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Securities Intermediaries and the Separation of Ownership from Control

Jill E. Fisch
University of Pennsylvania Law School, jfisch@law.upenn.edu

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Jill E. Fisch[†]

The Modern Corporation & Private Property[1] is a paradigm-shifting analysis of the modern corporation. The book is perhaps best known for the insights of Berle and Means about the separation of ownership from control and the consequences of that separation for the allocation of power within the corporation.[2] The Berle and Means story focuses on the shareholder as the owner of the corporation.[3] Berle and Means saw the mechanism of centralized management—in which the shareholder retains the economic interest but not the control rights associated with ownership—as threatening the conception of shareholder interests in terms of property rights.[4] In particular, they viewed the shareholder's role as evolving from that of a traditional owner to that of a "supplier of capital, a risk-taker pure and simple."[5]

Financial innovation has enhanced this evolution. As Professor Tamar Frankel explains, new financial instruments enable investors to decouple the "bundle of rights" historically represented by a financial asset, such as a share of stock, into multiple components in which risk, economic interest, and control rights need not be proportional to each

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† Perry Golkin Professor of Law, University of Pennsylvania Law School. Prepared for the symposium, *In Berle's Footsteps*, at the Seattle University School of Law. These thoughts are inspired by Tamar Frankel's paper prepared for this symposium: *The New Financial Assets: Separating Ownership from Control*, 33 SEATTLE L. REV. 931 (2010). I am grateful for helpful comments and probing questions raised at the Symposium and for research assistance provided by Vijit Chahar, University of Pennsylvania Law School, LL.M. Class of 2010.

1. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Harcourt, Brace & World 1968) (1932).

2. *See* William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 IOWA J. CORP. L. 737 (2001) (describing the book's historical context as well as its significance for contemporary corporate theory).

3. *See* BERLE & MEANS, *supra* note 1, at 294 ("From earliest times . . . the stockholder in the corporation has posed both as the owner of the corporation and the owner of its assets.").

4. *See, e.g.*, *id*. at 297 ("Must we not, therefore, recognize that we are not longer dealing with property in the old sense?").

5. *Id*. at 297.

other.[6] Frankel expresses a dual concern about the consequences of slicing and dicing corporate ownership interests. First, she worries about the complexity of the resulting financial instruments and the extent to which their attributes and risks are disclosed to investors.[7] Second, Frankel is concerned about the lack of transparency associated with financial engineering.[8] In particular, she fears that decoupling may create incentives for some market participants to exercise control rights in a manner that is inconsistent with the interests of other shareholders and the corporate enterprise and that, most problematically, these actions can be undertaken in secret.[9]

Frankel joins a well-respected group of scholars in identifying how derivatives and other instruments have increased conflicts of interest among shareholders.[10] Such conflicts pose a challenge for the Berle and Means conception in that managing the corporation "for the benefit of its owners, the stockholders"[11] becomes a more complex task if those owners have different financial interests. In effect, decoupling creates two sets of Berle and Means agents: traditional corporate managers and those who exercise the control rights of owners without holding a proportionate economic interest. Modern financial products may create economic incentives that cause their holders, like managers, to act in ways that pose a danger to the corporate enterprise. Writing in the shadow of the financial crisis of 2008, Frankel is particularly concerned about excessive risk-taking.

Decoupling is not limited to exotic financial products like derivatives and reverse exchange securities, however. A majority of publicly-traded equity securities in the United States are held through intermediaries. These intermediaries—mutual funds, pension funds, insurance companies, foundations, and so forth—introduce the same separation of ownership from control. The structure of the intermediaries, in which agents control investment and voting decisions on behalf of the beneficial owners who have contributed the investment capital, is analogous to that of the corporation. As with the corporation, those who exercise control have different interests and incentives from those they represent. In

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6. Tamar Frankel, *The New Financial Assets: Separating Ownership from Control*, 33 SEATTLE L. REV. 931 (2010).

7. *Id*.

8. *Id*.

9. *Id*.

10. *See, e.g.*, Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006) (describing how investors can use derivatives to engage in empty voting).

11. BERLE & MEANS, *supra* note 1, at 293.

short, the modern institutional investor itself functions much like the Berle and Means corporation.

