

## Revisiting Berle and Rethinking the Corporate Structure

*Kelli A. Alces*<sup>†</sup>

Adolf Berle and Gardiner Means painted what remains a defining portrait of corporate law.<sup>1</sup> The separation of ownership and control they described and the agency costs it causes are still a central concern of the law of corporate governance.<sup>2</sup> For that reason, Berle's work is relevant nearly eighty years after its publication. Seemingly forgotten, however, is that Berle's enduring description of the corporate structure was published before most of today's corporate law was in place. His work preceded the Securities Act of 1933 and the Securities Exchange Act of 1934 and even preceded the dominance of Delaware common law in the field of corporate governance.<sup>3</sup> Berle's prescience is part of why his work is still so important to the development of the corporate law, but relying upon and taking for granted his observations has locked corporate law scholars and jurists into a paradigm that may no longer fit and that may be keeping us from moving forward as we ought to.

The separation of ownership and control is an unavoidable consequence of the corporate form, and many advantages of the corporate form lie in that separation. While the separation remains, the *distance* between corporate shareholders and officers and directors has shrunk and could shrink further. That is, shareholders have become more sophisticated and less dispersed and enjoy enhanced protection from managerial abuse and increased rights to corporate information relative to when Berle and Means published *The Modern Corporation and Private Property*. Further, advances in securities markets and innovations in investment have changed what kinds of investors hold significant interests in the maximization of a firm's profits. With the ability to significantly

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<sup>†</sup> Assistant Professor, Florida State University. For helpful comments, I thank Gregg Polsky and the participants in the Seattle University School of Law, Adolf A. Berle, Jr. Center on Corporations, Law and Society Symposium, "In Berle's Footsteps."

1. ADOLF A. BERLE & GARDINER M. MEANS, *THE MODERN CORPORATION & PRIVATE PROPERTY* (Transaction Publishers 1991) (1932).

2. William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 738 (2001).

3. *Id.* at 760.

hedge investments, shareholders may not have financial exposure to a firm's financial health.<sup>4</sup> Simultaneously, owners of derivatives may have substantial interests in the value of a firm's residual claim, though they are not considered "owners" at all.<sup>5</sup> The residual claim is most commonly regarded as the ownership interest in a corporation, yet those with an interest in the value of that claim are increasingly difficult to pinpoint. "Ownership" of a corporation just does not mean what it did in the late 1920s and the early 1930s. The corporate structure defined by Berle and Means is helpful but too simple. As corporate law and investment change, so must our assumptions about the corporate form—both as it is and as it should be.

It is not clear that shareholders qua shareholders should hold a special status in corporate governance, particularly if we find less meaning in designating them as the "owners" of the firm. Yet, as the owners of the residual claim, they are the best, most readily identifiable proxy we have for the equity interest. A shareholder representative can help not only to mitigate the costs associated with the separation of ownership and control, but it can also address changes to the meaning of "ownership" of the corporation by focusing on the representation of the equity *interest* rather than remaining preoccupied with the whims of individual equity *holders*. Such a representative, or "equity trustee," can overcome the collective action problem plaguing shareholders and bring meaningful, sophisticated representation to the job shareholders must perform in corporate governance. The use of an equity trustee may also help corporate governance find the right balance for various investor interests, determining an appropriate place, strength, and role for each.

In Part I, this Article reconsiders the meaning of ownership. It begins by returning to Berle and Means's conception of corporate ownership as an important starting point. Part I then describes the shareholder primacy theory of corporate governance that grew out of the Berle and Means description of corporate ownership. That theory has been significant in shaping the corporate and securities laws enacted since the publication of *The Modern Corporation and Private Property*. The Part then explores the shareholder position's special place in corporate law and describes how it has become a weak proxy for the goal of long-term wealth maximization. Part II explores the use of an equity trustee and its potential role in addressing the current state of ownership and control. It presents the equity trustee as a way to properly capture the shareholder

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4. Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 SO. CAL. L. REV. 811, 825 (2006).

5. Tamar Frankel, *The New Financial Assets: Separating Ownership from Control*, \_\_ SEATTLE U. L. REV. 931 (2010).

role and effectively execute the shareholder job in light of the changes to shareholder interests and practices in recent years. Finally, Part III challenges corporate scholars to follow Berle's example by conducting the same kind of searching analysis of the current state and structure of the corporation. Asking the same kinds of questions and taking stock of what defines the corporate form now, especially as we are also on the cusp of a crippling financial crisis, may move corporate scholarship in the appropriate direction to respond to challenges posed this century.

### I. THE MEANING OF OWNERSHIP

Berle and Means considered the firm's shareholders to be the corporation's owners for the purposes of their work in *The Modern Corporation and Private Property*, but they also acknowledged that other theorists include bondholders, and even workers, as owners of the firm in some important ways.<sup>6</sup> This regard for a corporation's shareholders as a firm's owners and the most important party in interest gave rise to the shareholder primacy theory of corporate governance that has dominated for much of the last century.<sup>7</sup> While the value of the residual claim is our best proxy for the goal of long-term corporate wealth maximization, it is becoming increasingly difficult to find the party that most accurately represents that interest. Many investors have significant interests in the value of the residual claim without holding stock, and many shareholders have completely hedged their economic interest in a firm in which they own equity shares.<sup>8</sup> These changes to the meaning and representation of a corporation's ownership are significant, and this Part considers each in turn.

#### A. Berle and Means: The Goal of Corporate Control

In *The Modern Corporation and Private Property*, Berle and Means identified the separation of ownership from control as the defining problem facing corporate governance.<sup>9</sup> Their book explored the basic identity of the corporate shareholder and sought to describe what corporate shareholding in America had become.<sup>10</sup> They focused particularly on the evolution of corporations from a time when a few owners managed a firm themselves to one in which multitudes of private citizens invested in

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6. BERLE & MEANS, *supra* note 1, at 113.

