently going through a serious state of crisis.[115]

The immediate solution to this fundamental problem is to draw the attention of the institutional investors to their responsibility. This has already been done in the past, but only with modest success. Apart from the minor and technical difficulty of ascertaining proper addresses, German corporations and commercial banks have repeatedly reported that foreign institutional investors did not even reply to the reminders.

If "soft" communications are ineffective in the near future, political considerations will have to focus on the legal options by drawing on the experience of the foreign corporate lawmakers. In 1981 Japan, for example, introduced the written voting system for large corporations with two conjunctive minimum threshold values of an issued share capital of at least 500 million yen and at least 1,000 shareholders entitled to vote. Accordingly, the corporations are obliged to send a written company report together with a proxy card to each registered shareholder. Other possible solutions might be to lower the necessary quora, to institute a representative shareholder committee,[116] or to adopt the U.S. proxy voting system.[117] The last resort would be the forfeiture of the right of profit in case of lack of representation at the shareholders' meeting.[118]

C. The General Shareholders' Meeting as the Pivotal Point of Corporate Governance

The insufficient representation of shareholders at general meetings is only one of the problems growing out of the increased stock participation of foreign institutional investors in German publicly traded companies. A possible scenario

114. The phrase is from Uwe H. Schneider, *Strimmrechtsbeschränkungen im amerikanischen Aktien- und Kapitalmarktrecht, in* BEITRÄGE ZUM HANDELS- UND WIRTSCHAFTSRECHT. FESTSCHRIFT FÜR FRITZ RITTNER ZUM 70 GEBURTSTAG 613, 627 (Wolfgang Löwisch et al. eds., 1991), who articulates his strong scruples against the tacit understanding of the shareholders' key role in the successful governance of the corporation. That the energized participation of corporate governance by institutional investors is akin to reversing this trend is argued by Bernard S. Black, *Agents Watching Agents: The Promise and Limits of Institutional Shareholder Voice,* 40 UCLA L. REV. (forthcoming 1992). For the function of the shareholder within the regulated system of competition, see generally BERNHARD GROSSFELD, AKTIENGESELLSCHAFT, UNTERNEHMENSKONZENTRATION UND KLEINAKTIONAR 191 (1968); ULRICH IMMENGA, AKTIENGESELLSCHAFT, AKTIONARSINTERESSEN UND INSTITUTIONELLE ANLEGER 6 (1971); MARCUS LUTTER, DER AKTIONÄR IN DER MARKTWIRTSCHAFT 26 (1973).

115. For the paramount importance of authorized voting rights in favor of the commercial banks, with respect to the efficiency of the general shareholders' meeting, see KORBER, DIE STIMMRECHTSVERTRETUNG DURCH KREDITINSTITUTE 32 n.15 *et seq.* (1989); Schmalenbach, *supra* note 109, at 117.

116. *See* LUTTER, *supra* note 114, at 53.

117. *Cf.* Philipp Möhring, *Proxy-Stimmrecht und geltendes deutsches Recht, in* FESTSCHRIFT FÜR ERNST GESSLER ZUM 65. GEBURTSTAG AM 5. MÄRZ 1970 at 127 *et seq.* (Kurt Ballerstedt & Wolfgang Hefermehl eds., 1970).

118. *See* Schneider, *supra* note 13, at 322.

for the future development could also be a revitalization of the shareholders' meeting associated with enhanced supervision of the management by the shareholders and a stronger emphasis on shareholder value maximization instead of entrenchment. The driving force behind such a movement towards "shareholder democracy"[119] would possibly be the foreign institutional investors with their financial potency as a means of exerting pressure.[120]

Such external impetus would have the approval of F. Wilhelm Christians, chair of the supervisory board of Deutsche Bank, who, on the occasion of the thirtieth anniversary of the foundation of the Association for the Protection of Small Shareholders (Schutzgemeinschaft der Kleinaktionäre e.V.), uttered the view that the voting right was the proper tool for the shareholder to gain an influence not only on business policy but also on the configuration of the executive floor.[121] The current practice of publicly traded companies to fill vacancies on the board by co-option would be replaced by a more flexible elective method based on collaboration with the shareholders.

