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RAIDERS, TARGETS, AND POLITICS: THE HISTORY AND FUTURE OF AMERICAN CORPORATE CONTROL

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In the collective consciousness, the active market for corporate control of the 1980s stands discredited. Takeovers, LBOs, and the associated flotsam and jetsam have disappeared. The financing market has collapsed, along with the leading investment bank that aided corporate raiders. Proxy contests at large companies often appear to be ineffective. Institutional shareholders have become organized and sometimes vocal, but have been subjected to increasing criticism and political pressure. Overleveraged companies—the apparent victims of the 1980s—search for new equity funding. *Fortune Magazine* asked recently: "Was the sound and fury worth it?" Their answer was a resolute "No."

The collapse of the takeover movement of the 1980s, and indeed the broad political backlash that it has provoked, appear to place American corporate governance at a crossroads. The tactics of the past are no longer workable; yet there are as yet no clear signs of a viable alternative. There are many calls for wide-ranging reform, and there are many predictions about what kind of oversight process should and will arise, virtually all of which postulate some kind of permanent, radical change. Many economists argue that without changes in the laws to permit the re-emergence of takeovers, effective corporate oversight is doomed. By contrast, would-be reformers like Michael Porter are calling for a wholly new system of corporate governance—one in which centralized oversight and sweeping legal changes would replace the contentious takeover tactics of the past two decades.

Given these forces, it may seem to fly in the face of political and economic reality to suggest that the death of the market for corporate control has been greatly exaggerated. But the history of American corporate governance suggests just this conclusion. History shows that there have been many periods of transition in governance similar to the one we are now experiencing. Many times before, corporate "raiding" has given rise to political backlash, new laws, and regulations—and there has resulted a temporary suspension of the oversight process. The ultimate result is never revolution, but rather evolution. After a brief respite, market participants devise new tactics that reflect changes in the legal, political, and economic environment, and a vital free market in oversight reasserts itself.

*This interpretative essay draws on accumulated work on corporate governance and corporate control contained in both the legal and financial literature, as well as my own research on the history of the market for corporate control. It also draws on my experience as an adviser to institutional investors and a participant in proxy activity.

The revived market for corporate control of the 1990s will be governed by the same underlying dynamics as its 1980s predecessor. At its core will be a new class of active, entrepreneurial investors. As in the '80s, such investors will buy stakes in publicly-held corporations and bargain with management to bring about productive change and thereby realize a profit on their investment. The tactics of such entrepreneurs, however, will be markedly different from those employed by "raiders" during the 1980s. They will be less overtly hostile and less often aimed at achieving quick and complete control. Entrepreneurs will run independent directors for corporate boards, form committees to examine corporate policy, make proposals for specific changes in corporate strategy, make new "patient" equity investments in return for board representation, and make acquisitions through carefully orchestrated negotiations with target corporations and their major investors.

I call this new model of corporate oversight a "political" approach. This is because the new process reflects the rules and values that guide oversight of elected representatives in the public sector. The political model is based on substantive debate about the corporate agenda, limited suggestions for corporate change, negotiation, and compromise. Through the critical examination of current corporate strategies, the articulation of alternative corporate plans, and the mounting of limited voting challenges, the political model allows investors to address corporate shortcomings and solve problems.

This new dynamic is already apparent in the corporate governance arena. In 1992 alone, a significant number of companies have responded to pressures from investors that, while quite unlike the takeover pressures of the '80s, have increasingly proven effective in bringing about change. The names include a roster of companies with clear problems that the takeover mechanism did not and could not resolve, such as General Motors, Sears, Control Data, Hartmax, and Chrysler.

The political model is arising as a consequence of two major factors unique to the current transformation in the corporate governance arena. The first important change is the increased ownership concentration among institutional owners, which creates a more informed, more sophisticated, and more readily reachable audience for initiatives to change corporate policies. The second major development is the sweeping set of deterrents to control changes and financial transactions encoded in corporate charters and state laws over the past decade. These changes have greatly diminished the economic benefits from the tactics of the takeover era, and tilted incentives toward the use of the political model.

