When the Existing Economic Order Deserves a Champion: The Enduring Relevance of Martin Lipton's Vision of the Corporate Law

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In November 2004, at an academic meeting in London jointly sponsored by the London School of Economics and New York University Center for Law & Business, a small group of leading European and American corporate law and governance scholars witnessed a notable event. At this meeting, the keynote was delivered by Michael Jensen, *emeritus* Professor of Business Administration at the Harvard Business School and author, with William Meckling, of the seminal article of academic corporate law and corporate governance, *The Theory of the Firm.*[1] In his keynote Professor Jensen, who may fairly be regarded as the father of the agency cost theory of corporate governance that has been so influential in academic circles and beyond, outlined how his views of corporate governance have been affected by the events associated with the "tech bubble" of the late 1990s and those that followed its bursting. Mike Jensen explained that he now saw that security mispricing, instead of being a temporary self-correcting problem, was, under current circumstances, a problem that could and had spiraled out of con-

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As a general matter, we have not burdened the reader with a citation for every factual matter asserted in the article. Rather, we have attempted to address the relevance of *Takeover Bids In The Target's Boardroom* in light of economic phenomenon that actively engaged participants in the corporate law debate understand existed during the last quarter-century (e.g., stagflation, changes in executive compensation, increased holdings by institutional investors, more vigorous international competition, and an active mergers and acquisitions market) without detailing the vast body of empirical research that bears on those phenomena. We readily admit that our impression of these phenomena draws on our own personal knowledge and experience. The reader interested in the underlying facts must look elsewhere for extensive documentation. Our purpose here is to provide the reader with our perspective on Lipton's contribution to the larger debate about the role of the corporation in our economy, placing him within the societal context of the last twenty-five years as we understand it.

1. Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, printed in MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS AND ORGANIZATIONAL FORMS (Harvard University Press, Dec. 2000) and 3 J. ECON. 305 (1976), also *available at* http://www.ssrn.com/abstract=94043.

trol.[2] Of course, if Jensen is correct and stock markets can and do fundamentally misprice securities for extended periods, that fact has important implications for corporate law and governance policy.

The assertion that securities prices in widely traded securities can, for extended periods, be wrong is still controversial among financial economists. But this view was not news to at least one participant in the conference. Martin Lipton, who almost certainly has been more influential in the development of American corporate law and governance practices than any other private lawyer, has long premised much of his legal writing and work on the view that the market prices of traded securities can be and often are wrong. That morning gave Lipton the unusual pleasure of hearing an intellectual leader of the opposing forces move significantly towards the position that he had championed in public debates for twenty-five years.

Each of these eminent men—Jensen, the scholar who has influenced the world of affairs and Lipton, the senior advisor who has influenced scholarly debates—has represented a point of view in a debate that has raged over the last twenty-five years respecting the governance—and the essential purpose—of large business corporations. Of course, at a certain level of generalization all agree that, from a public policy perspective, the purpose of the corporation is to facilitate the creation of wealth and thus the improvement of human welfare.[3] But how best to govern these institutions so as to achieve that end, that is the nub of the debate. The view reflected in Professor Jensen's famous academic article—let's call it the Finance View—sees the current value of the firm's equity securities (the residual claimants to the firm's value) as the best way to measure the productivity of the corporation. When it gets down to policy, those with this perspective tend to emphasize the practical importance of the conflicting interests between management and shareholders in public corporations.[4] Some who adopt the Finance View tend to think that anyone who can raise the finance to buy up control of a corporation at current market prices will likely have a plan to make the corporation more valuable. Why else would they pay the required premium? After all, their willingness to pay the highest price demonstrates that they are the parties most likely to manage the firm to produce the highest future cash flows because that is the basis on which the markets value firms (or so they think).[5] On the

2. Professor Jensen's speech has been turned into a formal paper. *See* Michael C. Jensen, *Agency Costs Of Overvalued Equity*, Harvard NOM Working Paper No. 04-26; ECGI-Finance Working Paper No. 39/2004 (Mar. 2005), *available at* http://ssrn.com/abstract=480421 (forthcoming in FINANCIAL MANAGEMENT, Spring 2005) [hereinafter,"Jensen, *Agency Costs of Overvalued Equity.*"].

3. The questions of whether and how the distribution of the wealth resulting from the law's authorization of corporations with legal status as persons should be influenced by positive law are, of course, the subject of ongoing debate.

4. This Finance View would recognize that in some circumstances—insolvency primarily—the residual financial claimants of the firm are its creditors (not equity security holders) and thus, in those circumstances, the directors owe equitable duties to them and should prudently preserve and maximize firm value for their benefit.