7. William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation*, 34 J. CORP. L. 99, 100 (2008) [hereinafter *Shareholder Primacy*].

8. Frankel, *supra* note 5, at \_\_\_.

9. BERLE & MEANS, *supra* note 1.

10. *Id.*

large, public corporations that were operated by professional managers who owned very little of the firm's equity.<sup>11</sup> Beyond giving up power over day-to-day corporate decisions, shareholders also relinquished meaningful property rights in the corporation's assets.<sup>12</sup> They were said to "own" the corporation without enjoying the rights and privileges that usually accompany ownership.<sup>13</sup> Shareholders are willing to submit to this investment structure because it allows them to diversify their holdings, but the separation of ownership of assets from control over those assets presents unusual problems that Berle and Means sought to identify and resolve.

While the normative prescriptions that Berle and Means suggested have not withstood the test of time,<sup>14</sup> their description of the corporate form and their observations about its peculiarities in the realm of property ownership are still influential.<sup>15</sup> They claimed that "[i]t requires little analysis to make plain the fact that private property, as understood in the capitalist system, is rapidly losing its original characteristics. Unless the law stops the wide open gap which the corporate mechanism has introduced, the entire system has to be revalued."<sup>16</sup> They charted the rise of the public corporation as such businesses grew to include many thousands of owners and to control a significant share of American wealth. They tied their view of how the new American "princes of industry"<sup>17</sup>—the corporate managers—should operate firms to the origins of the business form. Berle and Means argued that because business owners once controlled and disposed of the business's assets, the shareholders—the putative owners of the firm—should direct corporate goals, though not the means used to achieve them.<sup>18</sup> Specifically, they identified the shareholders' ownership interest as being one that managers ought to seek to advance in their management of the corporation.<sup>19</sup> They argued that corporate managers' power must be exercised "only for the ratable benefit of all the shareholders as their interest appears."<sup>20</sup>

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11. *Id.* at 118–40.

12. *Id.* at 119.

13. *Id.*

14. Bratton, *supra* note 2, at 739.

15. *Id.*

16. BERLE & MEANS, *supra* note 1, at 219.

17. *Id.* at 4.

18. *Id.* at 6–7 (summarizing the rise of the public corporation as distinct from the private corporation), 112–14 (asserting, without challenge, the basic understanding that managers should operate the firm in a manner designed to enhance the interests of its owners).

19. Bratton & Wachter, *Shareholder Primacy*, *supra* note 7, at 108.

20. BERLE & MEANS, *supra* note 1, at 220.

*B. Shareholder Primacy*

The shareholder primacy theory of corporate governance finds its roots in Berle and Means's identification of the separation of ownership from control.<sup>21</sup> The theory holds that shareholders' ownership interests should dominate the way a corporation is run.<sup>22</sup> The shareholder primacy norm, or shareholder wealth maximization norm, addresses the separation by specifying what the goals of control should be. The goal of corporate management is, ultimately, the goal driving all property management—to maximize the value of the assets under the manager's control. Shareholders are the "owners" of the residual claim because they hold claims against the value of the firm's equity in a hypothetical liquidation. The value of the residual claim, or the value of the firm's equity, is the measure of a firm's wealth. Accordingly, the shareholders, as those holding claims against the equity interest, are the "owners" of the firm's equity. Shareholders, as residual claimants, are presumed to have incentives that are aligned with the maximization of the firm's wealth, so the argument goes, and therefore, their interests should be paramount in determining what is best for the corporation.<sup>23</sup> This reasoning has guided corporate governance law and practice and has dominated the scholarship since Berle's time, even as Berle himself switched camps and began to prefer a corporate decision-making structure that considered the interests of corporate stakeholders other than shareholders and the interests of society as a whole.<sup>24</sup>

Corporate law has always contemplated shareholder control by allowing shareholders to elect and monitor directors to some extent.<sup>25</sup> Shareholders have the ability to sue directors derivatively, on behalf of the corporation.<sup>26</sup> The law surrounding both derivative litigation and the corporate fiduciary duties that it is most often used to enforce is intricate and complicated. The Delaware courts walk a thin line between share-

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21. See BERLE & MEANS, *supra* note 1.

22. *Id.* at 120.

23. Shareholder primacists agree that corporations should be operated to maximize corporate wealth, but they disagree about what degree of shareholder control is appropriate. For instance, Lucian Bebchuk, a prominent shareholder primacist, consistently advocates stronger shareholder powers over corporate control. See Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 835 (2005). Stephen Bainbridge, on the other hand, espousing a theory of "director primacy," approves of shareholder primacy "ends," such as wealth maximization, but argues that the "means" shareholders prefer should not drive corporate decision-making. Stephen Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

24. Bratton & Wachter, *Shareholder Primacy*, *supra* note 7, at 135, 147, 149.

25. Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 417, 421 (2006).

26. *Id.* at 421.

holder interests and managerial discretion, with managerial discretion almost always winning the day.<sup>27</sup> A strong business judgment rule is coupled with strong, though rarely enforced, fiduciary rhetoric to try to keep managers faithful to shareholder wealth maximization without allowing individual shareholders to guide business decisions.<sup>28</sup> There is a pervasive sense that shareholders, as owners of the residual claim, have the right incentives and that they should be able to enforce, to some extent, an expectation that management acts to maximize the value of their shares. For this reason, shareholders have been given derivative standing to enforce duties owed to the corporation, and the shareholder franchise, however weak, has been preserved. Both voting and derivative standing are supposed to be ways for shareholders to exert their will or protect their interests. The owners of the business thus discipline its managers.

