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# On the Governance of the Modern Corporation

Oliver E. Williamson

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Commentary on the governance of the modern corporation spans the entire spectrum from those hostile to an enterprise mode of organization to those who offer apologetics. Most commentary falls in between, and much of it comes from lawyers who appear to be sympathetic with the enterprise mode but who do not appreciate the unique properties of the corporation as an efficiency instrument. Relatedly, many corporate critics have an imperfect understanding of subtle ways by which competition in product and capital markets performs, and sometimes can be made more effectively to perform, self-policing functions. Accordingly, when confronted with an actual or imaginary corporate governance issue, many critics favor legislative and regulatory reforms designed to effect greater regulatory control.[1]

Ralph Winter, in a recent monograph, has examined the leading reform proposals and assessed their merits.[2] Although the views I set out here are close to Winter's, I have less confidence in the efficacy of competitive processes than he and accordingly argue that the corporate governance problem is somewhat more serious than he indicates. My major reform proposal, however, is the same as his: Federal law is needed to override the protectionist features of state takeover statutes.[3] But I go beyond Winter to discuss some

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1. *See, e.g.*, R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION 227-36 (1976); Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 696-705 (1974); Chayes, *The Modern Corporation and the Rule of Law*, in THE CORPORATION IN MODERN SOCIETY 25, 38-45 (E. Mason ed. 1959); Stone, *Public Directors Merit a Try*, HARV. BUS. REV., Mar.-Apr. 1976, at 20 *passim*. For discussion of some of the proposals raised by these and other corporate critics, see R. WINTER, GOVERNMENT AND THE CORPORATION 47-67 (1978).

2. R. WINTER, *supra* note 1, at 47-67.

3. *See, e.g.*, MASS. GEN. LAWS ANN. ch. 110C, §§ 1-13 (West Supp. 1979); N.Y.



 

of the pecuniary incentives that sometimes attend takeover, and I contend that certain financial disclosure problems may be more serious than he represents.[4] I also examine the lack of both popular and corporate support for takeover reform. Except as corporate leaders take the long view on the merits of competition and act to upset protectionist state takeover statutes, the prospects for takeover reform are limited.

Some background on corporate governance is set out in the first section. The second section examines the public policy issues relating to governance reform, and concluding remarks follow in the third section.

## I. Background

### A. *Interventionist Proposals*

Those who counsel that extensive intervention in corporate governance is needed generally hold a low opinion of the efficacy of competition. They believe that competition in the product market is weak and unreliable and that competition in the capital market is a hoax. Incumbent managements purportedly enjoy excessive latitude on both accounts, and they exercise it in dubious ways.[5]

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Bus. Corp. Law §§ 1600-1613 (McKinney Supp. 1979-1980); Ohio Rev. Code § 1707.04.1 (Page 1978).

Winter describes the impediments to takeover that have been enacted by state legislatures:

> With the increasing use of tender offers over the last decade has come an increase in the number of state takeover statutes. These laws usually provide that the offeror file certain information with state securities officials a specified time before the offer becomes effective. They further require that the offer, once effective, be kept open for another specified period. Most require that the purchase be on a pro rata basis if less than all the tendered shares are purchased. Some of these laws permit state officials to hold hearings on whether the disclosure is adequate and the offer fair. Others make such hearings mandatory at the request of the target company. Unlike most corporate code provisions, takeover statutes have an extraterritorial effect. They apply not only to companies chartered in the state but also to firms with substantial business contacts with the state, no matter where the stockholders reside.

R. Winter, *supra* note 1, at 22 (footnotes omitted). *See generally id.* at 42-44. The role played by protectionist features can be seen, for example, in the attempted takeover of B.F. Goodrich by Northwest Industries. O. Williamson, Corporate Control and Business Behavior 100-03 (1970). *See also* Cary, *Corporate Devices Used to Insulate Management From Attack*, 39 Antitrust L.J. 318 (1969-1970).

4. *See* R. Winter, *supra* note 1, at 53-56.

5. *See, e.g.*, R. Nader, M. Green & J. Seligman, *supra* note 1, at 198-236; Chayes, *supra* note 1, at 36-37.