5. The following articles are leading corporate law examples of this kind of thinking: Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management In Responding to a Tender Offer*, 94 HARV.L.REV. 1161 (1981); Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive*

other hand, the Finance View saw and sees corporate boards, as populated by puppets of senior management, who are thought to be largely interested in maintaining the status quo. Thus, when the hostile takeover movement began to gain momentum in the late 1970s and early 1980s those with this perspective were unanimous in the view that such transactions should be encouraged by public policy by restricting the role of the board in such transactions and providing shareholders directly with the power to decide whether there should be a change in corporate control.[6]

Elements of this view are undeniably sound, of course, but the premise that the public welfare is advanced by a policy that seeks to optimize current stock price under all or most circumstances is highly debatable. Certainly Martin Lipton thought so in 1979 and he thinks so now. Michael Jensen appears to concur in that view today.

Lipton's view, which we might call the Institutionalist View, sees business corporations as social institutions authorized by law in order to facilitate improvements in public welfare. The corporation law itself, in this view, is seen as but a part of a larger economic and social policy that sought and seeks to promote wealth creation, not simply for the benefit of stockholders and managers, but more generally for the benefit of a nation that (at least by the latter half of the 20th Century) envisioned that economic progress meant not only profits, but as importantly, the humane treatment of workers, an improved environment, vigorous competition among firms for the benefit of consumers, and ethical behavior by corporations at home and abroad.[7] This Institutionalist View sees as a historical fact that government's sanctioning of the corporate form was provisional and instrumental. When in the past the form was seen as threatening to the general welfare, then it was natural to observe coercive government regulation—as in the case of the Sherman Act.

Tactics and Shareholders' Welfare, 36 BUS. LAW. 1733 (1981). Jensen himself is no longer so sure. He is troubled by the inability of the financial markets—through trading by contrarian investors—to push the price of firms closer to their so-called fundamental values, as measured by more standard cash flow generation estimates. Jensen, *Agency Costs Of Overvalued Equity, supra* note 2, at 15. In plain terms, the problem might be viewed thusly: If some traders know that the elephant herd is running the wrong way, but will be crushed to death by running in the opposite direction before they can influence their fellow elephants to understand that they are correct, how likely will they be to act on their contrary assessment of fundamental value, as opposed to simply trying to figure out when and how to drop out of the stampede before the herd reaches the cliff?

6. *E.g.*, Ronald J. Gilson, *A Structural Approach To Corporations: The Case Against Defensive Tactics In Tender Offers*, 33 STAN.L.REV. 811 (1981); Lucian A. Bebchuk, *The Case For Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982).

7. The famous case of *Dodge v. Ford Motor Co.*, 170 N.W. 668 (1919), that still is in many case books arguably stands for the opposite perspective. But it was atavistic even at its date of publication. There is a reason why *Dodge v. Ford* is in all the books: there are no other cases that really stand for the position of shareholder sovereignty as opposed to director sovereignty. Although the Finance View is now the predominant academic perspective, the Institutionalist View continues to have considerable academic appeal. For a very thoughtful current articulation of the utility resulting from an Institutionalist corporate law, see Einer Elhauge, *Sacrificing Corporate Profits In the Public Interest*, 80 N.Y.U. L. REV. 733 (2005).

In his important 1979 Business Lawyer article *Takeover Bids in the Target's Boardroom*,[8] the twenty-fifth anniversary of which we commemorate with this essay, Lipton expressed confidence that the Finance View of the corporation had been irrevocably rejected by American policymakers. In particular, Lipton regarded it as settled economic policy that the purpose of corporate law was to encourage corporate boards to implement long-term strategies that would generate economic growth for the benefit of all corporate constituencies and society as a whole. A corporate law that stripped directors of their authority to consider the effect of a takeover on all corporate constituencies, and the nation itself, in responding to takeover bids, would, he asserted, be contrary to that longstanding policy.

In supporting maintenance of this vision of good public policy, Lipton drew on principles of republican democracy. In the Institutionalist View, trying to construe the stockholders' response to a takeover-motivated tender offer as having the legitimacy of a democratic vote was fundamentally to misunderstand the nature of the corporate form. In this view, the corporation is not anything like a direct democracy. The corporate electorate had very limited rights, the most important of which were the rights to elect the directors and to ratify some of the more important transactions the directors might propose. The power to initiate corporate strategies did not reside in the stockholders; it resided firmly in the centralized decision makers: the board of directors.

Lipton wrote in 1979 because earlier than most he saw that the concept of the corporation as a social institution was under attack. Beginning around 1975, a series of intellectual and social forces had reached the point of development in which this attack became salient.

First among these forces was an idea—the efficient capital markets hypothesis. It laid the predicate for the belief among financial economists that markets were fully capable of evaluating the value that management teams were likely to create in the future. The corollary of that belief was that, because markets can accurately discount future projected flows of cash, there really is no difference between long-term wealth creation and immediate wealth creation as measured by market capitalization. Thus, if a hostile offer were made for all of a corporation's stock at any premium to market, it must be that effecting that transaction would place the assets under the management of better managers and would increase total social welfare. Among legal academics, early adopters of the view, notably Professor, later Judge, Frank Easterbrook and Professor Daniel Fischel, announced that the optimal legal rule therefore was one that required a board of directors to do nothing in the face of a hostile takeover.[9]

The second social force that eroded allegiance to the Institutional View of the corporation was not an idea but a change in structure. It was the gradual re-aggregation, so to speak, of shareholder interests. From the time of the development of large public stock markets in the late 19th century, the equity component

8. 35 BUS. LAW. 101 (1979).

9. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management In Responding to a Tender Offer*, 94 HARV.L.REV. 1161 (1981); Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981).

of the capital structure of American business had increasingly become represented by shares traded in public markets. This method of allocating savings to users of capital has many comparative virtues. Most notably, it affords cheap diversification of risk to owners of capital, thus allowing them (and the system) safely to expose their savings to greater risk in the reasonable expectation of higher returns. But one consequence of being diversified is that investors tend to be rationally apathetic respecting any one portfolio investment. Their piece of the enterprise is typically too small to affect outcomes or to justify the costs of monitoring management. Thus, relatively autonomous (or semi-autonomous perhaps) senior management naturally followed the development of large capital markets. But by the 1950s, with the beginnings of a private pension system in the U.S. and the beginnings of growth in the mutual fund industry, we begin to observe what might be called the reaggregation of American investor interests. The investment funds of diversified holders were being collected in the hands of investment institutions, an accumulation which in time would become so sizable as to reduce substantially the forces that incline shareholders to passivity. By the mid-1980s, it was not unusual for 40-50% of a major corporation's stock to be held by institutional investors, although it was not until 1990s that these investors begin to take an active direct voice in corporate governance. Lipton was prescient in 1979 in recognizing the growing pressure that this reaggregation of capital would place on corporate boards of directors.

By the 1980s, the existence of these large diversified investors helped lay a fertile field for the growth of the hostile takeover phenomenon, which was also nourished by the third force that converged on the idea of corporations as societal institutions. That was innovation in the finance industry, particularly the growth in the use of so-called junk bonds that often were deployed to finance hostile takeovers. Historically high interest rates in the 1970s had kept stock market valuations floating in an essentially static range for over a decade. When, under Paul Volcker's lead, the Federal Reserve Board broke the inflationary cycle in the early 1980s, financially sophisticated players recognized that stocks were cheap. What followed was an historic wave of finance-driven corporate acquisitions. The leveraged buyout phenomenon provided the actors and the incentives for the assault on the idea of the business corporation as an institution to move from an academic debate to a frontal attack on the status quo.

It is likely that none of these factors would, even in combination, have fueled an acquisition boom without a final factor. By the time of *Takeover Bids In The Target's Boardroom* was published in 1979, American confidence in the federal government's capacity to manage the national economy so as to produce continued growth, smooth the business cycle, include more Americans in the comforts of middle class life, and satisfy a host of emerging social expectations, had begun to flag. Stagflation (a frustrating combination of high unemployment and inflation) reigned—generating an unprecedented situation in which both consumers and workers were being punished by market forces. Foreign competition—notably Japanese automobile and electronics producers—was putting severe pressure on once "fat and happy" American enterprises. The election of a more con-

servative national administration in 1980 (in no small measure due to the discontent caused by our government's apparent inability to break us out of this economic slump) accelerated the policy shift to less regulation and greater reliance on markets to confront these forces of change.

Together these factors—an intellectual school of corporate law and economics centering on the efficiency- and wealth-generating utility of capital markets, the institutional aggregation of investor interests, financial market innovation, and a confluence of economic conditions that fostered both the creation and the growing strength of these forces—profoundly challenged the viability of the Institutionalist View of the business corporation. The hostile takeover, which was the topic of Lipton's 1979 concern, constituted an important medium in which that challenge was expressed.

As a corporate lawyer, Lipton engaged the public policy debate about the proper role of the business corporation through the specific prism of corporate law, particularly that slice of corporate law involving acquisitions. On this narrow yet significant field, *Takeover Bids in the Target's Boardroom* can be seen as an opening defensive salvo that had both practical and intellectual components. Notably, as of the 1970s and 1980s, this was a front that was not characterized by a division between management and labor. Whether or not these constituencies had different views about economic policy more broadly (as of course they often did), they were then united by a desire that corporate boards, rather than stockholders, should be empowered to decide whether a takeover would occur. By the nature of their interests, both labor and managers are Institutionalists with deep long-term investments in the corporations for which they toil. In at least the small sliver of economic policy occupied by corporation law, Martin Lipton was the champion of both these constituencies in articulating an Institutionalist vision of appropriate takeover policy.

Though Lipton understands the working of financial markets better than most, he never believed that the financial markets are the central feature of our economy's power. For him, social wealth is actually created, not in financial markets, but within corporations—where research scientists invent products, engineers plan, and marketing and production people at all levels of the corporation develop and execute strategies to deliver attractive goods and services efficiently. He and others of this view saw these complex systems as hugely valuable and worthy of protection from damage caused by transitory moods in the capital markets. For Lipton, then and now, market prices could be wrong in the sense of deviating sharply from the intrinsic value of the firm. He urged, in the article that triggers these thoughts, that the law should recognize that a board has the obligation to defend the corporation when it believes in good faith that a takeover offers inadequate value or that a bid poses dangers to other legitimate objects of corporate concern, including the interests of its workers, home community, or consumers. Although corporate law surely ought not immunize American corporations from the pressures of product market competition, Lipton believed it should permit directors to protect the corporation from financial entrepreneurs who might seek to take advantage of temporarily depressed share prices.