When these institutions in turn act as shareholders, they introduce a second layer of agency costs into corporate decision-making, and the decoupling identified by Frankel becomes the rule rather than the exception. Institutions may lack the incentives of traditional, rational shareholders and may act in ways that are inconsistent with the maximization of shareholder value. This agency problem is of particular concern in light of recent market and regulatory efforts to increase management's accountability through shareholder empowerment. In particular, the feasibility of improving corporate decision-making through shareholder empowerment depends critically on the actions and incentives of those empowered shareholders.

This essay explains how the intermediation of the U.S. capital markets exacerbates the traditional separation of ownership and control—as identified by Berle and Means—by adding a second layer of agency issues. The essay then considers the implications of this decoupling for recent efforts to increase shareholder control over management. The essay concludes by challenging the hypothetical shareholder construct. Intermediation raises the troubling question of whether the future of corporate law can rely on shareholders to safeguard the corporation—from managers or each other.

I. THE INTERMEDIATION OF THE U.S. EQUITY MARKETS

It has been nearly a century since Berle and Means published the first edition of *The Modern Corporation and Private Property*. In those years, the ownership of the capital markets has shifted dramatically. Although the early data is limited, institutions owned less than 10% of the stock of publicly traded U.S. companies from the 1920s through the 1950s.[12] By 2009, institutional investors owned 50% of total U.S. equities,[13] and retail investors (the household sector) held only 38%.[14] Insti-

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12. *See, e.g.*, JAMES HAWLEY & ANDREW WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM 48 tbl. 3.1 (Univ. Penn. Press 2000) (providing details on share ownership in 1922, 1952, 1956, and 1959); *see also* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1275 (2008) (stating that institutions owned 8% of outstanding shares in 1950).

13. Federal Reserve Statistical Release, Flow of Funds Accounts of the United States (2010), *available at* http://www.federalreserve.gov/releases/z1/Current/z1.pdf (including institutional investors such as banks, savings institutions, insurance companies, private pension funds, government retirement funds, mutual funds, closed-end funds, ETFs, and brokers and dealers in Flow of Funds data).

14. *Id*.

tutions own a higher percentage of the largest corporations; at the end of 2007, institutions owned 76.4% of the largest 1,000 corporations.[15]

A substantial proportion of institutional ownership takes the form of intermediated investment in the sense that the institutional investor acts as an intermediary, pooling the direct and indirect contributions of investors and controlling the investment of that money. Institutional intermediaries—which include mutual funds, hedge funds, and pension funds, among others—exercise virtually complete control over their portfolio investments. In addition to making investment decisions, institutions exercise voting power with respect to the securities that they hold. They also determine whether to lend securities held in their portfolio, whether to leverage their investment through borrowing, and whether to hedge their positions with derivatives.

By investing their money through an intermediary, investors delegate to that intermediary complete authority over investment decisions subject only to the specified terms of the investment vehicle. Investors neither have the power to approve, choose, or veto specific investment decisions, nor do they have the power to initiate a change in intermediary's investment strategy. However, in some cases, investors may have the right to vote upon a change in policy proposed by the institution.[16] Investors also lack the authority to determine how the intermediary will vote the shares that it holds in portfolio companies.[17]

As a result, investors in an institutional intermediary lack control rights over the portfolio companies in which the intermediary invests. They also have limited control over the intermediary itself. Investors often have the power to elect some or all of the intermediaries' directors

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15. Press Release, The Conference Bd., U.S. Institutional Investors Boost Ownership of U.S. Corporations to New Highs (Sept. 2, 2008), *available at* http://www.conference-board.org/utilities/pressdetail.cfm?press_id=3466 (citing The Conference Board, The 2008 Institutional Investment Report: Trends in Institutional Investor Assets and Equity Ownership of U.S. Corporations Report No. 1433-08-RR). The Report defines institutional investors as "pension funds, investment companies, insurance companies, banks and foundations."

16. *See, e.g.*, Jill Fisch, *Rethinking the Regulation of Securities Intermediaries* __ U. PA. L. REV. __ (forthcoming 2010) (describing right of mutual fund investors to approve a change in investment objectives).