Greater accountability is needed if superior social outcomes are to be realized. Reform proposals fall into three categories: (1) Corporations should be required to represent the interest of "affected" groups on the board of directors;[6] (2) greater disclosure of corporate financial detail and internal operating practices should be required;[7] and (3) federal chartering should be used as a means to effect more comprehensive regulatory control over pollution, employment discrimination, and the like.[8]

### B. *Requisite Background*

An understanding of corporate governance requires an understanding both of economic institutions and processes, as well as the reform inclinations of those who originate or are affected by reform proposals. These matters are briefly addressed here.

*1. Economics of the Enterprise Mode.*—My assessment of corporate governance is based on the following propositions, an elaboration of which is set out elsewhere.[9]

*(a) General.*—The corporation has remarkable properties for economizing on scarce resources in the production of private goods and services. Alternative production modes with equally good economizing properties do not exist. Accordingly, rather than diffuse the purposes of the corporation by using it to accomplish other worthwhile social goals, society will benefit more by concentrating the energies of the corporation on that goal it is best designed to promote: efficiency.

This is not to suggest that other worthwhile social goals be neglected. The message instead is that specialized instruments should be used in a discriminating way to promote specialized purposes. To the extent, for example, that redistribution is needed, this should be accomplished mainly through governmental programs to transfer generalized purchasing power.[10] Using the corpo-

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6. *See, e.g.*, R. NADER, M. GREEN & J. SELIGMAN, *supra* note 1, at 123-28; Cary, *supra* note 1, at 698-99; Stone, *supra* note 1, *passim*. *See generally* Chayes, *supra* note 1, at 38-45.

7. *See, e.g.*, R. NADER, M. GREEN & J. SELIGMAN, *supra* note 1, at 132-40, 157-79.

8. *See, e.g.*, *id.* at 62-71; *cf.* Cary, *supra* note 1, at 700-05 (proposal to create Federal Corporate Uniformity Act). *See generally id.* at 663-700.

9. *See* O. WILLIAMSON, *supra* note 3; O. WILLIAMSON, MARKETS AND HIERARCHIES (1975); Williamson, *The Modern Corporation as an Efficiency Instrument*, in GOVERNMENT CONTROLS AND THE FREE MARKET 163 (S. Pejovich ed. 1976).

10. For discussion of circumstances where transfers in kind may be more appropriate, see Tobin, *On Limiting the Domain of Inequality*, 13 J. L. & ECON. 263 (1970).

ration for this purpose is apt to be both ineffective and detrimental to its performance in efficiency respects.

Efficiency, of course, needs to be interpreted in social as well as private terms. To the extent that social costs differ from private costs at the margin, the private profit calculus will lead to societal suboptimal outcomes. Efforts to rectify this by requiring corporations to recognize these cost differences (as in the case of pollution taxes or controls) are in no way inimical to the economizing purposes that I would assign to corporations.

*(b) Product-Market Competition.*—Competition in the product market has both carrot and stick properties. The prospect that new products and processes will yield profits is needed to stimulate innovation. But an effective enterprise system is one in which successes are recognized and imitated. Cost excesses are continuously squeezed out under the pressure of product-market rivalry.

Although competition in the product market is effective in most industries over the long pull, corporate governance issues can nonetheless arise. For one thing, a few firms appear to enjoy product-market insularity for long periods of time. Unless subject to other competitive pressures or controls, the managements of such firms may operate them in ways that are contrary to efficiency. John Hicks' view that the best of all monopoly profits is the quiet life thus applies as much in the 1980's as in the 1930's.[11]

Furthermore, even where product-market competition is creditably effective in the short run, firms that have financed large fixed costs with equity do not have to recover all of their costs in order to remain viable.[12] Put differently, product-market viability tests take effect more slowly in firms that are heavily financed by equity. Accordingly, additional governance checks may be needed lest the managements of such firms permit expenses and operating costs to escalate.