### 1. The Collective Action Problem and Shareholder Power

Berle and Means detailed both the original justifications for these shareholder rights and also described how, even in the late 1920s and the early 1930s, shareholders of major American companies had become so numerous and widely dispersed that the common indicia of property ownership did not describe a shareholder's interest in a corporation.<sup>29</sup> The wide dispersal of shareholders led to collective action problems and apathy that made shareholder discipline of managers ineffective at best and almost impossible at worst.<sup>30</sup>

To remedy this ineffectiveness, Berle suggested the enforcement of trust-like fiduciary duties<sup>31</sup> and the use of sophisticated market representatives to concentrate shareholder power.<sup>32</sup> The latter suggestion was put into practice. Institutional shareholders have entered the market as a way to concentrate shareholder power. Fund managers, for example, exercise their investors' shareholder voting rights so that individual and widely dispersed shareholders do not have to pay attention to the performance of particular corporations and can instead simply monitor the performance of the funds in which they invest.<sup>33</sup> Because most of the relatively so-

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27. See Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 249–56 (2009).

28. Andrew Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 466–47 (2009).

29. BERLE & MEANS, *supra* note 1, at 244.

30. *Id.*

31. Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1074 (1931).

32. Bratton & Wachter, *Shareholder Primacy*, *supra* note 7, at 106 (quoting ADOLF A. BERLE, JR., *STUDIES IN THE LAW OF CORPORATE FINANCE* (1928)).

33. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

phisticated fund managers who represent investors seek the advice of knowledgeable analysts and proxy advisors who research issues put to shareholder votes, their rational apathy does not leave as significant a hole in corporate governance as there may have been in the past.

Although institutional shareholders hold the largest shares of most major American corporations and exercise most of the voting power, they have not proven to be the effective monitors Berle would have predicted. The failure is due, in large part, to the fact that the costs of managing funds cut into investor returns.<sup>34</sup> If the costs of an action taken to monitor a particular corporation might exceed its benefits, fund managers do better not taking the chance.<sup>35</sup> Even if the monitoring activity is successful or results in a net gain to the corporation, the benefits must be shared with all other shareholders, and the portion of the benefits that inure to the active fund manager may not cover the costs.<sup>36</sup> Therefore, a collective action problem still exists among institutional investors, even though they have concentrated the power of individual, dispersed shareholders.<sup>37</sup> Because they are competing with one another, the relative ability of institutional shareholders to communicate and coordinate does not overcome these problems.<sup>38</sup> Despite the persistent collective action problems plaguing the shareholder role in corporate governance, shareholders still hold the tools necessary to exert influence over corporate control in their voting power.

## 2. Shareholder Power and Changes in Corporate Control

Berle and Means's articulation of the separation of ownership from control began as a description of the fact that owners—the shareholders—do not exercise control over the daily business operations of a corporation or the disposal of its assets. A separation also exists *between* ownership and control; that is, the owners' ability to direct or influence control is limited and the means of influence are indirect and weak. The ability of shareholders to directly influence managerial decisions lies in their one real power over management—the right to elect a company's board of directors. If shareholders are unhappy with management, they can either sell their shares or elect a new board.<sup>39</sup>

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34. Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 452, 473 (1991).

35. *Id.*

36. *Id.* at 454.

37. *Id.*

38. *Id.* at 452–54.

39. Velasco, *supra* note 25, at 409.

For years, proxy fights were the common method of changing a corporation's management.<sup>40</sup> Interested shareholders would vie for proxies sufficient to defeat the incumbent board's reelection.<sup>41</sup> However, proxy fights were expensive and rarely successful, and they thus fell out of favor.<sup>42</sup> The market responded to the relative powerlessness of shareholders over corporate affairs when acquirers began launching tender offers in the 1960s.<sup>43</sup> A rigorous takeover culture peaked in the 1980s.<sup>44</sup> The market for corporate control identifies companies that are managed poorly and seeks to unseat current managers through acquisitions.<sup>45</sup> Shareholders enjoy significant potential power and profit in their ability to tender shares to acquirers.<sup>46</sup> Once an acquirer holds a majority of a firm's shares, it can install more effective management and enjoy the profits resulting from the change.<sup>47</sup>

However, the rise of such corporate acquisitions was hindered almost from the beginning by anti-takeover legislation. The Williams Act, which passed in 1968, significantly impeded the use of tender offers.<sup>48</sup> Managers responded strongly against the lack of job security and instability caused by hostile takeovers, and they were successful in lobbying for legislation that imposes significant barriers to those acquisitions.<sup>49</sup> In addition to the federal Williams Act, states have enacted anti-takeover legislation that makes hostile acquisitions very difficult and expensive.<sup>50</sup> Further, courts have upheld the use of market innovations, such as the poison pill, that effectively bar the hostile acquisition of companies implementing them.<sup>51</sup> All of these actions protect management from hostile takeovers and thus entrench them in their positions, regardless of how good of a job they are doing, perhaps to the detriment of the company's shareholders.<sup>52</sup>

The practical result of legislative actions to limit shareholder control is a shareholder primacy norm with limited means of shareholder

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40. JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 120 (2008).

41. *Id.*

42. *Id.*

43. *Id.*

44. See BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (1990).

45. MACEY, *supra* note 40.

46. *Id.* at 119.

47. *Id.* at 119–21.

48. *Id.* at 122.

49. *Id.* at 119.