To those steeped in the take-no-prisoner takeover battles of the past decade, political corporate governance initiatives may seem like pale ghosts in comparison. But the reality may well prove very different. The political model offers important benefits over the tactics of the takeover decade, including principally the ability to bring about major corporate change without the costs and disruption of an acquisition or change of control. At the same time, the political model is more sustainable in the broad view of public policy, because it reflects American traditions in the governance of all major institutions, public and private. The political model thus offers the prospect of a more sustainable governance process than did the one prevailing a few short years ago. If current trends continue and solidify, the result could be a sustainable, effective, and uniquely American process of corporate control. It would be a system based on substantive debate and expert oversight by active investors working in conjunction with—and kept honest by—major institutional investors.

THE AMERICAN ENTREPRENEURIAL OVERSIGHT SYSTEM

Unlike the corporate governance systems in other major industrialized countries—including those in Germany, France, Japan, and to a lesser degree Britain—the American system of governance has never relied on a stable set of close relationships between large financial institutions and major corporations. Rather, it has relied upon no one and everyone—upon the actions of uncounted numbers of individual, corporate, and institutional investors, operating within a deep, liquid, and anonymous securities market. Within that market, investors search for evidence of significant management mistakes—mistakes that can be reversed, and whose reversal means higher profits and an increase in share values. Investors finding mismanaged companies can then use the anonymity and liquidity offered by our stock market to secretly amass a position at current prices. Having built this position, they can then use the voting power associated with those shares, along with the voting power of other shareholders with similar beliefs, to bring about change. If they are successful, and their views are correct, corporate performance improves and share prices rise—and they profit from their undertaking. It is the potential for such profits that motivates a very large number of American financial market participants to consider, plan, and actively pursue entrepreneurial oversight activity.

Oversight by entrepreneurial insurgent investors has been generated by two central (and related) features of U.S. capital markets: their fragmentation and their openness to innovation. The fragmentation of our capital markets can be attributed in large part to a strong populist political undercurrent that pits Main Street against Wall Street. This has resulted in legal and regulatory constraints that have prevented the rise of an entrenched set of financial intermediaries with broad oversight authority, as has occurred in Germany and Japan. The absence of large institutional monitors, in turn, has created a vacuum that individual entrepreneur-monitors have found ways to fill. The opportunity for innovation has stemmed from the market's lack of entry barriers, depth, liquidity, and anonymity. These features have created the opportunity and incentive for specialized entrepreneur-monitors to arise, even if their objective pertains to only one company.

Entrepreneurial initiatives have historically been pursued through two broad strategies. One is direct acquisition of a controlling interest in the target company; the other is use of a relatively small amount of voting power to bargain, usually through public suasion. In simplistic terms, these two approaches are epitomized by the acquisition and the proxy contest. These tactics may be combined, however, and indeed they really reside along a continuum. The more voting control the entrepreneur acquires directly, the less is the need for bargaining with management or exhorting outside investors. Viewed on a broader canvas, there are virtually endless ways entrepreneurs can combine share ownership with suasion so as to exert influence on management. Tactics may be friendly or hostile, and can range from subtle negotiation to brute exertions of financial force. The entrepreneur, seeking maximum profits, chooses those tactics that combine acquisition and suasion so as to exert the critical degree of influence over management *at minimum cost.*

Having attained influence over or control of a target corporation, entrepreneurial investors can employ a variety of different organizational and incentive devices to change corporate strategy and structure. Some entrepreneurs may seek a quick one-time strategy shift, such as sale of a division, and thereafter end their relationship with the corporation. Others, with different skills and interests, may choose to run the corporation over the long term. To do so, they may take control of the board but otherwise leave the organizational structure of the firm intact. Or they may form a buyout group and take the corporation private. Or they may increase their investment through a preferred stock purchase—an arrangement that entitles them to board representation but also provides a guarantee that they may expand their influence should corporate performance fall off. These and other diverse oversight mechanisms all accomplish broadly similar goals, permitting entrepreneurs to gain influence over the management of corporate assets and impose a new organizational structure that leads to more efficient use of resources. There is nothing magic or optimal about any particular system or device. Indeed it is not the system itself that is important, but rather the entrepreneur's expertise, and the availability of some vehicle through which his or her ideas and influence can be brought to bear.