11. Hicks, *Annual Survey of Economic Theory: The Theory of Monopoly*, 3 ECONOMETRICA 1, 8 (1935).

12. The importance of this was emphasized to me in a conversation in the Spring of 1979 with Sanford Grossman, Professor of Economics and Finance at the University of Pennsylvania. The stipulation that fixed assets be financed by equity is critical. Were they financed instead by bonds, annual interest payments, and debt retirement arrangements would have to be made. Equity does not impose these same financial restraints; thus the managements of firms with large fixed assets financed by equity have access to greater discretion. *See generally* Grossman & Hart, *Takeover Bids and the Theory of the Corporation: The Free Rider Problem and the Efficient Management of Common Property*, 11 BELL J. ECON. (forthcoming 1980).

*(c) Capital-Market Competition.*—The primary functions of competition in the capital market are (1) to shift resources from lower to higher return activities, thereby equalizing rates of return at the margin, and (2) to force incumbent managements to behave as responsible economizing agents wherever latitude exists due to weak product-market competition or the cushion of large fixed costs. In comparison with takeovers, proxy contests are an ineffective means by which to police incumbent managements. But takeovers are also costly, a condition exacerbated by protectionist state takeover statutes.[13]

*(d) Organization Form.*—The rational internal organization of the corporation can and has done much to attenuate the degree of management subgoal pursuit. For example, the corporate form known as the multidivisional structure has exceptional internal control and incentive properties.[14] In particular, the capacity to manage diverse assets, when joined with an effective takeover mechanism, greatly reduces—but does not eliminate—the troublesome management discretion problems that worried Berle and Means in the 1930's[15] and has bothered other commentators, such as Edward Mason,[16] since.

2. *Reform Propensities.*—(a) *Regulation.*—Presented with a problem, real or imagined, the "natural" human reaction is to fashion a local solution. Search in the neighborhood of the problem and patch it up is the normal sequence.[17] Albeit effective for many individual problem-solving tasks, this same strategy is much less effective and may be dysfunctional when the effects of interaction with other parts of the system are great. A broader understanding of the system within which the shortfall is reported is needed if an efficacious remedy is to be devised.

Corporate governance issues require an appreciation for the properties of the enterprise mode of organization in the above-described product market, capital market, and internal organizational respects. Such an appreciation is not widespread. Furthermore, the political system rewards those who act decisively—in a bold, admin-

13. *See* note 3 *supra.*

14. *See* O. WILLIAMSON, *supra* note 9, at 132-54.

15. *See* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 220-32, 270-76 (1932).

16. *See* Mason, *Introduction* to THE CORPORATION IN MODERN SOCIETY 7-9 (E. Mason ed. 1959).

17. *See generally* R. CYERT & J. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963).

istrative fashion—rather than those who effect a remedy by reliance upon indirect market processes. Little wonder, therefore, that the propensity to regulate is so strong. Unfortunately, however, piecemeal regulation frequently impairs self-regulating features, is administratively costly, and typically has multiplier effects as shortfall after shortfall is successively "remedied" by follow-on regulation.

*(b) Competition.*—Competition is a hair shirt for those who have to wear it. Confronted, therefore, with claims that corporate governance is ineffective, corporations are understandably reluctant to propose solutions that entail the intensification of competition. Cosmetic internal adjustments are apt to be favored instead. Those failing, additional regulation—which corporations hope either to frustrate or to capture and manage—is the next most favored alternative.

The upshot is that support for competition as a governance solution is generally lacking. Lawyers do not understand it; politicians derive few rewards from it; and corporate managements are disinclined to inflict discomfort upon themselves. Academic proposals to reinvigorate the system by intensifying competition thus appeal to no substantial constituency.

## II. Critical Governance Issues

Issues of corporate governance are developed in two parts. The dilemmas posed by pecuniary economies, especially as these relate to takeover and antitrust scrutiny of conglomerate mergers, are examined first. The main areas in need of additional governance are then set forth.

### *A. Pecuniary Economies*

My discussion of the corporation as an efficiency instrument has emphasized the real economies for which the corporate form is responsible. Although a great deal of corporate activity is accurately described in those terms, the firm's profit criterion does not discriminate between pecuniary economies—savings from transfers, as in tax savings, and real economies—real cost savings of capital or labor. Rather the firm values economies of both kinds equally.