50. See, e.g., DEL. CODE ANN. tit. 8, § 203 (2009).

51. MACEY, *supra* note 40, at 123–24.

52. *Id.* at 119–121.

enforcement. The separation Berle and Means identified persists despite advances in corporate law and investment. While shareholders have found more concentrated and sophisticated representation, they still do not have a powerful voice in corporate governance. In a way, shareholder interests are held paramount only theoretically, as a concern for those interests implies a concern for the value of corporate equity. The indirect relationship between shareholder interests and corporate action is not necessarily a bad thing. Shareholders, even institutional investors, still lack the information and business acumen to profitably take decision-making authority from corporate managers. Instead, their role in corporate governance has largely been to respond to public information in their trades in a way that leads to a reliable valuation of corporate assets under current management.<sup>53</sup>

While individual shareholders may have trouble influencing corporate governance, the market for securities is supposed to impose discipline through its pricing of companies. The federal securities laws enacted just after the publication of *The Modern Corporation and Private Property*, as well as subsequent amendments, seek to bring information about the health of corporations to the securities markets. Complete, honest disclosures about public corporations are supposed to inform market trades that set corporate stock prices, which in turn, tell investors how healthy a company is and what its prospects for future profits are likely to be.<sup>54</sup> Market reliance on corporate disclosures has become a significant part of corporate governance law. The accuracy of those disclosures is crucially important to the efficient functioning of securities markets and, in turn, to the American economy. While those disclosure requirements do not seek to benefit shareholders exclusively, and thus are not properly part of the application of the shareholder primacy theory to corporate governance law, they and the securities markets emphasize the importance of stock price to corporate wealth and management. To the extent securities markets are presumed to be efficient, it is because stock prices are supposed to reflect all publicly available information about the relative health and profitability of a company under its current management.<sup>55</sup> This information appraises the management's ability and alerts shareholders and other market participants of potential problems with a firm's profitability. Shareholders make investment decisions

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53. BERLE & MEANS, *supra* note 1, at 247 ("The net result of stripping the stockholder of virtually all his power within the corporation is to throw him upon an agency lying outside the corporation itself—the public market.")

54. Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 965–66 (1991).

55. *Id.*

largely in reliance on the accuracy of stock prices, and managers make or lose careers based on their stock's performance.

Because shareholder primacy demands that corporate officers and directors work to enhance shareholder value, and because that value is measured by stock price, corporate managers focus on taking actions that will enhance stock price. The focus on stock price as a metric of corporate health may have caused significant problems recently<sup>56</sup> and may not be the optimal way to determine which course of action is best for the corporation. Using shareholder interests as a proxy for corporate interests and share price as a proxy for shareholder interests does not actually mean that what is best for share price is best for long-term corporate wealth maximization.<sup>57</sup> The next section explains the reasons for this disconnect between stock price and corporate health and argues that while individual shareholders' interests may not be the best determinant of corporate interests, the overall value of the equity position is the best proxy we have for long-term corporate welfare. Accordingly, we should find a way for corporate governance to honor that position.

### *C. The Residual Claim as a Proxy for Corporate Ownership and Corporate Welfare*

When corporations were owned by a few, concentrated shareholders who knew each other and could confer about questions of corporate business, honoring and identifying the owners' interests in making corporate decisions was not a difficult task. At the time, it was clear that those owners' interests should control and that the corporate assets should be controlled for their benefit.<sup>58</sup> As corporate share ownership expanded to more dispersed shareholders with diversified portfolios and less interest in the fortunes of each individual company in which they invested, the separation of ownership from control became apparent and changed the nature of corporate governance. The interests of particular equity holders have become harder to identify,<sup>59</sup> creditors exercise more control over the corporate affairs of even solvent companies,<sup>60</sup> and it is no longer clear how to identify which corporate constituents' interests and preferences should be prioritized.<sup>61</sup> Still, we have no better proxy

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56. See William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 710 (2010) [hereinafter *The Case Against*].

57. *Id.* at 726.

58. BERLE & MEANS, *supra* note 1, at 4.

59. Frankel, *supra* note 5, at \_\_\_.

60. See Frederick Tung, *Leverage in the Boardroom: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115 (2009).

61. See Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

for corporate wealth maximization than the equity position. The value of the residual claim best represents the interests of the goal of long-term corporate wealth maximization.

If we return to our basic understandings about corporations, it should be apparent that long-term wealth maximization is the proper corporate objective. Corporations are, first and foremost, businesses designed to produce and market products and increase those products' value and relevance to society over time. In order to be successful or even to be a worthwhile investment vehicle, a business must have long-term prospects for viability and potential for growth. To the extent that we replace this focus with one that worries over the value of a security, even if that security is stock, we irretrievably muddy the waters and seriously mangle managerial incentives and focus.<sup>62</sup>

#### 1. Incentive Compensation: Bringing Ownership and Control Closer Together

The recent unrest over incentive compensation is one example of this problem. There, a good faith attempt to shorten the distance between ownership and control may have actually widened it. Incentive compensation sounds sensible. It stands to reason that one way to encourage officers and directors to make decisions that will maximize the firm's value is to pay them more as a direct result of increases in the firm's value. One way to align their incentives with those of the residual claimants is to give managers a stake in the residual claim. This kind of compensation has allowed corporate executives, particularly senior officers, to earn staggering income. Stock options are the most commonly used and, often, the most lucrative form of incentive compensation and can work because they reward managers directly for increases in the company's stock price that occur during their tenure. Managers, then, have a direct interest in taking corporate actions intended to increase the stock price, which is supposed to be a reflection of the value of the firm's residual claim.<sup>63</sup>

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62. See Bratton & Wachter, *The Case Against*, *supra* note 56, at 726.

63. Professors Thomas and Martin state:

[T]he conflict between managers and shareholders interests can be mitigated through the use of incentive compensation packages which align the incentives of managers with those of shareholders. Stock options can be used to provide managers with an equity interest in the corporation. As executives' level of stock ownership increases, they will bear a greater percentage of the costs of any deviations from the standard of profit maximization. In this situation, self-interest will lead managers to act in shareholders' best interests.

Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1031 n.40 (1999).