Whether the participatory management model will yield a better result for the shareholders remains to be seen. Before a definite answer can be given, a number of intricate questions need to be settled. It may suffice to cite two examples. First, the present set of fiduciary duties[122] has to be scrutinized for eventual modification and refinement. The second problem area touches on the flow of communication between management, institutional investors, and ordinary investors. More precisely, what are the legal remedies necessary to cure the inevitable asymmetry of information when inside knowledge is exclusively divulged to institutional investors; when they get details outside the shareholders' meeting that were previously refused to small shareholders during the meeting;[123] or

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119. *See* FRANK D. EMERSON & FRANKLIN C. LATCHAM, SHAREHOLDER DEMOCRACY A BROADER OUTLOOK FOR CORPORATIONS (1954); Bernhard Freiherr von Falkenhausen, *Die amerikanische Aktionärs-Demokratie*, 15 AG 91–95, 122–128 (1960).

120. *See* J. I. Mahari, *Rückkehr zur Aktionärsherrschaft als unternehmerische Chance und rechtspolitischer Impuls: Vorstösse zur Beendigung der Machtdelegation an das Management anhand der Entwicklung der Take-overs in den USA*, 62 SCHWEIZERISCHE AKTIENGESELLSCHAFT/LA SOCIÉTÉ ANONYME SUISSE [SAG] 14–29 (1988); *see also* GÜNTER H. ROTH, DAS TREUHANDMODELL DES INVESTMENTRECHTS. EINE ALTERNATIVE ZUR AKTIENGESELLSCHAFT? (1973).

121. Christians, *supra* note 112.

122. *Cf.* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS (3d ed. 1989).

123. This preferential treatment, however, is burdened with the risk of responsibility towards the other shareholders. In the United States, this situation imposes a fiduciary duty upon the controlling shareholder. *See* DONALD C. LANGEVOORT, INSIDER TRADING HANDBOOK 81 (1987).

Institutional investors could also come under the category of primary insiders as defined in the Council Directive 89/592 of 13 November 1989 Coordinating Regulations on Insider Dealing, 1989 O.J. (L 334) 30. The personal qualification of possessing inside information within the meaning of Article 2, Paragraph 1 of this Directive, "by virtue of (a) holding in the capital of the issuer," does not appear to be limited to controlling shareholders or to those with a significant stake in the equity. Rather, it could also embrace all those who use their significant clout as a leverage for obtaining price-sensitive information. *See* EDDY WYMEERSCH, *The Insider Trading Prohibition in the EC*

when management and particular institutional investors make arrangements, for example to the effect that the latter will be allowed one seat on the former's board of directors on the condition not to participate in a hostile takeover, but rather to side with the target company?

D. FUEL TO THE MARKET FOR CORPORATE CONTROL

The investment decisions of institutional investors have substantial influence in the market of corporate control. The small elite of executive board members of the largest commercial banks is nearly ubiquitous on the supervisory boards of the publicly traded nonbanking companies. The direct stockholdings by "their" bank,[124] proxy voting rights and the voting rights of the shares in the portfolios of the affiliated capital management companies provide them with a strong power base. Together with intimate firm and industry specific knowledge, the influential role of bank representatives helps to smooth corporate control transactions.[125] Once the financial distress of a company becomes apparent to the board, a friendly takeover can be initiated without much fuss. This was demonstrated by the reorganization of the steel-making Krupp concern in 1967 and by the telecommunications and electrical appliances producer AEG after 1979 coming under the wing of the cash-rich Daimler-Benz AG which, in turn, is dominated by Deutsche Bank AG through the largest stake in the company amounting to more than 28 percent of the outstanding stock.[126]

This form of deal-making is not likely to disappear in future, but it will be complemented in view of a different legal framework and the appearance of new market participants. That the new EEC regulation on corporate takeovers[127] was

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Member States: A Comparative Overview, in EUROPEAN INSIDER DEALING—LAW AND PRACTICE 65, 76 (Klaus J. Hopt & Eddy Wymeersch eds., 1991). For a broader overview of the efforts to harmonize the insider trading laws in the Member States of the European Communities in view of the approaching completion of the internal market on December 31, 1992, see Thomas C. Paefgen, *Insiderhandel im Spannungsverhältnis zwischen gemeinschaftsrechtlicher Integration und nationalstaatlicher Regulation—e pluribus unum,* 36 AG 380-96 (1991).