17. Some commentators have raised the prospect of pass-through voting for investors in pension funds and mutual funds. *See, e.g.*, Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 47–52 (1991) (discussing pass-through voting and other alternatives to allow pension fund beneficiaries to determine fund voting policies); Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 IOWA J. CORP. L. 843, 888–89 (2009) (advocating optional pass-through voting to allow mutual fund shareholders to overcome the passivity of their intermediaries). ESOP plans, which do not represent the type of pooled investments described in this essay, are required to provide pass-through voting to their participants. *See* 26 U.S.C.S. § 409(e)(2).

or trustees,[18] but such voting rights are generally even less effective than the voting rights of shareholders in publicly held corporations.[19] Intermediaries, such as mutual funds and pension funds, are not subject to the accountability imposed by the market for corporate control. Indeed, some intermediaries are not even subject to capital market discipline in the form of exit[20]—most public pension funds, for example, require public employees to contribute a designated percentage of their salaries to the plan.[21] The separation of ownership and control within the intermediary is analogous to that identified by Berle and Means.[22] With respect to the underlying portfolio companies then, intermediation creates two levels of separation.

The intermediary's separation of ownership from control creates a second layer of agency costs.[23] The intermediaries' interests are often different from those of other shareholders and may not involve the exclusive goal of maximizing firm value. Passive investors, like indexed mutual funds, may prefer to minimize cost in an effort to match the returns of their benchmark rather than to engage in more costly activism. Business interests, such as the opportunity to manage an issuer's retirement plan, may cause an investment advisor to vote inappropriately to support management.[24] Some hedge funds may seek to benefit from momentum trading and volatility, and may adopt strategies through leverage and de-

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18. *See*, *e.g.*, 15 U.S.C. § 80a-10(a) (providing for mutual fund investors to elect fund board of directors); CalPERS, *Structure and Responsibilities*, http://www.calpers.ca.gov/index.jsp?bc=/about/organization/board/structure-responsibilities.xml (last visited Apr. 11, 2010) (explaining that six of 13 CalPERS board members are elected by current and retired CalPERS members (beneficiaries)).

19. *See, e.g.*, Fisch, *supra* note 16 (describing limited utility of mutual fund shareholder voting power).

20. Investors impose discipline on poorly performing investments through the capital markets by selling those investments.

21. *See, e.g.*, Steven K. Paulson, *Colo. Lawmakers Approve State Pension Rescue Plan*, DENVER POST (Jan. 26, 2010), *available at* http://www.denverpost.com/breakingnews/ci_14274153 (describing legislation mandating increased employee contributions to Colorado state pension system).

22. Indeed, some commentators have argued that the agency costs within institutional intermediaries are greater than those within public corporations. *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1283 n.21 (1991).

23. *See also* Jill Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 U. VA. L. REV. 785, 819–20 (2009) (describing how lack of transparency and regulatory constraints have limited the market's ability to discipline intermediary decisions, increasing agency costs).

24. *See, e.g.*, Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106, 79 SEC Docket 1673 (Jan. 31, 2003), *available at* http://www.sec.gov/rules/final/ia-2106.htm ("An adviser may have a number of conflicts that can affect how it votes proxies. For example, an adviser (or its affiliate) may manage a pension plan, administer employee benefit plans, or provide brokerage, underwriting, insurance, or banking services to a company whose management is soliciting proxies. Failure to vote in favor of management may harm the adviser's relationship with the company.").

rivatives that offer the potential for spectacular returns but that are "inconsistent with any concept of a shareholder as an owner of a corporation."[25] A number of public pension funds have been criticized for focusing on social investing at the possible expense of maximizing profits.[26] Similar concerns have been raised with respect to university endowments, which face pressure from members of the university community to engage in socially responsible investing when such investing may sacrifice returns.[27] Sovereign wealth funds have been described as pursuing "objectives that go beyond the purely economic, including the promotion of environmentally friendly strategies, industrial development, or the support of national champions."[28]

In addition to institution-specific objectives, the growth of intermediation increases investor appetite for risk. Most institutional investors are highly diversified, enabling them to reduce or eliminate the effect of firm-specific risk on their overall returns. Diversification, however, decouples economic interest from ownership in the same way as complex financial products. Indeed, the objectives of the diversified institutional shareholder do not provide meaningful limitations on managerial risk-taking and may cause managers to take excessive risk in an effort to boost share price.[29]

An additional layer of agency costs occurs within the intermediary. Those who make decisions on behalf of the intermediary, such as portfolio managers and investment advisers, may act out of self-interest rather than in the interests of the intermediary. Mutual fund portfolio manag-

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25. Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission is Appropriate?*, 80 NOTRE DAME L. REV. 909, 927 (2005).