Importantly, *Takeover Bids in the Target's Boardroom* urged that the hostile tender offer should not be viewed by policy makers as a development that required unique policy rules. Each generation faces evolving market circumstances and it was the genius of the corporate form to allow centralized management to forge new business strategies to address new challenges. All that good policy therefore required was that the new technique of the hostile tender offer be domesticated by ensuring that boards had the same strong hand in addressing them as they had in making other business decisions affecting control of the corporation (such as mergers and asset sales). If boards were recognized as possessing this authority, they would continue to be empowered to pursue long-term strategies for growth. And these strategies would presumably be beneficial not only to investors willing to entrust their capital to the firm over a number of years, but to workers, communities, and consumers, who would benefit from the greater stability and rewards that would flow from having public corporations focused on sensible long-range business plans. This was the idea—that the firm was a form of republican, not direct, democracy.

But Lipton recognized that there was a critical weakness in the analogy of the corporation to a political republic. In a polity, the citizens are, practically speaking, captives of geography. As continuing residents of the place, they must suffer the consequences of choices they make at the ballot box. They must eat their own cooking, so to speak. The citizenry that demands short-sighted policies will bear the costs of those policies. This fact arguably creates a discipline that should motivate decision makers to think about the long run. But the electorate in the corporate republic is transitory and increasingly so. When a hostile takeover is in process, this turnover accelerates even more. As Lipton noted, the stock then tends to flow rapidly into the hands of temporary holders who are seeking speculative returns from the offer. These are not long-term "investors" seeking to benefit from the corporation's promising product lines or attractive new services; they invest temporarily and for the specific purpose of seizing the immediate arbitrage opportunities created by the tender offer.

Especially because of the "coercive" techniques then coming into prominence in hostile tenders, but not only for that reason, Lipton recognized that to give these stockholders their head would result in nearly every premium tender offer succeeding.[10] But if we believe with him that market prices can be an *inaccurate* metric of the long-term productivity of the corporation, why (he asks) would we, as a matter of sound policy, permit these short-term speculators to disrupt the implementation of a well thought-out business strategy? To do so would or might deny customers the benefits of new products, unsettle the lives of workers who had committed their careers to the corporation, and injure communities that had supported the firm's growth.

10. *Takeover Bids In The Target's Boardroom*, *supra* note 8, at 113–15. Ironically, Lipton's understanding in 1979 of the strong economic incentives created by tender offers and their ability to "distort choice" was later stated in academic terms in an important article by one of the leading corporate scholars of the Finance View. *See* Lucian A. Bebchuk, *Towards Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985).

Of particular concern to Lipton was the emergence of a range of so-called "institutional investors" who, he pointed out, were increasingly coming to be the dominant holders of securities. With this evolution the ultimate investor now faced two agency problems: that of centralized management (the separation of capital from management) and that of professional managers of the investment fund in which a private investment is held (a separation of capital from capital). The incentives of these intermediate institutions concerned Lipton. He feared that they were, by their very design, unlikely to have much concern whether a bidder's plans for the target were likely to produce more economic growth in the future than the business plan that the target's board was already implementing.

Lipton sought to persuade policymakers that the interests of these short-term holders should not be given much, if any weight. As the Institutionalist View does, Lipton looked to the board of directors as a stabilizing force. The board is legitimate because it is elected by shareholders according to law and much better informed then they in assessing the prospects for long-term wealth creation.

Lipton's analysis does not leave shareholders out of consideration, of course. He attempts to reconcile the interests of all the constituencies of the corporate form by arguing that, within a long-term time frame, his view of appropriate policy would benefit all constituencies invested in the firm.[11] Let directors continue to make all key business decisions, Lipton says, and in the long run you'll be happy as a stockholder as well. He asserted that data shows that boards can be trusted to know when to sell and that stockholders whose boards resisted bids as inadequate were rewarded because their corporations were ultimately sold (or generated trading price increases) that outpaced the gains promised by the earlier-rejected tender offers.[12]

Through these arguments, Lipton accomplished an important polemical objective. It is unlikely that Lipton harbored hopes that his arguments would persuade those who spoke for institutional investors. But they were not his real target audience. Rather, he addressed policymakers—such as the Delaware courts—to whom he supplied a plausible rationale for supporting the view that directors inherently possess the authority to make a business judgment about a takeover bid. Viewed from the forest level, the appropriate policy for all was easy to discern: let boards do their job and all corporate constituencies would ultimately be better off.

As we now know, Lipton's vision of appropriate corporate law doctrine was received warmly by the Delaware Supreme Court in the 1980s in cases like *Unocal v. Mesa Petroleum Co., Moran v. Household International, Inc., Pogostin v. Rice*, and, of course, *Paramount Communications, Inc. v. Time Inc.*[13] Lipton did, of course, lose

11. *Takeover Bids in the Target's Boardroom*, *supra* note 8, at 106–110.