124. As the chairman of the German Association for the Protection of Shareholdings (Deutsche Schutzvereinigung für Wertpapierbesitz [DSW]) and leader of the Free Democratic Party (FDP), Otto Graf Lambsdorff points out, it is a self-evident sign of the different attitude towards the distribution of roles in corporate governance that German members of the executive board (Vorstand) talk of "their company" while their American counterparts report about "your company." *See* Wilhelm, *supra* note 107, at 121.

125. From this finding, it obviously requires a great leap to subscribe to the validity of the popular thesis that characterizes the relationship between the big banks and industry in the Federal Republic of Germany in terms of the power of the banks over industry. For a more differentiated view of this century-long debate, see Josef Esser, *Bank Power in West Germany Revised,* 13 W. EUR. POL. 17, 24 *et seq.*, 28 *et seq.* (1990).

126. *See* Hans H. Kallfass, *The American Corporation and the Institutional Investor: Are There Lessons from Abroad? The German Experience,* COL. BUS. L. REV. 775, 790–91 (1988).

127. Council Regulation 4064/89 of 21 December 1989 on Control of Concentrations between Undertakings, 1989 O.J. (L 395) 1. This "merger control" regulation was amended by Council Regulation 2367/90, 1990 O.J. (L 219) 5, and, as a result, was republished in a corrected version as

corrigendum to Council Regulation 4064/89 EEC on Control of Concentrations between Undertakings, 1990 O.J. (L 257) 13.