Society, in contrast, benefits only when real cost savings are realized.[18] In the degree to which incentives of a pecuniary kind

18. This assumes that real cost savings are productively employed elsewhere in

have been created, however, it is unrealistic to expect firms to be unresponsive to them. Occasional public policy dilemmas can and do arise in this way, mergers being among these. The attempted takeover of Mead Corporation by Occidental Petroleum illustrates the tensions.

Occidental is a diversified petroleum firm with 1978 sales and assets of $6.2 billion and $4.6 billion, respectively. Mead is a large paper company with 1978 sales and assets of $2.3 billion and $1.5 billion, respectively. In terms of sales, Occidental was the 33rd largest industrial in 1978 while Mead was number 127.[19] Had the two firms merged, the combined enterprise would have ranked 20th.

Occidental had large unused tax credits that were due to expire. Joining Mead's financial statement with Occidental's would permit these tax credits to be utilized if a consolidation could be effected.[20] Occidental first proposed a merger and, when this was declined by the Mead management, followed with a takeover bid. Mead contested the takeover on both antitrust and securities regulation grounds.[21] The Antitrust Division of the United States Department of Justice brought a parallel antitrust suit.[22]

Although the Justice Department raised several horizontal antitrust concerns,[23] Occidental was prepared to answer these by selling assets where horizontal overlap existed. The major allegation which could not be so rectified was the inventive "Count Four," a deep pocket objection in which economies were alleged to be anticompetitive.[24] Occidental's financial strength would permit Mead to achieve real economies that would otherwise go unrealized. As a consequence, Mead would become entrenched as a dominant firm

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the economy. Pecuniary economies shift purchasing power but do not release resources for productive employment.

19. FORTUNE, May 7, 1979, at 270, 274.

20. *See* I.R.C. §§ 381-383; B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS §§ 16.10-.14 (4th ed. 1979).

21. Mead Corp. v. Occidental Petroleum Corp., No. C-3-78-241 (S.D. Ohio, filed Aug. 18, 1978).

22. United States v. Occidental Petroleum Corp., No. C-3-78-288 (S.D. Ohio, complaint dismissed without prejudice Apr. 4, 1979). Occidental eventually withdrew its tender offer and a stipulation of mootness was entered into by the United States and Occidental on April 2, 1979.

23. Complaint of Plaintiff at 5-12, United States v. Occidental Petroleum Corp., No. C-3-78-288 (S.D. Ohio, complaint dismissed without prejudice Apr. 4, 1979).

24. Amended Complaint of Plaintiff at 11-14, United States v. Occidental Petroleum Corp., No. C-3-78-288 (S.D. Ohio, complaint dismissed without prejudice Apr. 4, 1979).

in the production of coated free sheet paper. The key paragraphs in the Justice Department's amended complaint are the following:

> 45. The most efficient way to expand capacity significantly . . . involves the use of large, fully integrated plants known as "greenfield plants." A greenfield plant must have (a) access to power, timber and water resources, (b) large-scale pulping and paper-making facilities, and (c) efficient transportation to markets. . . .
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> 46. The cost of establishing a greenfield plant to produce coated free sheet paper is estimated to be up to $500 million. . . . Few companies in the paper industry possess, or have the ability to obtain, the resource necessary to establish and operate greenfield plants.[25]

If, as the Government claimed, a greenfield plant was the "most efficient and cost effective"[26] investment, if, out of mutual dependence recognized or otherwise, the leading firms in the paper industry were unwilling to make such an investment, and if Mead under Occidental ownership would undertake such an expansion, gross social benefits would be realized. Accordingly, if the Government took Count Four seriously and understood its ramifications, and assuming that offsetting social costs were not great, the Government should have been commending Occidental for upsetting what appeared to be an investment conspiracy among the leading free sheet producers. Indeed, but for the Occidental initiative, the case that the Government should have been bringing is one that indicted the largest producers of coated free sheet for persistent failure to make the most efficient and cost-effective investment—presumably out of mutual forebearance, the concern being that a large greenfield investment would increase supplies and give rise to unwanted rivalry.

The Government appeared to be totally unaware of these ramifications. Instead, it concentrated its attention entirely on purported adverse consequences. The following issues arise in this connection: (1) Are there adverse market-power effects, and if so, are these quantitatively significant in relation to the efficiency

25. *Id.* at 12-13.