12. The following recent articles are characteristic of Lipton's attempt to show that giving directors a strong hand benefits stockholders. *See, e.g.*, Martin Lipton, *Twenty-Five Years After Takeover Bids in the Target's Boardroom: Old Battles, New Attacks and the Continuing War*, 60 BUS. LAW. 1369 (2005); Martin Lipton & Paul K. Rowe, *Pills, Polls, and Professors: A Reply To Professor Gilson*, 27 DEL. J. CORP. L. 1 (2002); Martin Lipton, *Pills, Polls and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002).

13. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Pogostin v. Rice, 480 A.2d 619 (Del. 1984); and Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990).

an important contest in *Revlon v. MacAndrews & Forbes Holdings, Inc.*,[14] when the Supreme Court held that directors were bound to give primacy to the stockholders' interests in getting the best price immediately available when a company was put up for sale. But more generally, Lipton's view of the board's judgment as being the central feature of corporation law was adopted by the Delaware courts in dealing with the novel hostile takeover phenomenon. Under Delaware law, for example, boards of directors generally have the discretion to reject a takeover bid in favor of their existing business strategy, so long as their view that the status quo promises more long-term benefit is reasonable.[15] In making that determination, the board of a Delaware corporation can give weight to the interests of other constituencies, at least to the extent that there is a rational relationship between their interests and the long-term best interests of stockholders.[16] Outside Delaware, the embrace of this view has been even more passionate. In a majority of states, explicit statutes exist that permit boards to reject a takeover on the basis that the takeover threatens the best interest of the corporation's employees, community, and customers.[17]

On that front of the economic policy battlefield that involves the contest over the appropriate takeover policy of substantive corporate law, Lipton can take pride in the extent to which his arguments in *Takeover Bids in the Target's Boardroom* have been adopted. Even more dramatically, his audacious originality produced the innovation of the poison pill and its intellectual defense. However one feels about the social utility of the device, almost certainly the pill represents the most important private law innovation in the field of corporate law of the last fifty years. Nearly as consequential was Lipton's important role in the movement toward increasing the professionalism and power of independent directors. Lipton seized upon the emergence of independent board majorities as additional intellectual ballast for his argument that boards should be trusted to decide whether

14. 506 A.2d 173 (Del. 1986).

15. This is, of course, a simplification of a complex body of law, but cases like *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Moran v. Household Int'l. Co.*, 500 A.2d 1346 (Del. 1988), 651 A.2d 1361 (Del. 1995) and—most obviously—*Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990) all have a Liptonian flavor. In other writings, we have dilated more on the nuances of the doctrinal law, noting areas of that law (e.g., the so-called *Revlon* doctrine, see *infra* notes 16, 18) that lean more toward the Finance, rather than Institutionalist, View. *See generally*, William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation On Bridging The Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002); Leo E. Strine, Jr., *Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, 55 STAN. L. REV. 863 (2002); William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning The Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449 (2002); Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any "There" There?*, 75 S. CAL. L. REV. 1169 (2002); William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards Of Review In Delaware Corporation Law*, 56 BUS. LAW. 1287 (2001); Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919 (2001); William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO. L. REV. 261 (1992).

16. *Unocal*, 493 A.2d at 955–56; *Revlon*, 506 A.2d at 182.

17. *See* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2525 and n. 64 (2005) (stating that as of 1999, forty-one states had constituency statutes).

and to what buyer corporations should be sold or merged.[18] To his continuing delight, many scholars holding the Finance View bemoan the rejection of their perspective by Delaware and other states and find themselves constantly reworking their policy proposals in order to come upon one that can shake the grip of the director-centered approach to takeovers that is at the heart of Lipton's Institutionalist View.

Within the domain of pure corporate law, across multiple issues Lipton's career as a lawyer may therefore be seen as an intelligent, even a brilliant effort, over decades, to support the forces of the status quo—to protect a system of wealth creation that he believes has served his nation well and that should not be frivolously endangered. In a sense, Lipton has devoted much of his professional life to challenging anyone who claimed to have come upon a persuasive affirmative answer to the following question (as he might tendentiously frame it): why should we entrust the fate of important societal institutions to arbitrageurs, short-term investors and corporate raiders when duly elected boards of directors are likely to do a better and more responsible job?

In his mission to deploy corporation law to protect his vision of the good, Lipton has had remarkable success. This is not to say that he pursued his vision exclusively in a defensive manner, by resisting change entirely. He did not. When necessary to strengthen the board-centered system of corporate law he favored, Lipton has often been an advocate for progressive reform, especially when innovation seemed essential to ward off even more sweeping and possibly destructive change. In this regard, the most obvious recent example was his leadership with others in shaping the New York Stock Exchange's new corporate governance listing standards.[19] These standards, while imposing serious new obligations on boards, were quintessentially Institutionalist in perspective because they were designed to permit the continuation of director-centered governance through measures designed to make that system more effective and credible.