Cf. Oliver Axster, *Die Europäische Fusionskontrolle*, FESTSCHRIFT FUR KARLHEINZ QUACK ZUM 65. GEBURTSTAG AM 3. JANUAR 1991, at 567, 572 *et seq.* (Harm P. Westermann & Wolfgang Rosener eds., 1991); J. BLANK, EUROPÄISCHE FUSIONSKONTROLLE IM RAHMEN DER ARTT. 85, 86 DES EWG-VERTRAGES (1991); Cornelis C. Canenbley & Andreas Weitbrecht, *EEC Merger Control: A Preliminary Analysis*, 18 INT'L BUS. L. 104 *et seq.* (1990); Joel Davidow, *Competition Policy, Merger Control and the European Community's 1992 Program*, 29 COLUM. J. TRANSNAT'L L. 11, 28 *et seq.* (1991); Thomas C. Ebenroth & K. W. Lange, *Die Auswirkungen der Europäischen Fusionskontrollverordnung auf das bundesdeutsche Recht der Unternehmens Zusammenschlüsse*, 46 BETRIEBS-BERATER [BB] 845 *et seq.* (1991); W. Elland, *The Mergers Control Regulation (EEC) No. 4064/89*, 11 EUR. COMPETITION L. REV. [ECLR] 111–18 (1990); W. Elland, *The Merger Control Regulation and Its Effect on National Merger Controls and the Residual Application of Articles 85 and 86*, 12 ECLR 19–28 (1991); Frank L. Fine, *EC Merger Control: An Analysis of the New Regulation*, 11 ECLR 47–51 (1990); Horst-Peter Götting & Werner Nikowitz, *EEC Merger Control: Distinguishing Concentrative Joint Ventures from Cooperative Joint Ventures*, 13 FORDHAM INT'L L.J. 185–204 (1989-90); N. Herzig et al., *System und Schwächen der Fusionsrichtlinie*, Supp. 12, DER BETRIEB [DB] (1991); G. Hitzler, *Die europäische Fusionskontrolle kann beginnen*, 1 EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [EuZW] 369–71 (1990); Helmut Hölzler, *EG-Fusionskontrolle: Konzepte und Konsequenzen*, 44 WM 489-94 (1990); T. Janicki, *EG-Fusionskontrolle auf dem Weg zur praktischen Umsetzung*, 40 WIRTSCHAFT UND WETTBEWERB [WuW] 195–205 (1990); Wolfgang Kirchhoff, *Europäische Fusionskontrolle*, Supp. 14, 45 BB (1990); Martin Mendelsohn, *International Franchising*, 3 INT'L Q. 45, 74–92 (1991); Hans M. Müller-Laube, *Europa 1992: Die europäische Fusionskontrolle—Gedanken zu einem neuen europäischen Recht*, 31 JURISTISCHE SCHULUNG [JuS] 184, 188 *et seq.* (1991); Ernst Niederleithinger, *Die europäische Fusionskontrolle und ihr Verhältnis zum nationalen Recht: Aus der Sicht des Bundeskartellamtes*, *in* WETTBEWERBSPOLITIK AN DER SCHWELLE ZUM EUROPÄISCHEN BINNENMARKT. REFERATE DES XXII. FIW-SYMPOSIONS 79 *et seq.* (1989); Ernst Niederleithinger, *Das Verhältnis nationaler und europäischer Kontrolle von Zusammenschlüssen*, 40 WuW 721–30 (1990); Ernst Niederleithinger, *Vier Prognosen zur europäischen Fusionskontrolle*, *in* FESCHRIFT FUR KARLHEINZ QUACK ZUM 65. GEBURTSTAG AM 3. JANUAR 1991, *supra* at 645, 646 *et seq.*; H. J. NIEMEYER, DIE EUROPÄISCHE FUSIONSKONTROLLVERORDNUNG (1991); D. Ridyard, *An Economic Perspective on the EC Merger Regulation*, 11 ECLR 247–54 (1990); Alexander Riesenkampff, *Perspektiven und Probleme der europäischen Fusionskontrolle*, *in* BEITRÄGE ZUM HANDELS- UND WIRTSCHAFTSRECHT. FESTSCHRIFT FÜR FRITZ RITTNER ZUM 70. GEBURTSTAG, *supra* note 114, 491 *et seq.*; Andreas Röhling, *Offene Fragen der europäischen Fusionskontrolle*, 11 ZEITSCHRIFT FUR WIRTSCHAFTSRECHT [ZIP] 1179 *et seq.* (1990); Otto Sandrock & Elke van Arnheim, *New Merger Control Rules in the EEC*, 25 INT'L LAW. 859 (1991); Peter M. Schmidhuber, *Die europäische Fusionskontrolle und ihr Verhältnis zum nationalen Recht: Aus der Sicht der Kommission der Europäischen Gemeinschaften*, *in* WETTBEWERBSPOLITIK AN DER SCHWELLE ZUM EUROPÄISCHEN BINNENMARKT. REFERATE DES XXII. FIW-SYMPOSIONS, *supra*, at 95 *et seq.*; Karsten Schmidt, *Europäische Fusionskontrolle im System des Rechts gegen Wettbewerbsbeschränkungen*, 45 BB 1990, at 719 *et seq.*; Karsten Schmidt, *Die europäische Fusionskontrolle und ihr Verhältnis zum nationalen Recht: Aus der Sicht der Wissenschaft*, *in* WETTBEWERBSPOLITIK AN DER SCHWELLE ZUM EUROPÄISCHEN BINNENMARKT. REFERATE DES XXII. FIW-SYMPOSIONS, *supra*, at 65 *et seq.*; D. Schroeder & T. A. Örter, *Die neue EWG-Fusionskontrollverordnung*, 11 ZIP 677 *et seq.* (1990); Winfried Tilmann, *Zur EG-Fusionskontroll-VO 1989*, *in* FESTSCHRIFT FUR OTTO-FRIEDRICH FRHR. V. GAMM 663 *et seq.* (Willi Erdmann et al. eds., 1990); James S. Venit, *The "Merger" Control Regulation: Europe Comes of Age . . . or Caliban's Dinner*, 27 COMMON MKT. L. REV. 7-50 (1990); Andreas Weitbrecht, *Zusammenschlusskontrolle im Europäischen Binnenmarkt*, 1 EuZW 18–21 (1990).