26. The phrase was employed by the Government's lead attorney, Barbara Reeves, in characterizing the pernicious properties of a greenfield investment. Supplemental Memorandum of Plaintiff in Support of Its Motion for Preliminary Injunction at 7, United States v. Occidental Petroleum Corp., No. C-3-78-288 (S.D. Ohio, complaint dismissed without prejudice Apr. 4, 1979).

 

gains? (2) Are there other objectionable features, and if so, can an antitrust case be brought on these grounds? (3) If market-power effects are insubstantial and an antitrust action is precluded, what can be done?

As I have shown elsewhere, a merger that achieves real cost economies will yield allocative efficiency gains except as relatively large market-power effects also obtain.[27] On the Government's hypothesis, a greenfield investment is cost-effective, presumably by a wide margin. Whether a conventional antitrust objection exists thus turns on a demonstration of large, adverse market-power effects. The "worst case" scenario is this: In 1977, the four largest producers of coated free sheet paper accounted for fifty-eight percent of the $800 million market, Mead's share being fifteen percent. The market was growing, and, if neither other producers nor Mead retired existing plants, Mead's maximum increase in the market share would be ten percent by the time a $500 million greenfield plant was completed.[28] Although standards for judging market-power effects are imprecise, almost no economist would consider this a major reshaping of the market. And it is totally irresponsible to claim, as the Government did, that such a greenfield investment would cause Mead "effectively to dominate this market."[29] The Government's powers of speculation are vast, however, and it went on to allege that "Occidental's *unique* financial resources"[30] would lead other firms to withdraw from the coated free sheet market, concentrate their investments in other market segments, and lead to "increased concentration as a domino effect throughout the paper industry."[31] The more natural competitive response of imitating cost-effective investments went unmentioned.

Also unmentioned in the Government's complaint and supporting argument were the tax-credit features that attracted Occidental to Mead in the first place.[32] The reason for this is simple: The Antitrust Division does not have the authority to challenge mergers except as adverse market-power effects can be shown. The Occidental–Mead acquisition attempt came at an embarrassing time. Congress had been holding hearings on the need for addi-

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27. *See* Williamson, *Economies as an Antitrust Defense Revisited*, 125 U. PA. L. REV. 699 (1977).
28. Amended Complaint of Plaintiff, *supra* note 24, at 12.
29. *Id.* at 13.
30. *Id.* (emphasis added).
31. *Id.* at 14.
32. *See* note 20 *supra* and accompanying text.

tional legislation to prevent large conglomerate acquisitions—mainly because of sociopolitical concerns over the large size of resulting corporations.[33] The Assistant Attorney General in charge of the Antitrust Division, John Shenefield, acknowledged that some large conglomerate mergers are difficult to reach under section 7 of the Clayton Act.[34] But he assured the congressional committee that the Antitrust Division would engage in "creative lawyering" and "careful analysis"—almost a contradiction in terms—in enforcing section 7.[35]

Indeed, creative lawyering easily reduces meaningful antitrust enforcement to a shambles. Misguided antitrust enforcement during the 1950's and 1960's—of which *Brown Shoe Co. v. United States*,[36] *United States v. Von's Grocery Co.*,[37] and *United States v. Arnold, Schwinn & Co.*[38] are examples—illustrates the hazards. The enforcement nadir came in 1962, when the FTC reasoned perversely that "the necessary proof of violation of the statute consists of types of evidence showing that the acquiring firm possesses significant power in some markets *or* that its over-all organization gives it a decisive advantage in efficiency over its smaller rivals."[39] This is, as Donald Turner pointed out, bad law and bad economics.[40] The Antitrust Division's argument under Count Four of the Occidental complaint is of the same ilk, and the same assessment applies.

The logic of the enterprise mode of organization collapses in the face of protectionist antitrust enforcement. A case can be made, however, that Count Four represents an aberration rather than a true reading of the Antitrust Division's general intent. It is the "creative lawyering" response to the dilemma that was posed when pecuniary economies (tax credits) were joined with the large aggregate size which an Occidental-Mead combination would have represented.