Problems with this approach to compensation have become apparent. Stock options may give officers too much of an interest in short-term stock price increases at the expense of long-term gain.<sup>64</sup> Also, manipulations in options themselves, such as options backdating, have created serious public relations problems and expensive litigation.<sup>65</sup> Rather than trying to devise precise compensation formulas to perfectly align managerial interests with those of the corporation, which has long been a goal of executive compensation innovators, it might be more appropriate to realize that such a bundle of securities might not exist. It might not be possible to design a group of securities or incentives that perfectly approximates the corporation's value at any given time. Any attempts to do so may have unintended consequences for managerial incentives along with the intended benefits. If it were true that shareholders did have perfectly aligned incentives, then making managers shareholders would be enough to resolve agency costs caused by the separation of ownership and control; however, making managers shareholders has not yet been sufficient to resolve such agency costs. Does that mean that we have not made managers "owners" of the corporation by giving them stock or stock options? If we have effectively made managers owners, at least to the extent that they own stock in the corporation they manage, then the agency problem may be caused by something other than the separation of ownership from control. If they are not owners, then perhaps we are using the wrong definition of "ownership."<sup>66</sup>

## 2. Trouble Defining "Ownership"

Because of the ways securities have evolved over time, many security holders other than shareholders have direct financial interests in the value of the residual claim, and individual shareholders themselves, or at least those casting votes on their behalf, may not.<sup>67</sup> The blurring of these lines has made pinpointing the proper "owners" of the corporation more difficult. It is less clear why some parties that have interests in the value of the residual claim have the wrong incentives or even worse incentives

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64. "Some analysts have argued that the equity-based executive compensation which became increasingly important, particularly stock options, created incentive for executives to massage accounting data to make profits appear high in the short-run and thus drive up the company's stock price." Brett H. McDonnell, *Sox Appeals*, 2004 MICH. ST. L. REV. 505, 514 (2004).

65. The Associated Press, *Broadcom to Settle Backdating Suit for \$160 Million*, N.Y. TIMES, Dec. 29, 2009, available at <http://www.nytimes.com/2009/12/30/technology/companies/30broadcom.html?scp=8&sq=options%20backdating&st=cse>.

66. See, e.g., Bratton & Wachter, *The Case Against*, *supra* note 56, at 675-76 (explaining Jensen & Meckling's theory that shareholders and managers share incidents of ownership through their reserved contract rights).

67. Frankel, *supra* note 5, at \_\_\_; Hu & Black, *supra* note 4.

than some direct shareholders who may have completely hedged their investment in a firm's stock and so are not exposed to vacillations in the value of the residual claim. A few innovations in particular make it far more difficult to identify exactly which interest represents "ownership" and which interested parties should exercise the most control.

With the increased trading of derivatives—that is, securities whose values are derived from the values of other securities—shareholders are not the only investors with economic interests in the value of a company's stock.<sup>68</sup> For instance, options holders or sellers may have direct economic interests in the value of a corporation's stock price. If we think that it is important to give ownership rights to the parties having an interest in the value of the residual claim, then we should not assume that shareholders are the only such group or that they are all necessarily exposed to the financial consequences of a firm's success or failure. If we think that an interest in the residual claim is the important metric and that interest is what essentially creates an "equity owner" or a part-owner of the firm, then why do options holders not count? Why do we not take the time to figure out which parties are actually interested in the value of the residual claim before allowing securities holders to vote or bring derivative actions? While some options holders are investing in an interest in the value of the residual claim, shareholders may have hedged their financial interest in the equity of the firm, thereby divesting themselves of the economic incentive that makes their rights and their voice in corporate governance legitimate.<sup>69</sup>

One such example of the disconnect between shareholder power and financial interest is the "empty voting" that Professors Henry Hu and Bernard Black explained.<sup>70</sup> Empty voting, in its most basic form, involves acquiring the right to vote shares in a corporation without having an economic interest in the value of the shares.<sup>71</sup> This allows shareholder votes to actually be cast *against* the economic interest in the firm.<sup>72</sup> Empty voting is a much more extreme example of simpler forms of conflicted interest. Shareholders could always buy derivatives to hedge against movements in the corporation's stock price and could hold significant economic interests opposed to the best interests of one corporation in which they have invested. It is no secret or surprise that shareholders' individual interests may significantly differ.

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68. Frankel, *supra* note 5, at \_\_\_\_.

69. Frankel, *supra* note 5, at \_\_\_\_; Hu & Black, *supra* note 4, at 832.

70. Hu & Black, *supra* note 4, at 825.

71. *Id.*

72. *Id.* at 835.

Because of their different portfolios or different interests in a given corporation beyond shareholding, individual shareholders have always been poor or, at least, unreliable representatives of an entire shareholder class.<sup>73</sup> Such economic differences also undermine the validity of the relatively weak shareholder democracy. Shareholder votes are not necessarily cast in the corporate best interest and, to the extent that those shares voted against the corporate interest are concentrated and organized, such adverse votes can affect outcomes.<sup>74</sup> In such circumstances, it is much harder to classify ownership of stock as meaningful ownership of the firm or defend the shareholder position as one that should wield voting power. It is not at all clear that shareholders are the group that should exercise powers over corporate governance. Their financial interest in the residual claim can no longer be assumed. Still, it is difficult to discover all of those who have the right economic interest in the residual claim. Thus, shareholders are still our best proxy for that position. Going forward, it may be useful to find a way to represent that position without relying on any one shareholder or group of shareholders to do so on behalf of others. The next Part suggests the use of an equity trustee, or shareholder representative, to represent the equity interest without focusing in particular on individual equity holders.

## II. REPRESENTING THE EQUITY INTEREST

To some extent, Berle and Means and the shareholder primacists are correct that it is incumbent upon management to pursue shareholders' best interests in making business decisions for the corporation. If long-term wealth maximization is the standard, preference of the equity interest must be the norm. Some scholars argue that directors have to balance a number of interests in deciding how to operate the business profitably.<sup>75</sup> In any case, corporate law has given shareholders a particular role and a set of monitoring tasks that no other group can perform in the same way because of their interest in the value of the residual claim. The equity interest may have preferences that compete with those of other parties in interest, and the shareholder interest is not always able to dominate because of other powers reserved by other investors. Loan covenants,

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73. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006).