26. *See* Mary Williams Walsh, *Calpers Wears a Party, or Union, Label*, N.Y. TIMES, Oct. 13, 2002 (describing these criticisms). *See also* Steven Malanga, *A Grandstanding Politician Investigates Wall Street*, REAL CLEAR MARKETS, Sept. 23, 2009, http://www.realclearmarkets.com/articles/2009/09/23/a_grandstanding_politician_investigates_wall_street_97422.html (describing loss after CalPERS sold tobacco stock).

27. Teresa H. Clarke, et al., *University Endowment Summit: Critical Issues in Endowment Management* 18–20 (2005), *available at* http://www2.goldmansachs.com/ideas/global-markets-institute/past-research-and-conferences/past-research/more/university-endowment-summit-pdf.pdf.

28. Shams Butt, et al., *Sovereign Wealth Funds: A Growing Global Force in Corporate Finance*, 19 J. APP. CORP. FIN. 73, 75 (2007). As Treasury Secretary Lawrence Summers noted:

> The logic of the capitalist system depends on shareholders causing companies to act so as to maximise the value of their shares. It is far from obvious that this will over time be the only motivation of governments as shareholders. They may want to see their national companies compete effectively, or to extract technology or to achieve influence.

Posting of Lawrence Summers to Economists' Forum, *Sovereign Funds Shake the Logic of Capitalism*, http://blogs.ft.com/economistsforum/2007/07/sovereign-funds.html (Jul. 30, 2007, 9:04 EST).

29. *See*, *e.g.*, Gregory Scott Crespi, *Maximizing the Wealth of Fictional Shareholders: Which Fiction Should Directors Embrace?*, 32 IOWA J. CORP. L. 381, 395–97 (2007) (exploring management risk-assessment in the context of fully diversified shareholders).

ers, for example, like corporate managers, have an incentive to maximize their personal profit. As many commentators have observed, portfolio managers are typically evaluated and compensated on a short-term basis, usually quarterly.[30] This may lead to both investment and governance actions that sacrifice long-term value in favor of maximizing the portfolio's current net asset value.[31]

Other motivations may cause the objectives of intermediary agents to differ from those of the shareholders of the companies in which they invest. The investment decisions of public pension funds, for example, may be influenced by the political aspirations of public officials. Officials of both New York and California's public pension funds have been accused of directing fund investments on the basis of political connections and kickbacks.[32] California Treasurer, Phil Angelides, was criticized for accepting campaign contributions from companies with ties to CalPERS and CalSTERS, on whose boards he sat.[33] CalPERS's activism at Safeway was criticized as resulting from President Sean Harrigan's personal pro-union sympathies.[34]

The foregoing few examples demonstrate the extent to which the interests of institutional intermediaries may not reflect the interests of shareholder-owners in maximizing firm value, as contemplated by Berle and Means. As with modern financial instruments, the decoupling effected by intermediation offers the potential to alter corporate decision-making. The extent to which this decoupling affects corporate operations depends on the extent to which intermediaries can exercise governance power. As a result, intermediation has substantial consequences

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30. *See, e.g.*, Posting of Simon Wong to Harvard Law School Forum on Corporate Governance and Financial Regulation, *Tackling the Root Causes of Shareholder Passivity and Short-Termism* (Jan. 31, 2010, 9:41 EST), http://blogs.law.harvard.edu/corpgov/2010/01/31/tackling-the-root-causes-of-shareholder-passivity-and-short-termism/#more-6483 ("Presently, many owners evaluate their fund managers' performance quarterly.").

31. *See, e.g.*, *id*. ("It is unsurprising, therefore, that asset managers focus on delivering short-term returns, including through pressuring investee companies to maximize near-term profits.").