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33. *See Hearings on Need for Additional Legislation to Prevent Large Conglomerate Acquistions Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 95th Cong., 2d Sess. (1978).

34. *Id.* at 208 (statement of John Shenefield, Asst. Att'y Gen'l, Antitrust Div., Dep't of Justice).

35. *Id.* at 206 (statement of John Shenefield, Asst. Att'y Gen'l, Antitrust Div., Dep't of Justice).

36. 370 U.S. 294 (1962).

37. 384 U.S. 270 (1966).

38. 388 U.S. 365 (1967).

39. *In re* Foremost Dairies, Inc., 60 F.T.C. 944, 1084 (1962) (emphasis added).

40. Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313, 1324 (1965).

There are four ways of dealing with tax-induced combinations: (1) Fine tune the tax statutes to prevent tax-credit advantages from being realized by acquisition; (2) tolerate the occasional tax-induced acquisitions despite possible lack of merit (even to include real diseconomies) in other respects; (3) resist large tax-induced acquisitions by bringing a contrived antitrust case; or (4) give the Antitrust Division additional legislative authority to resist large conglomerate acquisitions. Inasmuch as tax reform commonly encounters political obstacles, the first alternative, which otherwise is the most preferred course of action, may not be feasible. The fourth alternative may also be politically infeasible. Moreover, the special conglomerate legislation contemplated under (4) would serve to weaken the market for corporate control.[41] The operative choices are thus reduced to (2) and (3). While I can understand the pressures to bring a contrived case, such actions elicit contempt for antitrust enforcement and relieve the incentive to take corrective action of the first kind.

This unhappy scenario suggests that corporate governance reforms of a more general kind be considered. These are addressed below.

### *B. Corporate Governance Reforms*

Four legitimate corporate governance concerns are considered here: Federal takeover regulation, corporate charter reform, financial disclosure, and special cases for public directors. Consider these seriatim:

*1. Federal Takeover Legislation.*—The case for federal legislation to override protectionist state takeover statutes has been convincingly made by Ralph Winter:

> Although the enactment of takeover laws is usually in the name of shareholder protection and to some extent may further that end, the effect is to make takeovers more difficult. The cost of takeovers is usually increased while the expected gain is correspondingly diminished. The offeror is denied both secrecy and speed while management has a number of legal and nonlegal weapons it can utilize defensively in the meantime, such as "defensive" mergers, the creation of a new class of stock, changes in the procedure for electing or eliminating directors, or an antitrust action. Where hearings are mandatory and the delay is in-

41. For an early and instructive discussion, see Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

> evitably extended, the conclusion that such statutes are designed to protect incumbent management is inexorable.[42]

Problems, however, arise in mobilizing political support for federal reform of state takeover statutes. As Winter points out, "Existing management of many corporations can be expected to lobby for" protectionist state takeover statutes.[43] Indeed, the fact that such statutes are "applicable only to larger companies suggests that much of the pressure is from existing . . . firms."[44] Where will the corporate support to override these protectionist state statutes originate?

An act of corporate statesmanship is evidently needed. Not only do corporate managers need to take a long view of competition and its crucial importance to the merits of an enterprise system, but managers have to be prepared to bear risks as well. Those confident of their competence as managers will be most prepared to take a leadership position. But corporate managers, like other managers, have a strong preference for security. A total failure of corporate leadership in this matter, however, would constitute a serious indictment.

2. *Charter Reform.*—Not only do protectionist state takeover statutes need to be overridden, but protectionist charter provisions by individual corporations need to be discovered and reversed. By way of illustration, consider the amended corporate charter of the Brunswick Corporation, which provides that

> there shall be required for the adoption or authorization of a Business Combination with an Interested Person [possibly a takeover agent] the affirmative vote or consent of the holders of *two-thirds of the outstanding shares* of stock of the Corporation entitled to vote in elections of directors . . . *which are not beneficially owned, directly or indirectly, by such Interested Person.*[45]

The amendment goes on to stipulate that no revision of this condition shall be permitted except under very similar voting requirements. That terms such as these serve to protect incumbent managements against unwanted takeover, even though the management may be operating the firm discreditably, is transpar-

42. R. WINTER, *supra* note 1, at 22-23 (footnote omitted).
43. *Id.* at 43.
44. *Id.*
45. Composite Certificate of Incorporation of Brunswick Corporation art. 8, at 4 (as amended through May 13, 1977) (emphasis added).

ent.[46] Effecting their reversal, however, may be politically very difficult.