Literally millions of investors follow the approximately 20,000 nationally-traded public corporations in the U.S. Over the course of time, many become—sometimes inadvertently—entrepreneurial monitors. Any shareholder who reads a proxy statement, becomes alarmed at a management proposal, and takes action is serving the functions of an entrepreneur. In each generation of corporate history, however, there has also been a class of *professional* entrepreneurial monitors—people who devote their careers to seeking gains from undertaking insurgent initiatives. The most successful have become national figures, amassing huge amounts of wealth and power through a seemingly quick and effortless series of financial plays. The pattern is similar whether the entrepreneur is Robert Young in 1955 or Carl Icahn in 1985.

Six primary characteristics distinguish entrepreneurial investors from other market participants who also sometimes undertake corporate control initiatives. First, entrepreneurs are typically self-made individuals, unaligned with establishment corporate and financial power structures. This independence enables them to undertake truly insurgent initiatives without fear of economic reprisal. (In personality,

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many are indeed anti-establishment: 1960s raider Victor Muscat named his investment company Defiance Industries.) Second, raiders typically operate through small and short-lived economic organizations, such as investment partnerships; this once again minimizes both the economic costs and political visibility they risk from their actions. Third, true entrepreneurs are principals, not agents, risking their own wealth and reputations on the success of their ventures. Fourth, entrepreneurs are typically underdiversified investors; as such, they signal their credibility and "bond" their commitment to other shareholders by risking a relatively large proportion of their own wealth on individual ventures. Fifth, entrepreneurs are risk-seekers, free from legal and personal impediments that would prevent their pursuing highly aggressive investing strategies. And finally, entrepreneurs are individuals who have acquired the ability to identify corporations in need of major change and then devise effective, sometimes confrontational, means for bringing about such change.

The decentralized, market-based monitoring performed by such entrepreneurs has several important advantages over the centralized systems of Germany or Japan. There is greater specialization of labor. Oversight is not forced upon organizations whose main expertise is in other areas, such as fiduciary investment management, but rather is pursued by individuals and organizations dedicated to the monitoring purpose. There is greater freedom from conflicts of interest because the monitoring function does not have to be performed by institutions with long-term business ties to corporations. There is a far larger number of individuals devoting time to searching out company problems, and thus a greater likelihood that problems will be quickly caught and corrected. And, because of the wide audience of potential entrepreneurs demanding and producing such information, there is more information produced and disseminated about public corporations in the U.S. than in Japan or Germany.

But entrepreneurial monitoring also has two broad shortcomings. One is the potential for self-dealing. Because entrepreneurs are not long-term, visible players, there is more room for insincere entrepreneurs to bluff their way into power in order to steal assets than exists in a centralized monitoring system. Much of the early evolution of U.S. corporate law can be viewed as a game of "catch-up" aimed at warding off abuses by entrepreneurial investors as well as by managements. The potential for self-dealing remains, however, particularly at smaller companies where entrepreneurs are accorded less political and public scrutiny.

The second broad shortcoming with the entrepreneurial system is that it can solve only a limited class of structural corporate problems. Because entrepreneurs must rely on outside information to analyze target companies, and because they take such large risks in order to signal their credibility and press for change, they cannot undertake initiatives at troubled companies with complex problems that have no readily apparent solution. Insurgents are thus attracted by simple and obvious problems such as an underperforming division, low payouts, or poor use of cash flows; they are not attracted by problems such as insufficient innovation or changing consumer preferences.

Overall, the vast amount of entrepreneurial activity in the American corporate arena, its varied forms, and the broad record of economic change that has resulted suggest that the entrepreneurial system of monitoring is robust and effective. It mimics the American democratic traditions of public-sector governance, eschewing any mandated or centralized solution to oversight, and instead relying on a decentralized system whose very eclecticism renders it resilient to changes in politics, economics, and the identity of the central players.

A BRIEF HISTORY OF CORPORATE RAIDING

By the mid-1800s, decentralized monitoring by entrepreneurial investors was widespread in U.S. markets. Monitoring tactics ran the gamut from informal suasion to hostile takeovers. At the more informal end of the spectrum, shareholders formed committees to investigate management practices, made proposals about specific corporate policies, opposed management initiatives, and pressed for enhanced disclosure. In 1885, for example, dissatisfied stockholders formed a committee to demand more information from the Broadway and Seventh-Avenue Railroad Company. "Their curiosity seems reasonable," noted the *New York Times*. "They have an inkling that their company has issued $500,000 of bonds of its own and guaranteed $1,125,000 for the Broadway surface road, but they do not know by what authority or for what purpose."