But, however successful Lipton was within his sector of the policy battle, the Institutionalist View he championed arguably did not fare so well in the overall *policy* war. That is, looking back on the quarter-century since *Takeover Bids In the Target's Boardroom*, the success of Lipton in helping to secure the values underlying the Institutionalist View depends, to a large extent, on the width of one's frame of vision.

Judicial decisions, after all, are important, but in the end can only weakly control fundamental economic forces. The last twenty-five years demonstrate the inability of corporate law on its own to secure the Institutional vision. Although Lipton's perspective largely won out in courts and state legislatures, he may have underestimated the extent to which corporate law itself could insulate managers from short-term thinking. During the period following *Takeover Bids In The Target's Boardroom*, real world economic pressures gradually caused well-intentioned man-

18. *See, e.g.*, Martin A. Lipton and Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59 (1992).

19. *See* NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL, CORPORATE GOVERNANCE LISTING STANDARDS § 303A (2004), *available at* http://www.nyse.com/pdfs/section303A_final_rules.pdf.

agers seeking to generate increased competitiveness for their firms or to satisfy shareholder demand for growth in share value to consider voluntary change-in-control transactions. Entry into these transactions made it more difficult for boards to ignore short-term stockholder interests, especially when the long-term future of a company might best be secured by its sale to a large industry player,[20] making the board subject to the *Revlon* doctrine and raising a difficult trade off between pure stockholder interests and those of other constituencies that was more and more difficult for boards to elide. The frequent success of hostile interlopers in acquiring corporations that announced friendly strategic mergers exemplifies this phenomenon.[21]

Deepening the influence of the stock market pressures at the root of the Finance View was the nature of the corporate republic itself. In that republic, it is ultimately capital that has the only voting power. Therefore, unless capital's incentives are rationally channeled towards the creation of wealth in the long-term, rather than the extraction of immediate returns from (arguably hyper-) active trading strategies, it is unrealistic to think that the corporation law itself can do much to prevent boards from responding to financial market pressures, even if those pressures might push in the direction of policies that ultimately, over the long run, are destructive. Although the Institutionalist View gave full-throated voice to the interests of other corporate constituencies, directors and managers knew that only stockholders had the power to change the board. The threat (proved real by many successful examples) that an acquirer could simply pursue its offer through the ballot box diminished the extent to which Liptonian takeover policies could insulate boards from short-term thinking.[22] And, the reaggregation of capital through financial intermediaries increased the threat as premium bidders found it easier to solicit the necessary proxies to win an election. These fundamental evolutionary facts in the end tend to make the original Institutionalist perspective and agenda not tenable.

Correspondingly, CEO attitudes towards the acceleration of the M & A market evolved as well. Financial buyers offered equity participation in deals to senior management and thus the management-led leveraged buyout developed. Later, changes in the nature and magnitude of executive pay occurred (with the support and advocacy of institutional investors) that created incentives both for change-in-control transactions, and for making increases in the company's stock trading price the principal expression of corporate success. The once-solidly Institutionalist ranks of CEOs increasingly echoed the Finance View, rhetorically emphasiz-

20. The Finance View's influence through the *Revlon* doctrine, *supra* note 14 and accompanying text, tempered the Institutionalists' victories in *Moran* and *Unocal*. In this regard, see the famous case of *Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994).

21. For data on this deal-jumping phenomenon, see, for example, Robert E. Spatt, *The Four Ring Circus—Round Nine: A Further Updated View of the Mating Dance Among Announced Merger Partners and an Unsolicited Second or Third Bidder* (Feb. 24, 2005) (unpublished manuscript, on file with The Business Lawyer), presented at the Tulane Corporate Law Institute (Mar. 11, 2005).

22. Lipton himself has argued that this reality is a reason why giving directors a strong hand in takeovers does not injure stockholders—because directors usually end up doing the deal with the highest current value. *E.g.*, Lipton, *Polls, Pills & Professors Redux*, *supra* note 12, at 1058–59.

ing "stockholder value." Even outside the M&A market, the increase in equity-based compensation tied to company stock prices led more than a few managers to manage quarter to quarter with a focus less on fundamentals and more on GAAP accounting results.[23] And, quite importantly for the Institutionalist Vision advocated in *Takeover Bids In The Target's Boardroom*, the national identity of American corporations changed in a manner that Lipton did not anticipate. The implicit but unmistakable idea that American corporate boards were patriotically focused on their nation of domicile became quaint as household American brands (Chrysler and Columbia Records to name just a couple) became, through M&A transactions, mere divisions of corporations controlled elsewhere.

For all these reasons, some respected corporate law scholars, less drawn into the doctrinal debates than their more passionate colleagues in the academy, have argued persuasively that the actual results of the last generation's corporate law policies look more attractive to those holding the Finance View than to those holding the Institutionalist View.[24] In other words, the doctrinal victory that Lipton won as to appropriate takeover policy seems in retrospect a holding action that placed some brakes on the overall movement of American economic policy toward the Finance View.