3. *Disclosure*.—Resources cannot be expected to flow to high yield uses except as information about these opportunities is known. Where corporations are specialized in a few lines of business, this can often be inferred from an examination of the aggregate financial statements of each. Where corporations are highly diversified, however, this is much more difficult to ascertain. By way of illustrating the importance of financial disclosure, consider the information disclosure that attended the acquisition of the Electric Autolite Company by Ford Motor Company.

There were three major sparkplug manufacturers in the 1950's: Autolite, Champion, and AC. Autolite and Champion were independent and closely held, while AC was a division of General Motors. Supplying sparkplugs to a major automobile firm as original equipment was a considerable advantage in selling to the sparkplug replacement market. This was apparent to both automobile firms and their sparkplug suppliers. Indeed, the replacement market sales advantage that accrued to suppliers of original equipment was so highly valued that sparkplug manufacturers were prepared to—and did—sell sparkplugs to automobile manufacturers at less than cost. It was not until Champion Spark Plug Company went public in 1958, however, that the magnitude of this advantage was fully disclosed. The president of Electric Autolite Company explained with respect to this disclosure that

> Electric Autolite was "concerned" because, when Champion Spark Plug Company "went public" in 1958, "the figures that came out were very large—showing very large profits" and "when Ford saw those figures and saw how much profit there was in it" Electric Autolite "felt" that "the very essence of that much profit going to a supplier would be enough to make Ford think in terms of integration."[47]

Ford did so think and a merger with Autolite was proposed and accepted, though it was subsequently challenged and divestiture ordered.[48] Whether the same merger would have been pro-

46. There are some additional, more subtle conditions on valuation of terms for a business combination that also serve to insulate the Brunswick management against unwanted takeover. *See id.* arts. 8-9.

47. Trial Memorandum on Behalf of Defendant Ford Motor Company at 14-15, United States v. Ford Motor Co., 286 F. Supp. 407 (E.D. Mich. 1968), *quoted in* O. WILLIAMSON, *supra* note 9, at 93 n.14.

48. *See* United States v. Ford Motor Co., 286 F. Supp. 407 (E.D. Mich. 1968)

posed in the absence of profit disclosure is uncertain. Possibly the timing was fortuitous. Be that as it may, Autolite regarded disclosure as a crucial factor. More generally, the point is this: Financial disclosure minimizes the need to expend considerable engineering and economic resources to ascertain profit opportunities.

Financial disclosure is not costless, however, and accounting statements can be massaged. Whether a net social gain would be realized by requiring greater disclosure is thus problematical: The benefits may be less that expected, because of massaging, and may be more than offset by the costs entailed in providing the information.

Whatever these social costs, the costs of disclosure incumbent managements perceive are apt to be greater. Thus not only are incumbent managements sensitive to the increased accounting expenses that greater disclosure entails, but they wish neither to invite new competition nor to have to explain internal investment decisions when doubtful programs are undertaken or renewed, as they sometimes are. Also, and related to this last point, unwanted takeover efforts may be encouraged.

Although drawing the line on appropriate financial disclosure is difficult, a presumption in favor of greater disclosure can be based on the following baseline logic. Assume that financial disclosure was optimal when corporations were relatively specialized. Then as corporations become more diversified, composite financial disclosure is suboptimal, ceteris paribus. Put differently, something akin to line-of-business reporting has better resource allocation consequences than does composite disclosure as diversification increases. In principal, no additional information than that which the firm already generates for its own internal decisionmaking purposes would appear to be required. Whether excessive costs are incurred thus partly turns on whether regulation is sufficiently flexible to respect differences in internal reporting practices or instead imposes costly uniform accounting procedures. The possibility that "complicated legal advice would be necessary to establish the adequacy of each filing" is a legitimate concern.[49]

But if the case for greater financial disclosure is uncertain, the case for wide-ranging "social impact" statements is even more dubious. As Winter puts it:

(merger found to violate antitrust laws), *aff'd*, 405 U.S. 562 (1972); United States v. Ford Motor Co., 315 F. Supp. 372 (E.D. Mich. 1970) (divestiture found to be appropriate remedy), *aff'd*, 405 U.S. 562 (1972).