After little more than a year of European merger control, the first outlines of its actual application are drawn—and material problem areas are identified—by Claus D. Ehlermann, *Die europäische Fusionskontrolle—erste Erfahrungen*, 41 WuW 535–45 (1991). Mr. Ehlermann is Director General of the "competition" Directorate General (GD IV) within the Commission of the European Communities. The so-called merger task force forms an integral part of GD IV. *See also* John Cook & Trevor Soames, *EEC Merger Regulation: A Practical View*, 19 INT'L BUS. L. 330–35 (1991); John Cook &

energetically fostered by the United Kingdom is not surprising because it will fuel the market for corporate control and the huge British and U.S. pension funds are likely to be the foremost beneficiaries.[128] Although the number of possible takeover candidates in Germany is fairly limited,[129] there is a growing concern for competitive distortions due to the imbalance of financial strength of the market participants that might have an adverse effect on enterprises of key relevance for the German economy. Some question whether fund managers are qualified to determine the structure of conglomerates as well as the reorganization or even the disentangling of highly complex business combinations.[130]

E. Demise of the Small Shareholder

1. *Petrification of the Stock Market*

Institutional investors increasingly chart the course for stock movements. According to a poll among U.S. private investors, 60 percent believed that program trading is a nail in the coffin of a floating stock market and degrades the market to the stage of creating a "casino" for large investors with billions of dollars under their belts.[131] Small shareholders felt like passengers in a roller coaster, lifted up on a high flight and then crashed to the ground by new investment strategies.

Moreover, the stock market might become narrow, just like the spot market for crude oil in Amsterdam, as soon as institutional investors adopt a more steady investment policy leaving only a small amount of shares for trade on the open

Trevor Soames, *EEC Merger Regulation II: The Appraisal Process*, 19 INT'L BUS. L. 490–95 (1991); Frank L. Fine, *The EEC Merger Regulation: Boom or Bust After One Year*, 6 BUTLERWORTHS J. INT'L BANKING & FIN. L. [JIBFL] 533–37 (1991); Martin Heidenhain, *Europäische Fusionskontrolle gewinnt Konturen*, 2 EuZW 449 (1991); H. J. Niemeyer, *Unternehmenszusammenschlüsse nach Inkrafttreten der EG-Fusionskontroll-VO*, 37 RECHT DER INTERNATIONALEN WIRTSCHAFT [RIW] 448 (1991); H. J. Niemeyer, *Europäische Fusionskontrolle. Erste Umrisse einer Verwaltungspraxis der EG-Kommission*, Supp. 25, 46 BB (1991); Colin Overbury, *First Experiences of European Merger Control*, EUR. L. REV. 79-98 (1991); K. P. Rohardt, *Die europäische Fusionskontrolle beginnt Gestalt anzunehmen*, 41 WuW 365–83 (1991); M. Siragusa & A. Subbitto, *Ein Jahr EG-Fusionstontrolle—Eine Zwischenbilanz aus der Sicht des Praktikers*, 41 WuW 872–78 (1991).

128. *See* Schneider, *supra* note 13, at 324.

129. This has to do with the special structure of the German industry, with the importance of large numbers of medium-sized and smaller but often very profitable companies (Mittelstandsunternehmen), which mostly have the legal status of a company with limited liability (Gesellschaft mit beschränkter Haftung [GmbH]). While there are about 430,000 GmbHs in the Federal Republic of Germany—including many small ones—there are only about 2,650 stock corporations (Aktiengesellschaften [AGs]), out of which only about 500 are listed. *See* Herbert Hansen, *Ende 1990: 2682 Aktiengesellschaften*, 37 AG R 290 (1991); Herbert Hansen, *Die GmbH baut ihren Vorsprung als umsatzstärkste Rechtsform aus*, GMBH-RUNDSCHAU [GmbHR] 192–95 (1991).