Full proxy contests for control were also widespread. Reporting on a dissident victory in one such contest in 1860, the *New York Times* said that "it was believed that the progress of financial disembarrassment under the late Board, a majority of whom held but a very small share of Stock interest, has been too slow for a property of such important productive capabilities."

Hostile takeovers became common by the late 1860s, and a first set of famous takeover artists arose, including the infamous Jay Gould and Jim Fiske. Early takeover entrepreneurs sought to acquire blocks of stock from families, founders, and institutional investors that would give them working control, or allow them enough leverage to wage a successful proxy contest. In some cases where a few big blockholders were willing and able to sell full control, entrepreneurs could accomplish takeovers in complete secrecy, without any public notice that ownership of a major corporate entity had changed hands.

Early in the 20th century, entrepreneurial oversight came to include a new, larger-scale, and more formal kind of proxy contest—one in which dissidents and management campaigned for support coast-to-coast among tens of thousands of dispersed individual shareholders. In 1915, W.C. Durant captured control of General Motors through a nationwide campaign. In 1929, John D. Rockefeller, holder of 15% of Standard Oil, mounted a campaign to oust the chairman and his board. In 1932, A.P. Giannini, founder of Transamerica Corporation, came out of retirement to re-claim control of an empire that he had come to believe was poorly managed by its current officers.

Also common in this era were proxy solicitations over specific aspects of corporate policy. In 1903, Talbot Taylor and Company solicited stockholders of the Southern Pacific Company, arguing that the directors were administering company affairs so as to favor the Union Pacific Railway, a large holder with representation on the Southern Pacific Board. In 1930, the *New York Times* noted that ten proxy contests were currently underway, only two of which were aimed at achieving control of the target company's board. At Freeport Texas Company, a stockholders' committee sought to impose more extensive disclosure requirements on management. At Youngstown Sheet and Tube, a stockholders' committee was trying to thwart a merger with Bethlehem Steel. At the Chicago, Rock Island, and Pacific Railway, stockholders opposed a new bond issue. Two contests involved competing reorganization plans for troubled companies. In summing up this activity, *The Times* reported, "Opinion on Wall Street is that the livelier interest which stockholders are taking in their companies as exhibited by these disagreements is a good omen as to the progress of business."

In the years immediately following World War II, proxy contests grew and came to include secret attempts to amass larger and larger blocks of voting shares, presaging the rise of the modern hostile tender offer. Beginning with the period of unprecedented economic prosperity in the late 1940s, a new generation of professional entrepreneurial investors arose—one unmatched since the "robber barons" of the 1870s and 1880s.

Norton Simon was one typical example of the new breed of entrepreneur. In 1943, Simon took over the ailing Hunt Packing Company. In the ensuing years he rebuilt it into one of the largest and most profitable food corporations in the nation, whose flagship product was Hunt Catsup. In 1946, he approached Ohio Match Company, announced that he owned a substantial stake in that firm, and asked for a seat on the board. Through the mid-1950s he continued to build a far-flung empire that included Wesson Oil, Harbor Plywood, McCall's Publishing, the Saturday Review, Wheeling Steel, the Northern Pacific Railway, and American Broadcasting-Paramount Theaters. Commenting on Simon's activities in 1955, *Time Magazine* observed, "In each case, he calls his operations 'a technical service to management,' and rarely fights for complete control unless the company scorns his ideas."

By 1955, a series of entrepreneurial giants had emerged, undertaking initiatives at some of the largest corporations in the United States. The largest and most famous were Robert Young's successful bid to oust management at the New York Central Railroad in 1954 and Louis Wolfson's unsuccessful quest for control of Montgomery Ward in 1955. Commenting on the trend, *Time Magazine* noted:

> *An old phrase is gathering new meaning among U.S. businessmen. The phrase is "company raiding." Today, some businessmen use the phrase to describe shrewd investors who snap up an undervalued company with the idea of liquidating it for a quick profit; others apply it to investors who take over such firms and ram through drastic changes to improve the properties and turn in bigger profits. The phrase has been applied to Robert R. Young, Louis Wolfson,*

Times of economic expansion and prosperity create the best opportunities for corporate raiders; prosperous times give rise to resource-rich companies making easily-corrected mistakes, such as over-conservatism or poor acquisitions.