74. Hu & Black, *supra* note 4, at 825. Professors Hu and Black analyze the Perry–Mylan example, in which “Perry combined full ownership of Mylan shares with coupled assets (equity swaps and other hedges), which offset its economic ownership . . . [leaving Perry] with 9.9% voting ownership and zero net economic ownership.” Perry also held a non-related asset—shares of King Pharmaceutical. Because “Perry was left with full voting rights, but a negative overall economic interest [in Mylan Corp]—it would profit if Mylan overpaid for King.” *Id.*

75. Blair & Stout, *supra* note 61, at 283; Bainbridge, *supra* note 23, at 579–80.

for example, may prevent a corporation from taking risky actions that shareholders might prefer, or collective bargaining agreements may prevent the corporation from lowering wages. A director must consider all circumstances in choosing the profit-maximizing course.<sup>76</sup>

While directors are responsible for making business decisions, the shareholders have also been given a particular job. They are to monitor and discipline management according to the officers' and directors' success in maximizing corporate profit. However, the collective action problem means that the shareholder voice may fall short of corporate law's expectations for it. In prior work, I have suggested using a shareholder representative I call an equity trustee to overcome the shareholder collective action problem and to do the shareholder job more effectively.<sup>77</sup>

An equity trustee would represent the identifiable interest of the equity class in long-term corporate wealth maximization. As noted above, corporate law values the incentives of those with financial interests in the value of the residual claim. However, it has become increasingly difficult to reliably identify those parties, and while they are the obvious choice, shareholders do not all necessarily share that interest. Individual equity holders have interests that vary widely and may actually be at odds with each other given whatever their other investments are. These divergent interests and the collective action problem make individual shareholders poor shepherds of the equity cause. Giving the equity interest a sophisticated, attentive representative to do the shareholder job and exercise shareholder powers would go a long way toward making the equity position in corporate law and governance more meaningful.

In some ways, the use of an equity trustee could be seen as a natural progression in response to the collective action problem. When Berle and Means first wrote about the wide dispersal and relatively anonymous nature of share ownership, they anticipated that something akin to institutional investors could concentrate the power of many shares through one active monitor.<sup>78</sup> Institutional investors have become very common and now account for the vast majority of shareholding, but they have failed to actively participate in corporate governance.<sup>79</sup> They have, how-

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76. Bainbridge, *supra* note 23, at 579–80.

77. Kelli A. Alces, *Strategic Governance*, 50 ARIZ. L. REV. 1053 (2008); Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239 (2009); Kelli A. Alces, *The Equity Trustee* (unpublished manuscript, on file with author).

78. Bratton & Wachter, *Shareholder Primacy*, *supra* note 7, at 106 (quoting ADOLF A. BERLE, JR., *STUDIES IN THE LAW OF CORPORATE FINANCE* (1928)).

79. During the rise of the institutional investor,

[m]any scholars came to accept that the individual shareholder would remain rationally apathetic and passive but trusted these large shareholders to take a more active role in

ever, reached out to proxy advising firms for help with deciding how to vote. Proxy advisors make recommendations to institutional investors about how they should vote on broad corporate issues.<sup>80</sup> In this way, proxy advisors counter some of the effects of rational shareholder apathy by helping institutional shareholders to wisely cast their votes. The institutional investors simply delegate their information-gathering responsibility. An equity trustee picks up on some of the same themes and concerns but goes a step further.

Like institutional investors, an equity trustee would concentrate the voice of many dispersed shareholders into one knowledgeable, sophisticated entity. However, instead of managing a portfolio of assets that create interests that may differ from the corporation, an equity trustee would represent the interest in corporate wealth maximization as it regards one company. It would represent the collective equity interest, not individual equity holders. It is difficult, then, to figure out how to select the equity trustee.

To prevent the capture by management to which other “gatekeepers” have fallen victim,<sup>81</sup> the equity trustee should not be selected by management. Instead, a committee of the corporation’s seven largest shareholders, called the equity committee, should appoint the equity trustee at stated intervals. Because the makeup of the equity committee can change at any time and may indeed change frequently, the equity trustee would not be pressured to abide by the preferences of committee members to the exclusion of other shareholders. Further, the individual interests of the equity committee members are likely to differ significantly, so the committee provides a useful nexus between the equity trustee and the actual shareholders without running the risk of binding the equity trustee to idiosyncratic shareholder preferences. As noted above, it is not at all clear that individual shareholders should matter very much to corporate governance, but they are the best proxy we have for the residual claim. The best way to represent that very important interest may be to have a loose association of significant shareholders choosing a representative who will owe duties to the entire class.

Selected for a finite, renewable term by the equity committee, the equity trustee would owe fiduciary duties to shareholders to represent the equity interest carefully and zealously. The trustee would not be respon-

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monitoring corporate management . . . . Although such expectations were not fulfilled—most institutional investors turned out to be less interested in spending money and effort on monitoring management . . . .

Dalia Tsuk Mitchell, *The End of Corporate Law*, 44 WAKE FOREST L. REV. 703, 724–25 (2009).

80. Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 898 (2007).

81. JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006).

sible for making business decisions, but rather for informing shareholders of important matters, advising shareholder votes, determining whether shareholder litigation is appropriate, and serving as a shareholder voice before management when necessary.<sup>82</sup> The equity committee would be responsible for supervising the equity trustee and for determining if the equity trustee has violated its duties to shareholders.<sup>83</sup> Participation on the equity committee would be mandatory for the seven largest shareholders, barring disabling conflicts, but would not necessarily be very time consuming.<sup>84</sup> The members of the equity committee would not have to do much more to monitor the equity trustee than they do to monitor management now—this level of effort would go further toward effective monitoring of a position as limited as that of the equity trustee than it does toward the monitoring of directors who have more expansive roles.