Acknowledging this reality is no slight to a remarkable professional achievement. We are, after all, lawyers, not omnipotent social planners. To call Marty Lipton a powerful force deployed in a not wholly successful defense of the status quo; a protector of a view of the ideal nature of the corporation and its governance rooted in the past—may to some sound like an indictment. Are not history's leaders those who first recognize the shape of the future and help in its realization? Sometimes yes, of course, but we think not inevitably so. At least in circumstances in which a set of institutions function well to meet their social purpose—such as U.S. economic institutions during the post-war period, there is great value in the status quo. Protection of that value in an uncertain world being profoundly affected by deep changes has, we think, great social value. There is a limit to the amount of dynamic change an organism can withstand in a healthy state in any given period. We need mechanisms to monitor change, just as there need to be agents of change. The magic resides in the balance and, when social processes are

23. In his recent article, Jensen recognizes the serious costs that flowed from managing so as to maximize the corporation's current stock price as opposed to maximizing the corporation's long-term generation of cash flow. Jensen, *Agency Costs of Overvalued Equity*, *supra* note 2. He uses strong words to express his feeling about managing to the market:

> Indeed, "earnings management" has been considered an integral part of every top manager's job for at least the last two decades. But when managers smooth earnings to meet market projections, they're not creating value for the firm; they're both lying and making poor decisions that destroy value. I realize it is not fashionable to use such harsh language to describe what are almost universal practices. But when numbers are manipulated to tell the markets what they want to hear (or what managers want them to hear) rather than the true status of the firm—it is lying, and when real operating decisions that would maximize value are compromised to meet market expectations real long-term value is being destroyed.

Id. at 3.

24. Marcel Kahan & Edward B. Rock, *How I Learned To Stop Worrying and Love the Pill: Adaptive Responses To Takeover Law*, 69 U. CHI. L. REV. 871 (2002).

involved, there is no science that allows policy makers to determine the optimal amount of change or even whether change promises benefits that exceed the accompanying risks or is simply reckless adventure.

Defense of the initial Institutionalist View of the corporation was bound in time to fail. The evolution from a relatively stable world of pre-1970 to the world of today irresistibly has brought pervasive change to the management of business corporations and the markets within which businesses must compete. Today, products have much shorter life cycles, competition in product markets is far more intense and global, shareholders are large, energized and have institutional agents, and capital and securities markets are larger, much more complex, and dynamic. These forces require change in the old Institutionalist View. But the Finance View of the late 1970s (that in effect held that the market capitalization of a firm at any moment was a fair estimate of its intrinsic value) also is now the "old" Finance View. After the "new economy" bubble of the late 1990s, the ECMH[25] -centered Finance View of sound corporate policy seems no longer tenable, either. The current task is to design the synthesis of the two views, through institutional arrangements that balance the need for long-term multi-constituency planning and productive partnership with constraints on waste, excess and self-aggrandizement.

The intellectual and political energy required to forge and implement a sensible synthesis along these lines is enormous. A daunting array of policy issues—tax, financial market, trade, and macroeconomic, just to name a few—would require consideration for a coherent, synthetic economic framework to be developed. To expect Lipton, a corporate lawyer, to fill in the complete framework of a next generation Institutionalist Vision would be unfair and unrealistic.

That said, within the domain of corporate law itself, new challenges have emerged that Lipton is well-equipped personally to address in this synthetic manner, forging part of a revised, modern Institutionalist Vision. The mounting influence of institutional investors has created momentum behind reform of the director election process. Unsurprisingly, Lipton has been one of the most thoughtful and effective voices in opposition to the Securities and Exchange Commission's proposed rule providing for shareholder access to the company's proxy.[26] Here, the arguments he makes bear a strong family resemblance to the concerns that motivated his early work: we must take care not to destroy the institutional arrangements, particularly the board of directors, that have worked so well for us in the past.

The policy problem that the current proxy access issue presents, however, illustrates the larger challenge that the Institutionalist Vision confronts. After all, the demand by institutional investors for a more open and competitive corporate election system is not, on its face, inconsistent with the model of corporate law advocated by Lipton. It does not seek to reduce director power but merely to

25. ECMH, of course, means the efficient capital markets hypothesis.

26. *See, e.g.*, Martin Lipton & Steven A. Rosenblum, *Election Contests In the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003).

change the process by which directors are elected. Lipton himself has sharpened institutional investors' focus on the election process by arguing that the replacement of directors through elections, and not tender offers, should be the medium through which stockholders influence the direction of corporate policy.[27] Even if Lipton and like-minded members of the Institutionalist school are successful in combating the current proxy access initiatives, it is doubtful the rising influence of institutional investors can in the long run be staunched.

Rather, it seems likely that more, not less, equity capital will be invested through institutional investors.[28] The approach to investing that these institutions will take will provide the greatest source of pressure for corporate law change. Will these institutions (or, more accurately, the agents who operate them) be dominated by an immediate stock price orientation (as presumably most hedge funds are), or will they be patient investors in sound companies searching for long-term economic growth? Because they will have increased power over American business, we expect the institutional investor forces to exert pressure that will revive the historic American distrust of centers of finance. Just what obligations should be imposed on, and what incentives should exist for, institutional investors and those who operate them? How should these growing centers of power be harnessed for the public good and the promotion of the greatest long-term economic growth?