32. *See, e.g.*, Peter Lattman & Craig Karmin, *Rattner Involved in Inquiry on Fees*, WALL ST. J., Apr. 17, 2009, *available at* http://online.wsj.com/article/SB123992516941227309.html (describing allegations of kickbacks by New York public pension plans); Martin Z. Braun & Gillian Wee, *How Pension Placement Agent Exploited Political Ties*, BLOOMBERG, May 18, 2009, *available at* http://www.bloomberg.com/apps/news?pid=20601127&sid=atwTqj6OjY7U (stating that "[i]ndictments and civil complaints filed by regulators so far depict public officials allowing such connections and financial self-interest to trump merit when deciding who will be entrusted to invest taxpayer money").

33. Malanga, *supra* note 26 (describing these criticisms).

34. Sonja Steptoe, *CalPERS: Corporate Reformer Under Fire*, TIME, Dec. 17, 2004, *available at* http://www.time.com/time/magazine/article/0,9171,1009728,00.html (describing conflict-of-interest charges leveled against activism at Safeway).

for the debate over shareholder empowerment, the topic to which this article now turns.

II. THE IMPLICATIONS OF INTERMEDIATION

The existence of additional agency costs within the intermediary structure offers reason to question the proposition that institutional investors can improve corporate decision-making by more active participation in corporate governance. A number of commentators have argued that institutional ownership offers a mechanism to reduce the agency costs associated with the separation of ownership and control.[35] Activist institutions, it is said, can counteract dispersion and provide a concentrated source of governance power rivaling that of management.[36] Berle himself advocated intermediation as a solution to the separation of ownership and control.[37]

The hope of reducing agency costs through institutional activism has led to regulatory and structural changes to increase shareholder power.[38] For example, in the last several years, many large U.S. companies have shifted from plurality to majority voting.[39] Unlike plurality voting,

35. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 830–49 (1992); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

36. *See, e.g.*, Sharon Hannes, *Corporate Stagnation: Discussion and Reform Proposal*, 30 IOWA J. CORP. L. 51, 74 n.103 (2004) ("Many corporate observers believe that the growth in institutional ownership signals the end of Berle and Means' prophesized separation of ownership and control.") (referring to Lyman Johnson & David Millon, *Corporate Takeovers and Corporate Law: Who's in Control?*, 61 GEO. WASH. L. REV. 1177 (1993)).

37. Berle stated:

> Suppose . . . trust companies were in the habit of accepting, on "custodian account," deposits of stocks from small shareholders, thereby gathering many small holdings into an institution commanding a block so large that protection was worthwhile, and that they also provided themselves with power to represent the depositors of stock. Such institutions could easily keep themselves informed as to the affairs of the corporation . . . and, as representing their clients, could take the action necessary to prevent or rectify violations of property rights . . . .

Bratton, *supra* note 2, at 752 (quoting Adolf A. Berle, Jr., STUDIES IN THE LAW OF CORPORATE FINANCE (William S. Hein & Co. 1995) (1928)). Berle later retreated from this position, recognizing that the intermediaries, if they remained passive, would exacerbate the separation of ownership and control and, if they instead exercised power, would substitute institutional managers for corporate managers without solving the separation of ownership and control. William Bratton & Michael Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*, 34 IOWA J. CORP. L. 99, 143 (2008) (describing Berle's refinement of his position in 1954).

38. *See generally* Stephen J. Choi et al., *Director Elections and the Influence of Proxy Advisors*, __ EMORY L.J. __ (forthcoming 2010) (describing increases to shareholder voting power and importance).

39. In 2005, more than 90% of the S&P 500 companies employed plurality voting. *See*, *e.g.*, Brooke Masters, *Shareholders Flex Muscles: Proxy Measures Pushing Corporate Accountability Gain Support*, WASH. POST, June 17, 2006, at D01 (stating that, as of 2005, fewer than 30 of S&P 500 companies had majority voting or director resignation policies in place). By 2008, over 80%

majority voting enables shareholders to defeat a director candidate nominated by management even without nominating a competing candidate, thereby increasing the significance of shareholder voting in uncontested elections. The effectiveness of majority voting is enhanced by a recent change to a New York Stock Exchange rule that eliminates discretionary broker voting in uncontested director elections.[40] As the New York Law Journal explained, the effect of the rule is a "massive shift of voting power from brokers to institutions . . . ."[41]