While the equity trustee would be charged with acting on behalf of the equity interest represented by the long-term maximization of the value of the residual claim, it is important to refrain from using incentive compensation to try to align the trustee's interests. While compensation with stock and options may give the equity trustee a stake in the value of the residual claim, it may also give the trustee the same misguided incentives that have plagued executives with similar compensation packages. Attaching the equity trustee's interests too closely to the stock *price* again places an emphasis on a *symptom* of the value of the residual claim instead of focusing efforts on the substance. Stock price reflects the value of the residual claim, in part, but can also include other information or noise about market or industry fluctuations. Additionally, stock price can be manipulated through accounting or management decisions in ways that cause it to reflect information about short-term value to the exclusion of long-term effects.<sup>85</sup> For those reasons, tying the equity trustee's compensation to stock price might cause the trustee to have some of the same problems representing the shareholder class as individual shareholders and management have. Instead, it makes more sense to pay the equity trustee a fixed salary as other professionals would be paid. This prevents the equity trustee from having interests in short-term price fluctuations and focuses the equity trustee's attention on steady, long-term gain.

The biggest advantage to the equity trustee form is that each corporation and equity committee can structure the office as they see fit. I do not propose that equity trustees be mandatory. Rather, shareholders who

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82. Kelli A. Alces, *The Equity Trustee*, 42 ARIZ. ST. L. REV. \_\_ (forthcoming 2010).

83. *Id.*

84. *Id.*

85. McDonnell, *supra* note 64, at 514.

want an equity trustee can push for the appointment of one. An equity committee can come together to consider the question and decide whether an equity trustee is desirable. Then, the equity committee and management can negotiate an agreement with the equity trustee that determines that trustee's specific powers and duties. It is a flexible tool that the parties can use to return the shareholder voice to its intended place in corporate governance.

Making that change might actually inspire changes to the role of shareholders in corporate governance. Because the shareholder pool has changed so dramatically over the course of time, it stands to reason that corporate governance might also adapt and change. Maybe the shareholder collective action problem has prevented those changes from occurring. Perhaps thinking about the shareholder voice in a new way will open possibilities for more effective governance forms or will, at least, help us understand how governance may improve. The equity trustee is one suggestion about how the corporate governance structure may be changed for the better. Adopting the use of equity trustees would demonstrate an understanding of both the importance of the equity position and the difficulty in pinpointing the particular parties in the best position to fulfill its role in corporate governance. Further, the proposal questions basic assumptions about the corporate form and acknowledges important changes in corporate structure. Berle and Means have inspired corporate law scholars to consider the corporate form and document its changes. Following their example can open new avenues for future scholarly undertakings.

### III. FUTURE AVENUES FOR RESEARCH

Perhaps Berle and Means's greatest contribution is the care they took to paint a thorough and contemporary portrait of corporate governance, emphasizing how it had evolved from the first corporate governance laws were enacted and how the character of property ownership changed as a result. They asked the basic questions about what it meant to be a shareholder, what rights shareholders had, what responsibilities they should have, and how management should be obligated to respond to the corporate structure. They started from scratch and built a picture of corporate governance from the ground up, noting points along the way at which problems might arise. *The Modern Corporation and Private Property* was published after the 1929 stock market crash, before the 1933 and 1934 securities acts were promulgated, and even before Delaware corporate law dominated public corporations. For that reason, the authors' observations and description of the corporate structure influenced much of the law and theory that followed.

Just as important as the thoroughness of Berle's work is its humility. He acknowledged that the world he was describing would change dramatically before he and other scholars could even begin to understand it. On the very first page of *The Modern Corporation and Private Property*, the authors acknowledge that, "[s]pectacular as its rise has been, every indication seems to be that the system will move forward to proportions which would stagger imagination today . . . ."<sup>86</sup>

As Berle and Means were when they wrote *The Modern Corporation and Private Property*, we are trying to make sense of a catastrophic financial collapse and trying to think of ways to address the pervasive effects of financial markets on our society. Various scholars have made great strides in achieving this goal and have challenged very basic assumptions about the corporate structure, and in doing so, about corporate governance as well. The current dominance of law review articles in legal scholarship means that small contributions are made a piece at a time, with scholars engaging in a constant dialogue about the state of affairs. The increased popularity of empirical research has helped to measure and quantify certain aspects of corporate law and practice in new ways. As the scholarship advances, so does our understanding of innovations in financial markets. Still, we remain, in many ways, stuck with the governance forms that Berle and Means described, fully acknowledging the changes that have occurred in the meantime but not yet determining how those changes should affect corporate governance. Instead, we have clung perhaps too faithfully to the traditional corporate form even as our financial markets may have outgrown it.

Some scholars have worked to clarify our understanding of corporate governance by describing the current governance structure in new ways. There are far too many significant contributions to list comprehensively here, but a few examples make the point. For instance, Margaret Blair and Lynn Stout's work on team production has changed the way scholars talk about directors' duties and the corporate form.<sup>87</sup> Stephen Bainbridge's work on director primacy has served a similar purpose by helping to focus our attention on what directors are supposed to do, while also thinking outside the bounds of strict shareholder primacy.<sup>88</sup> Corporate bankruptcy scholars have helped us develop an understanding that the role of creditors in corporate governance at times supersedes the role

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86. BERLE & MEANS, *supra* note 1, at 1.

87. See Blair & Stout, *supra* note 61.

88. See Bainbridge, *supra* note 23, at 551 (distinguishing between honoring shareholder ends and shareholder means and arguing that directors manage the nexus of corporate relationships in a manner designed to maximize shareholder wealth, while they are not bound by shareholders' preferred means in doing so).

of shareholders.<sup>89</sup> Others have called for significant changes to the corporate structure. For instance, Douglas Baird and Todd Henderson argue that corporate fiduciary duties should be eliminated in light of enhanced investor sophistication and the relative weakness of corporate fiduciary duties as they are currently enforced.<sup>90</sup> Bernard Black and Henry Hu introduced us to the practice of empty voting and other investor innovations that challenge our basic assumptions about the proper role of shareholders.<sup>91</sup> To that end, numerous scholars have explored the work done by institutional shareholders and what that should tell us about how such shareholders fit into corporate governance.<sup>92</sup> The contributions of modern scholars to our understanding of corporate governance as presently constructed are too numerous to list exhaustively here. We have a solid picture of the investment and managerial cultures and are able to respond quickly, but thoughtfully, to new trends and innovations.