130. J. Plender, *The Limits to Institutional Power*, FIN. TIMES, May 22, 1990, at 18.

131. Warren E. Buffett, *How to Tame the Casino Society*, WASH. POST, Dec. 4, 1986, at A23.

market.[132] This is not the case yet. Rather, the Financial Executive Institute has established in a study in 1990 that, on average, U.S. pension funds keep their shares for only thirty months. The annual turnover of all the publicly traded shares was 51 percent in 1987 and 38 percent in 1980, which produced annual costs between $25-30 billion.[133] This is roughly the same amount of capital that was raised by means of stock issues.

However, the costly turnover is not an immutable matter of fact. On the one hand, whether it makes sense to force up the stock price by a permanent transfer of ownership without creating any new value is questionable.[134] On the other hand, the proposal to induce long-term stock holdings by means of a graduated capital gains tax schedule has not yet been removed from the agenda of a cohesive economic and fiscal policy.[135]

2. *De Facto Disenfranchisement*

Institutional investors do not diminish the legal status of the small shareholders. Indeed, the growing trend towards institutionalization of stock ownership might lead to a revitalization of the shareholders' meeting.[136] But it is to be feared that the small private investor will be pressed into the role of a dividend recipient when, even in corporations with a widely dispersed share capital, there is no chance for changing majorities. This is the likely result once institutional investors decide to pool their voting rights. The voting power of the small shareholder is then as worthless as if he had put his money in a corporation with one single majority shareholder.

3. *Victimization by Bust-Up Takeovers*

Finally, the long-term-oriented small shareholder is in danger of falling victim to mega-mergers and bust-up takeovers. Insufficient legal protection against business combinations jeopardizes the minority shareholder as does insufficient protection by capital markets against liquidation takeovers. Shareholder wealth is transferred from the target to the bidder company.[137]

Therefore, if the publicly traded corporation participates in the free market for corporate control, shareholders should be granted the statutory right to take appropriate precautionary measures against detrimental abuses of the free market system. That is exactly what Franz Heinrich Ulrich, the former speaker of the executive board and later chair of the supervisory board of Deutsche Bank, indicated with respect to the introduction of the maximum voting right in 1975:

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132. As to the gradual dehydration of the stock market, see FRIEDRICH KÜBLER, GESELLSCHAFTSRECHT 171 (3d ed. 1990).

133. *See* PETER S. LYNCH, ONE UP ON WALL STREET 289 (1989).

134. *See* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 323–26 (5th ed. 1990); LYNCH, *supra* note 133, at 283 *et seq.*

135. *Cf.* Block & Hoff, *supra* note 62; Lipton, *supra* note 17, at 64.

136. *See supra* note 119 and accompanying text.

137. *See* Gregg A. Jarrell & Annette B. Poulsen, *The Returns to Acquiring Firms in Tender Offers: Evidence from Three Decades*, FIN. MGMT., Autumn 1989, at 12-19.

> Both the executive board and the supervisory board are convinced that Deutsche Bank must remain an independent and neutral publicly traded corporation in order to measure up with its business objective and to be able to continue its present development, hence that there should be no major shareholder with a dominating influence.[138]

Although the recent takeover of Feldmühle-Nobel AG and Pirelli S.p.A's acrimonious fourteenth-month struggle to complete a reverse merger of its tire business with Continental AG—one of the first-ever hostile corporate battles in Germany and also one of the longest in Europe—have revealed the pseudo-safety of the maximum voting right laid down in the bylaws,[139] there remains a deep-rooted aversion to autocracy in corporate Germany. The universal language of money is only rudimentarily understood in those circles.

V. Summary and Conclusion

Corporate America's annual meeting seasons of 1989 and 1990 witnessed a remarkable renaissance of the old-fashioned proxy contest.[140] However, the proxy contest is no longer an empty ritual in which shareholders routinely go along with management as Edward J. Epstein suggested by comparing shareholder voting to elections held by the Communist party of North Korea: "Except in the rarest of cases, there is only one slate of directors running for office. Management controls the voting process and counts the votes."[141] While Epstein's comment might have been realistic at the time of its publication in 1986, it now must be viewed with reservation. Shareholder proposals and proxy contests appear to be the only passable route for change of corporate control after the demise of the junk bond market and of leveraged buy-outs in general. In addition, the proliferation in the United States of state anti-takeover statutes (currently thirty-nine) and myriads of restrictive state court decisions have contributed to foreclosing the use of cash tender offers as a vehicle for staging hostile takeovers.[142]