Patrick McGinnis—to anyone, in fact, who starts a proxy fight, whether for good or ill, or who takes over a company. ...

By any name, company raiding or company revitalizing, Chicago's Pat Lannan thinks that his operations—and those of many other raiders—are good for U.S. business. ... Executives who are attuned to stockholder desires are faster to expand into promising new fields, and less likely to hoard capital against some distant and unlikely rainy day. Says raider Lannan: "'Raider' is a term coined by frightened managers. For every Robert Young-New York Central Contest and every Wolfson-Montgomery Ward fight there are thousands of management changes going on today. Every management change sets off the reorganization of still other companies. This is a rebellion of the owners."

In the late 1950s, a new entrepreneurial device began to appear in the corporate governance arena: the cash interfirm tender offer. The primary advantage of the tender offer over the proxy contest, according to both observers and principals of the day, was lower costs. In a tender offer, the entrepreneurial investor had only to name a price at which he was willing to buy a large block of shares, and then wait to see whether sufficient shares were tendered. There was no coast-to-coast campaign, no stream of communication and analysis, and no need to convince relatively uninformed investors of the correctness of the insurgent's cause. As Victor Muscat, a well-known entrepreneur, put it, "[Proxy fights] aren't worth the trouble. Tender offers are easier. At least the money is going into stock and not such things as proxy solicitations and court suits."

Tender offers grew in frequency and size throughout the 1960s, serving as the vehicle for a new series of corporate entrepreneurs. The increased size of tender offer targets was made possible by increased financing availability. Banks had begun by the early 1960s to compete for the right to finance bids. Such financing was "contingent"—that is, linked to the ability of the bidder to attract a sufficient number of shares—and therefore virtually costless for the entrepreneur to secure. Contingent financing meant that entrepreneurs with reputations could make bids for companies much larger than their own.

In the early 1980s, hostile takeover bids began to be financed by contingent commitments to issue high-yield publicly-traded bonds. This innovation, spearheaded mainly by the upstart investment bank Drexel Burnham, expanded by a quantum leap the scope of activities available to entrepreneurs. It enabled them to undertake initiatives at the largest corporations if their reputations were sufficiently good to support the financial commitment. In addition, Drexel came increasingly to serve as the focal point of ongoing investment "pools." Such pools, which closely resembled those common in the late 1800s, allowed a group of related individuals and organizations to continually draw upon one another for capital to fund a variety of corporate initiatives.

Also rising to prominence in the 1980s were investment partnerships, which were used by entrepreneurs to assemble financing to undertake initiatives at large corporations. The rise of investment partnerships was spurred by the emergence of institutional investors and particularly public pension funds, which made it possible to raise very large amounts of money from a few major investors. Concurrent with the rise of investment partnerships was the rise of one specific form of partnership transaction—the leveraged buyout. Large LBOs made use of the joint innovations of the investment partnership and the broad new market for public debt. The partnership provided a pool of equity capital through which the partners acquired stock ownership. At the same time, the large public debt market provided the means to raise money to buy out pre-existing public investors.

RAIDERS, LAWS, AND POLITICS: THE EVOLUTIONARY CYCLE OF ENTREPRENEURIAL INVESTING

While corporate raiding has been a constant in American capital markets since the early 1800s, there have been dramatic shifts over time in the intensity and scope of corporate raiders' activities. In active times, the frequency of initiatives has increased along with the size of target companies. In each new period of raiding, moreover, the tactics and rhetoric used by entrepreneurs have differed markedly from that which came before.

Cycles of decline and rebirth in entrepreneurial activity have been driven by three factors. One is changing economic circumstances. As broad economic conditions shift, and with them the average economic conditions of major corporations, entrepreneurial initiatives as a whole become more or less profitable. Times of economic expansion and prosperity create the best opportunities for corporate raiders; prosperous times give rise to resource-rich companies making easily-corrected mistakes, such as over-conservatism or poor acquisitions. Lean times, in contrast, give rise to resource-poor corporations living on the edge, where there is little to gain from immediate and simple changes in corporate strategy, and hence little incentive for entrepreneurs to risk their wealth in pressing for change.