The scope of shareholder voting power has also increased. "Say on pay," an annual advisory shareholder vote on executive compensation, is part of many of the bills proposed in response to the 2008 financial crisis.[42] The Emergency Economic Stabilization Act of 2008[43] required companies that received TARP funding to provide say-on-pay, and several companies have voluntarily implemented say on pay provisions.[44] Shareholders may also receive the power to nominate their own director candidates and to compel management to include those nominees in the company's proxy statement. In 2009, the Delaware legislature passed legislation explicitly authorizing proxy access bylaws.[45] The SEC has also reintroduced a proxy access proposal,[46] and although efforts to secure the adoption of a rule authorizing proxy access have been unsuc-

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used majority voting. Marcel Kahan & Edward Rock, *Embattled CEOs*, (NYU Law and Econ. Research, Working Paper No. 08-43, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1281516&rec=1&srcabs=1293926.

40. *See* Order Approving Proposed Rule Change to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08, Exchange Act Release No. 34-60215 (Jul. 1, 2009), *available at* http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf.

41. David A. Katz & Laura A. McIntosh, *A Seismic Shift in Mechanics of Electing Directors?*, N.Y.L.J., Jul. 27, 2006, at 5 (describing effect of then-proposed NYSE rule change).

42. *See, e.g.*, Shareholder Vote on Executive Compensation Act, S. 1181, 110th Cong. § 2 (2007); Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. § 2 (2007); Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 2002, *available at* http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/111_hr_finsrv_4173_full.pdf.

43. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

44. *See*, *e.g.*, Editorial, *Stockholders Should Demand a Say on Executive Pay*, SEATTLE TIMES, May 14, 2009, *available at* http://seattletimes.nwsource.com/html/editorialsopinion/2009221158_editb15sayonpay.html (noting that resolutions had been approved by fifteen companies this year and that Hewlett-Packard and Occidental Petroleum had agreed to adopt say-on-pay without a shareholder vote); SmartPros, *Say-on-Pay is on the Way*, March 2, 2009, http://accounting.smartpros.com/x65641.xml (listing Occidental Petroleum, Intel, Hewlett-Packard, MBIA, Motorola and Ingersoll-Rand as companies that have adopted say-on-pay).

45. DEL. CODE ANN. tit. 8, § 112 (2009). The legislature also adopted a provision authorizing bylaws that provide for reimbursement of a shareholder's proxy solicitation expenses. *Id*. at § 113.

46. Facilitating Shareholder Director Nominations, Securities Act Release No. 33-9046, Exchange Act Release No. 34-60089, Investment Company Act Release No. IC-28765, 17 C.F.R. §§ 200, 232, 240, 249, 274 (Jun. 10, 2009), *available at* http://www.sec.gov/rules/proposed/2009/33-9046.pdf.

cessful for many years, SEC Chair Mary Schapiro has stated that she is "committed to bringing final rules before the commission regarding the ability of shareholders to nominate directors."[47]

Some commentators have called for still more shareholder empowerment. Most famously, in a 2004 article, Lucian Bebchuk proposed allowing "shareholders to initiate and vote to adopt changes in the company's basic corporate governance arrangements."[48] Bebchuk's analysis is responsive to the observations by Berle and Means that practical and regulatory developments have weakened shareholder control from its roots in property rights.[49] Importantly, however, the proposal is premised on the expectation that institutional investors, who will dominate the proposed voting decisions, "will be relatively sophisticated and well-informed on the corporate governance issues involved."[50]

To be successful in improving corporate performance, shareholder empowerment critically depends on the existence of a hypothetical shareholder—a shareholder who will exercise governance power knowledgably and who will deploy that power to maximize firm value. Although some commentators have suggested that institutional investors are well suited for that role, there are reasons to question this conclusion. First, as some scholars have noted, institutions may simply lack the capacity to exercise greater governance power effectively.[51] Shareholder empowerment may, in that case, simply increase the power of third party advisors, such as RiskMetrics, that have no economic interest in the underlying portfolio companies.[52] Second, even where institutions exercise governance power effectively, their chosen ends may not be consistent with the hypothetical shareholder construct, or with the best interests of the corporation they seek to control.