Among the most visible proxy contests in the year 1990 sketched out above, the confrontation between American General and Torchmark bears much resemblance to the earlier Gillette Corp. case in April 1988 where a dissident group also put pressure on the management to accept "the possibility of a sale or

138. Schneider, *supra* note 13, at 326.

139. For the current discussion of the legal and economic validity, Uwe H. Schneider, *Gesetzliches Verbot für Stimmrechtsbeschränkungen bei der Aktiengesellschaft?*, 35 AG 56–63 (1990); Wolfgang Zöllner & Ulrich Noack, *One Share—One Vote?*, 36 AG 117, 119 *et seq.* (1991) (in favor). *But see* Michael Adams, *Höchststimmrechte, Mehrfachstimmrechte und sonstige wundersame Hindernisse auf dem Markt fuer Unternehmenskontrolle*, 35 AG 63–78 (1990); Theodor Baums, *Höchststimmrechte*, 35 AG 221–42 (1990) (opposed). *See also* the comparative study, with emphasis on U.S. securities and capital markets law, by Schneider, *supra* note 114, at 620–26.

140. William Meyers, *Escalating the Proxy Wars*, INSTITUTIONAL INVESTOR, May 1990, at 95–97. Patricia Vowinkel, *More Proxy Fights Seen as Takeover Funding Fades*, REUTER BUS. REP., Mar. 14, 1990 (LEXIS, World Library, Allwld file).

141. EDWARD J. EPSTEIN, WHO OWNS THE CORPORATION?: MANAGEMENT VS. SHAREHOLDERS 13 (1986).

142. R. J. McCartney, *New Takeover Tactic: Ballots Instead of Bonds*, WASH. POST, Apr. 8, 1990, at H1.

merger.''[143] The four remaining incidents, Simmons versus Lockheed, Belzbergs versus Armstrong, Icahn versus USX, and also BTR versus Norton that was unfortunately timed at the end of the American takeover boom of the 1980s, share the same factual pattern concisely summarized by Louis Lowenstein, professor of law at Columbia University School of Law: ''The proxy fights are 'just used as a cleaning-up of some of the unfinished business of the 1980s.' Investors are 'trying to salvage what's left of a not-very-good investment.' ''[144]

Provided that this assessment is correct, that the sudden increase of proxy battles constitutes a merely temporary phenomenon, institutional investors are best advised to join the various actions set in motion by the handful of financiers who found themselves with unwanted minority stakes in companies when the money market dried up. The latter's zeal and influence to make up their current paper losses might be used as a spearhead to remove the ''home-court advantage''[145] of incumbent management. As soon as this specific goal of ''a more level playing field''[146] is achieved,[147] such as by the setting-up of a communication network, confidential voting, and prerogatives in the event of significant financial decisions, the alliance of corporate management with the ill-reputed corporate raiders will be halted. In fact, economics suggest that in the long run corporate raiders will be eliminated. In the first place, their persistent perception of ''huffing and puffing''[148] sends the wrong signal to the board of directors. The more activity the institutional investors display in corporate monitoring, the more important it is that shareholder-sensitive board members be secure in the ''long-termism'' of such efforts, rather than laboring under the apprehension that their investors will bail out overnight.[149] Furthermore, the gains from the fine-tuned realignment of institutional investors' and corporate managers' interests are not subject to sharing with third parties because this would simply reduce the likelihood that any distributable gains will be generated.[150]

The tighter monitoring of the board of directors will likely raise the eyebrows of antitrust authorities,[151] if, for obvious efficiency reasons, the community of

143. Lowenstein & Millstein, *supra* note 18, at 744.

144. McCartney, *supra* note 142, at H10.

145. Sherman, *supra* note 95, at 67 (quotation of Carl C. Icahn).

146. G. Davis, Comptroller of the State of California and a trustee of the state's public employee pensions funds, *quoted in* J. M. Rosenberg, *Annual Meetings: Chance for Institutional Investors to Rock the Boat,* The Associated Press, Apr. 12, 1990.