Other scholars have suggested that we move beyond the corporate form. For example, Larry Ribstein has argued that certain unincorporated forms may be better suited to certain businesses' needs, even if those firms are large and currently publicly held.<sup>93</sup> Also, an important scholarly movement has looked overseas for ideas about how corporate governance might best be structured. Comparative corporate governance scholarship has made important contributions as we strive to understand our place in a global economy and as we try to re-order our organization of business.

Still, we have not done enough to question our basic assumptions about the corporate structure as it stands now. Enough has changed since the days of Berle and Means that it may be appropriate to start with a nearly blank slate in an effort to describe the various forms of corporate power and corporate investment and how those elements of the corporate structure fit together. There are strong arguments that if such an undertaking were necessary, the market would be making significant changes to corporate governance.

That argument, while essential to any body of scholarship that seeks to influence a robust market, does not tell the entire story. For one, corporate laws, which are not as easily modified through market forces,

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89. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006); Tung, *supra* note 60.

90. Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1333 (2008).

91. See Hu & Black, *supra* note 4.

92. See, e.g., Black, *supra* note 33; Rock, *supra* note 34; Anabtawi, *supra* note 73.

93. Larry E. Ribstein, *Uncorporating the Large Firm*, 4 (Univ. of Ill., Law & Econ. Research Paper Series, Paper No. LE08-016, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1003790](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003790) (last visited Apr. 2, 2010).

may stand in the way of what would otherwise be the natural evolution of the corporate structure.<sup>94</sup> Much of corporate structure is determined by statute, and relevant laws may prevent corporations and market participants from evolving as they otherwise might.<sup>95</sup> Further, market participants do not always have the luxury of examining the current corporate landscape critically or with an eye for improvements. For instance, even though institutional shareholders might realize gains from more carefully monitoring management, no single fund manager wants to invest the resources in doing so because that cost may hurt its bottom line and put it at a competitive disadvantage compared with other similar funds.<sup>96</sup> For any market participant to take the time to devise a scheme that might improve corporate governance, it would require more investment than it may be worth for that individual. Also, encouraging market actors to accept a new idea may call for more of an appetite for risk than they may have. To that end, legal scholars, with plenty of time and inclination to think of corporate governance and market forces in new ways, can play an important role in commenting on market evolution and suggesting new paths it may take. It is a conversation that we can have with market participants; our critical thinking and suggestions can become part of the market evolution.

Now would be an appropriate time to take stock of corporate governance and corporate investment, as Berle and Means did, by questioning our basic assumptions about the corporate structure and by noting critical ways in which it has changed over the years. We should develop a complete understanding of the different forms corporate investment takes and what those forms mean for corporate rights and responsibilities. While forms of investment evolve and investor behavior changes as the market adapts to shifting conditions, the corporate governance structure is relatively static and may not respond quickly enough to significant shifts in the market. For public companies, the most recent compulsory changes to corporate governance structure have come from federal securities laws or public listing requirements promulgated by the major exchanges.<sup>97</sup> These changes still do not address basic corporate governance

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94. See, e.g., MACEY, *supra* note 40 (arguing that statutory provisions and the common law can stand in the way of rational, healthy market-based corporate governance mechanisms); Black, *supra* note 33, at 608 (noting that shareholder passivity is not a foregone conclusion but is a result of a combination of federal laws that discourage and inhibit shareholder collective action).

95. See *supra* text accompanying notes 34–44.

96. Rock, *supra* note 34, at 473.

97. See, e.g., New York Stock Exchange, Listed Company Manual, NYSE §§ 303A.09, 303A.10, *available at* [http://www.nyse.com/Frameset.html?nyseref=http://www.nyse.com/regulation/nyse/1182508124422.html&displayPage=/lcm/lcm\\_section.html](http://www.nyse.com/Frameset.html?nyseref=http://www.nyse.com/regulation/nyse/1182508124422.html&displayPage=/lcm/lcm_section.html) (last visited Feb. 3, 2009); American Stock Exchange, Company Guide, AMEX §§ 802, 803, *available at* <http://wallstreet.cch.com/AMEX/Comp>

issues, such as which parties should have what powers, how their rights should be enforced, and how officers and directors should be monitored. All of these questions should be examined anew now that corporate business and investment in securities have experienced such a jarring revolution.

Legal scholars are already picking apart the financial crisis of 2008–2009 to look for clues about how it happened and to try to figure out how a similar crisis could be avoided in the future. Examining who owns what and what that means, and ought to mean, in the structure of a firm might help to move forward from the crisis. Living as far as we do from the world Berle and Means explored, we should not assume that they describe a corporate form that we would find useful.

#### CONCLUSION

Berle and Means provided an extremely valuable portrait of corporate law and the corporate form in *The Modern Corporation and Private Property*. Elements of their descriptions of the public corporation endure today. Changes in investment have changed the ways corporations work and have influenced our notions of corporate ownership. Those differences may necessitate changes to the corporate structure. One valuable change might be to adopt the use of equity trustees to represent the equity interest and perform the shareholder job in corporate governance. As legal scholars, we should carefully examine the corporate structure while questioning our basic assumptions about the corporate form.

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anyGuide (last visited Feb. 3, 2009). See also NASDAQ Corporate Governance: Summary of Rules Changes (Nov. 2003), available at <http://www.nasdaq.com/about/CorpGovSummary.pdf> (last visited Feb. 3, 2009); Sarbanes–Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 779 (codified as amended at 15 U.S.C. §§ 7201–7266 (2008) and in scattered sections of 15 U.S.C., 18 U.S.C., 28 U.S.C., & 29 U.S.C.).