III. CONCLUSION—OBJECTIFYING THE CORPORATE ENTERPRISE

In their last chapter, Berle and Means quote Walther Bathenau's description of the depersonalization of ownership of the public corporation

47. Reuters, *US SEC Won't Finalize Proxy Access Until Early 2010*, Oct. 2, 2009, http://www.reuters.com/article/idUSN0213181320091002.

48. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005).

49. BERLE & MEANS, *supra* note 1, at 128–29.

50. *Id*. at 891.

51. *See, e.g.*, Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 177 (2001) (finding that institutional activism has had little or no effect on the performance of targeted firms). *See also* Jill Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1035–39 (1994) (reviewing literature questioning the effectiveness of institutional activism).

52. *See* Choi et al., *supra* note 38 (describing influence of RiskMetrics on institutional proxy voting).

and the resulting objectification of the corporate enterprise.[53] Although they recognize that the future of the corporation may involve a shift away from fidelity to the interests of shareholders, Berle and Means resist the shift, in part because shareholder interests tether the exercise of the corporation's economic power.

The analysis in this essay suggests that this reliance on shareholder interest as a constraint on corporate decision-making may be misguided. Berle and Means offer a reminder that the original justification for shareholder control rights was based on the traditional conception of the shareholder as the owner of a property right. The economic interest of the property owner supplied the shareholder with the incentive to exercise control in a manner that maximized firm value. It is unclear whether minority shareholders ever exercised control in this way—at least in the public corporation—but intermediation has exploded the myth of those hypothetical shareholders. Institutional intermediaries and their decision-makers hold a variety of complex economic interests that challenge their incentive to maximize firm value. At the same time, their ability to reduce firm-specific risk through diversification, coupled with the relative insensitivity of many institutions to overall levels of market risk, may produce operational decisions that impose excessive costs upon society.[54]

The problem remains: if dispersed public shareholders, financial innovation, and intermediation combine to reduce the aspects of control associated with ownership, is there a substitute that can adequately contain management power? The answer to that question depends, in part, on the specification of the corporation's objectives.

Here, Berle equivocated. In the last chapter of *The Modern Corporation*, Berle and Means identified a potential vision of the corporation that rejects the private property conception in favor of broader social objectives. The authors stated that the weaknesses of both shareholder and manager control "have placed the community in a position to demand that the modern corporation serve not alone the owners or the control but all society."[55] This vision is consistent with Berle's "New Individualism Speech" in which he argued that managers should exercise their control power in trust, but in trust for the public interest, not the private property

53. BERLE & MEANS, *supra* note 1, at 309.

54. *See, e.g.*, William Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. __ (forthcoming 2010) (manuscript 52–54, on file with authors) (suggesting that management responsiveness to shareholder demands resulted in excessive levels of risk in financial firms prior to the financial crisis of 2008).

55. BERLE & MEANS, *supra* note 1, at 312.

interests of shareholders.[56] It is, however, inconsistent with most of the preceding discussion in *The Modern Corporation*.[57]

As Bill Bratton and Michael Wachter explain in detail, in his later years, Berle moderated the defense of shareholder primacy that animates much of *The Modern Corporation*[58] in favor of an approach that Bratton and Wachter term "corporatism."[59] Although corporatism lost out in 1932, recent events offer reason to be wary of claims that shareholder empowerment is the solution to the growth of managerial power identified in *The Modern Corporation*. In the end, Berle's writing, hinted at in Chapter Six and developed in his subsequent work, provides the seeds for justifying reforms that limit both management and shareholder power in favor of increased regulatory oversight of the public corporation.

56. *See* Bratton & Wachter, *supra* note 37, at 110–13 (describing New Individualism Speech and Berle's position as reflected therein).

57. *See id*. at 107–08 (describing Berle's earlier writing in defense of shareholder primacy).

58. Bratton and Wachter argue that Berle had already become a corporatist by the time of the book's publication. *See id*. at 122 ("the Berle of mid-1932 was a corporatist.").

59. *Id*. at 102–03 (explaining "corporatism").