147. Because of ''tilting the playing field in favor of management'' the constitutionality of the PBCL, *supra* note 30, was challenged by two lawsuits filed in the E.D. Pa., inter alia on behalf of several Belzberg-affiliated entities, within minutes after its enactment. *See* Vindu P. Goel, *Pennsylvania's New Anti-Takeover Law Fuels Controversy, Faces Fight in Court,* WALL ST. J., Apr. 30, 1990, at A9A; *see also* sources cited *supra* note 31.

148. Nussbaum & Dobrzynski, *supra* note 63, at 104.

149. Charkham, *supra* note 74, at 769.

150. The interplay between equal treatment, fiduciary duty, and shareholder value is discussed at length in Easterbrook & Fischel, *supra* note 88, at 703 *et seq.*

151. Possible other sources of friction are: (i) compliance with disclosure requirements according to the securities and exchange regulations; and (ii) the market perception of the institutional investors

institutional investors initiates a corresponding concerted action. However, the fear of such scrutiny cannot be justified. The greatest safeguard against collusion is the role of fund managers as agents; they cannot delegate their specific fiduciary responsibility to any other group or individual.[152]

Nonetheless, institutional investors have just as little ground for denying their growing economic power as for concealing their frustration about the degree of corporate influence. According to John C. Wilcox, managing director of Georgeson & Co., a New York City based firm that specializes in advising companies locked in takeover battles, this striking discrepancy is ripe for a radical change. He has recently forecast, "Institutional investors will be the kingmakers in 1990."[153]

With the benefit of hindsight, we can today say that this prognosis has proven to be too optimistic. A whole string of factors hindered its fulfillment.

- the spontaneous appearance of state legislators in the corporate arena as auxiliary troops of local target companies;
- the bad reputation of the central figures acting in the proxy contests that from the onset prohibited any coalition;
- the avoidance of conflict by the resignation of incumbent management;
- the irresistible power of money; and
- the sports wisdom that you should never change a winning team.[154]

If the institutional investors' time of triumph is still to come, it only implies that putting off something does not mean the opportunity is gone forever. To the contrary, the combination of proper circumstances is more likely to occur than the fall in wealth of the institutional investors. Nevertheless, being labeled the kingmakers must not be confused with being the rulers themselves. It does not mean that institutions are going to start to manage corporate America or Germany, but it does mean that they are not going to be purely passive either.[155] It appears as if the omnipresence and omnipotency of the institutional investors will trigger the rapprochement of the U.S. corporate concept of separation of shareholders and managers and of the German model of codetermination.[156]

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as the second generation of corporate raiders. *See* Anise C. Wallace, *Institutions' Proxy Power Grows*, N.Y. TIMES, July 5, 1988, at D1.

152. Machold, *supra* note 102, at 755.

153. McCartney, *supra* note 142, at H1.

154. *See* Smith, *supra* note 54, at C1.

155. Black, *supra* note 23, at 570–75; Brett D. Fromson, *The Big Owners Roar*, FORTUNE, July 30, 1990, at 66; Douglas W. Hawes, *United States: Role of Institutional Investors*, 64 SCHWEIZERISCHE ZEITSCHRIFT FUR WIRTSCHAFTSRECHT/REVUE SUISSE DE DROIT DES AFFAIRES [SZW/RSDA] 187, 188 (1990). *But see* the recent incisive criticism in Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 478–90 (1991) (applying rigorous collective action and agency analyses to recent manifestations of institutional shareholder activism).

156. For a review of this proposal of hybridization, see K. BLEICHER ET AL., UNTERNEHMENSVERFASSUNG UND SPITZENORGANISATION: FUHRUNG UND UBERWACHUNG VON AKTIENGESELLSCHAFTEN IM INTERNATIONALEN VERGLEICH *passim* (1989); Manuel R. Theisen, *Das Board-Modell: Lösungsansatz zur Überwindung der "Überwachungslücke" in deutschen Aktiengesellschaften?*, 34 AG 161, 167–68 (1989).