In the current world in which stock price is often the focus of executive incentive compensation, in which institutional investors have organized monitoring agents and are a powerful lobbying force, and in which the obligation of outside directors to shareholders has been emphasized by courts and others, takeover policy is unlikely to be as significant as it was following the publication of *Takeover Bids In The Target's Boardroom*. More likely to be contested will be questions affecting voting, such as the utility of staggered boards, access to the company's proxy card, and reimbursement of proxy solicitation costs. Are there policies within the corporate law that, with sensitivity and creativity, can hold boards more accountable but only to those stockholders who make a commitment to the corporation of some enduring sort? Is there a way to give stockholders of that kind

27. *E.g.*, Lipton & Rowe, *Pills, Polls, and Professors: A Reply To Professor Gilson*, *supra* note 12, at 26–35; Lipton, *Pills, Polls and Professors Redux*, *supra* note 12, at 1054, 1060–61.

28. We see little reason why the efficiency for individuals and governments seeking a rationally diverse portfolio of investing through intermediaries (particularly those that offer index funds) will diminish. There are additional reasons to believe that financial market pressures on the Institutionalist model will grow in strength. Consider, for example, the huge amounts of money now flowing into so-called hedge funds, which have little interest in the fate of particular corporations over time. Indeed, the speed with which shares change hands and the prevalence of hedged positions is now raising a new problem for corporate law, which is the possibility that stockholders of record will hold no economic investment in the corporation. Thus, they may vote their shares against the economic interests of both the corporation and its current shareholders, seeking to promote some collateral financial interest. If the corporate law cannot be assured stockholder votes are motivated by their desire to do what is best for their investment in the firm—in the very precise sense that the voters will vote to maximize the value of the shares they are voting—then many of the tools traditionally used by corporate law to ensure fairness and integrity (e.g., cleansing votes by disinterested stockholders, in particular, and merger approval votes, in general) become suspect. Combating this threat is another task for Lipton and others of an Institutionalist point of view.

an increased say in the election process periodically, while simultaneously reducing the leverage of stockholders looking only for an immediate return? If the election process is reformed and the corporate analogy to a republic is strengthened, should the costly and distracting precatory proposal process be jettisoned as a tradeoff? To what extent should the fiduciary duties of institutional investors to their own shareholders be the subject of greater enforcement, looking more like the scrutiny that corporate directors now face?

We suppose that questions like these will increasingly occupy those interested in the effective functioning of our system of corporate law. Thus it would appear, ironically, that the most important intellectual challenge that Lipton might now undertake within the field of corporate law is formulating a plausible array of policies designed to promote responsible, wealth-creating behavior by institutional investors—the very constituency whose growing power he so presciently predicted and feared in *Takeover Bids In the Target's Boardroom*.[29] In particular, one of Marty Lipton's insight and imagination could valuably focus his attention on the behavior of those institutional investors who manage the trillions of dollars invested in pension and index funds. These funds in a real sense are too large and diversified and face investment horizons that are too long to care rationally about maximizing the current price of any of their holdings, especially if maximizing current price is damaging to long-term wealth creation. The beneficiaries of these funds undoubtedly have a special interest in ensuring that improvements in fundamental economic performance, and not short-term gimmicks, are the focus of American corporations.

In and of itself, the orientation of institutional investors towards a longer-term perspective focused on fundamental economic performance will, of course, be insufficient to secure the entirety of the Institutionalist vision. Without national economic policies designed to protect corporate constituencies other than stockholders, their interests are likely to be a decidedly subordinate concern for corporate boards elected by equity capital owners. But, if Lipton and other Institutionalists can, by policy measures, promote more rational, long-term thinking by the institutional investors who wield voting clout in the corporate republic, then these constituencies might benefit from the increased leeway corporate boards will have to formulate investment strategies designed to make their corporations durable, profit-generating, employment-creating, and charitable-donating, taxpaying institutions for decades to come.

A keen observer of the corporate law debates during the last quarter-century would appreciate the poetic justice of an eloquent advocate of the Institutionalist

29. Within the ranks of institutional investors, John Bogle, the force behind the success of Vanguard and of the index investing movement, has Institutionalist tendencies and has called for the creation of a "Federation of Long-Term Investors." *See* John C. Bogle, *After The Fall: What Lies Ahead For Capitalism and the Financial Markets?*, Address at the University of Missouri (Oct. 22, 2002), *available at* http://www.vanguard.com/bogle_site/sp20021022.html. Academics have also begun to focus on the incentives and obligations of the institutional investors, as an interesting recent article in this journal illustrates. Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1 (2004).

Vision helping to turn the financial intermediaries he fears into true "Institutional" investors, whose influence and behavior, like that of corporations, is restrained and channeled by our polity to advance the interests not only of their stockholders, but of the broader national interest affected by their legally-authorized emergence as powerful economic and social forces.