49. R. WINTER, *supra* note 1, at 54.

> The point . . . is not that disclosure has no net benefits. Of course it may, but they depend very much on what is to be disclosed, how much it will cost, and why it is needed. Disclosure can be justified case by case, not on the undifferentiated wholesale grounds suggested by the critics.[50]

Put differently, if a specific disclosure need exists, the case should be made expressly in these terms. Unstructured claims that more information is always better than less are unhelpful as a guide for sound public policy.

4. *Special Cases for Public Directors.*—Christopher Stone has examined the case for public directors and rejects them except in two carefully delimited situations:[51] Repeated delinquency, *e.g.*, repeated violation of the law, is one; a serious problem, *e.g.*, pollution, that is generic to an industry is another. In both instances, the purpose is to facilitate better access to, and utilization of, information. But the general case for public directors—or other "special interest" directors—is not apparent. Appeal to notions that corporations are generalized instruments for serving purposes other than efficiency would be needed for the general case to go through. As I indicated at the outset, I seriously doubt that such a case can be made.

## III. Concluding Remarks

As between direct and indirect corporate governance measures, the critics of the corporation favor direct changes in governance. Federal chartering, extensive disclosure, and a reconstituted board of directors are all advocated. Corporation managements disfavor the first two, but many have acted to "diversify" membership of the board of directors. Enthusiasts of the enterprise mode of organization see little merit in direct intervention and argue that product and capital markets work well to perform self-policing functions. Winter urges that greater reliance be placed on indirect market governance forces. Specifically, a federal takeover statute is needed to override protectionist state takeover laws.

My position is closer to this last view, though I am less convinced that product markets are as competitive as some believe, whence the issue of corporate governance is a relevant one. Additionally, while some supporters of the enterprise system appeal to "economic theory" to support the proposition that managements

50. *Id.* at 55.
51. Stone, *supra* note 1, at 21.

will utilize capital in the stockholders' interests,[52] I would suggest that the data also be considered. Specifically, although it is formally correct to say that a profit-maximizing enterprise will equate rates of return to all sources of financing at the margin, the facts disclose that rates of return on retained earnings are below those of bonds and that new equity returns are highest.[53] Thus, although the fiction of perfect capital markets may be useful for some purposes, it is not one to which appeal should be made for purposes of arguing that a managerial discretion problem is nonexistent.

The proposition that a federal override of protectionist state takeover laws is needed has not attracted widespread support from either the business community or their regulators. That the business community has not endorsed it is easy to understand: Competition is a hair shirt, which explains why the protectionist state statutes were passed in the first place. That regulators are unenthusiastic reflects populist preferences for small enterprise and skepticism that takeover has the invigorating properties that I attribute to it. The fact that takeover efforts too often reflect pecuniary rather than real cost incentives contributes to these attitudes. But for this, the benefits of maintaining an active market for corporate control would be more compelling.

"If it's not broken, don't fix it" is a sound maxim. But what to do about a squeaky wheel or an engine knock? Some would ignore these also, perhaps because they recognize that bureaucratic intervention, once begun, is given to escalation. But bureaucratic intervention would not be needed if the "make markets work more effectively" approach were adopted. Except, however, for occasional, laudable deregulation efforts, who is making the case for the intensification of competition?

What corporate charters have been changed in recent years to make takeover easier? What state has changed its security laws to favor such a result? Is it surprising that the critics of the corporation express dismay over corporate governance in these circumstances? Although cosmetic changes may postpone unwanted federal regulation of corporate governance structures, the intensification of capital-market competition would be a much more important development. Support for such a change requires a long view on the merits of capitalism. The need for corporate leadership is clear.

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52. *See, e.g.*, R. WINTER, *supra* note 1, at 28-30.

53. Baumol, Heim, Malkiel & Quandt, *Earnings Retention, New Capital and the Growth of the Firm*, 52 REV. ECON. & STAT. 345, 354 (1970).