The second cause of the broad cycles in corporate raiding is the cycle of creation and destruction in entrepreneurial tactics. Each new period of entrepreneurial activity is accompanied by a new set of tactics, which allows the new generation of raiders to influence corporate management and decision-making subject to the laws and regulations of the time. Defending companies and the intermediaries that advise them seek to invent strategies that make the new offensive tactics strategically ineffective or too costly. Ultimately, at the end of each entrepreneurial era, effective defensive strategies that are readily available at low cost create a temporary shut-down in entrepreneurial activity, rendering obsolete an entire generation of entrepreneurs expert in a particular, well-established set of tactics.

The march of defensive tactics is apparent in each major period of corporate raiding. In the late 1800s, corporations defeated shareholder proposals and proxy initiatives by moving meetings and changing the bylaws without notice. They defeated takeovers by issuing new stock to managers in order to lock up ownership. In the 1910s and 1920s, corporations responded to heightened proxy activity by adopting dual-class recapitalization schemes, until they were prevented from doing so by an edict from the New York Stock Exchange. In the 1950s, corporations by the hundreds eliminated cumulative voting and classified their boards of directors to escape proxy contests by corporate raiders. They waged counter-fights for control of their assailants and sold their most valuable assets to third parties. In the 1960s and 1970s, corporations adopted another wave of classified boards and supermajority amendments, and engaged in "pac-man" counter-takeovers, attempting to buy the companies that were trying to buy them. In the 1980s, corporations adopted a panoply of new takeover protections. They introduced "stakeholder" amendments and poison pill plans; sold friendly blocks to white squires and ESOP plans; changed their charters to require lengthy pre-notification of proxy initiatives; continued to engage in "scorched earth" defenses; executed defensive recapitalizations; and sought once again to issue dual-class stock, until deterred by an SEC ruling.

The third broad influence on corporate raiding is politics. Throughout American history, there has been a widespread and profound political distrust of financial entrepreneurs and financial markets. Corporate raiders in particular have drawn suspicion and anger due to their vivid and predatory gambits to acquire companies, amass quick and spectacular profits, and buy and sell assets with vast symbolic importance to thousands of individuals. Popular sentiment about raiders can be seen as early as 1868, when the *New York Times* said that

> *[Recent revelations] bring to light the rottenness which underlies great speculative movements on the stock exchange. They demonstrate the manner in which truth, fair dealing, and all characteristics of a credible business relationship are trampled on Wall Street. They prove what manner of men they are who take the lead in colossal transactions, who command unlimited banking facilities, who force prices up or down at will, who damage or improve public credit and inflict distress upon the multitudes.*

The deepest political ire is reserved for entrepreneurial tactics that are purely financial—that is, predicated solely on buying and selling, preferably with speed and secrecy. Such tactics arouse Americans' populist distrust of the riskiness, complexity, and apparent unaccountability inherent in large financial market transactions. Perhaps more important, they appear to reflect contempt for the American "due process" model of both public- and private-sector governance—a model predicated on open, substantive debate and a rigorously observed process that ensures full participation by all constituents.

The American political suspicion of financial schemers combines with the incentives guiding entrepreneurs to create a vicious cycle of invention and destruction in corporate raiding. Entrepreneurs seek to invent strategies that minimize costs and maximize profits. Such strategies naturally emphasize speed, secrecy, direct purchases of shares, and other tactics whose very purpose is to circumvent the costly and cumbersome trappings of the public-sector due process model of governance. As purely financial tactics become more successful, they are

As institutional ownership continues to grow and becomes more long-term—both inevitable trends in the next 20 years—institutions will become virtually compelled to engage in active oversight, risking both economic and legal reprisals if they ignore their often unwanted role as swing voters.

directed at ever-larger corporations. Then comes the inevitable reaction, driven by public suspicion of financiers and their tactics, which in turn leads ultimately to sweeping new regulations. The managements of large corporations, with the resources to organize politically, often become the most effective promoters of new regulation, stirring populist fears of financial manipulators and deploring violations of corporate due process. In 1954, for example, the American Institute of Management decried

adventurers who do not hesitate to promise the impossible to stockholders distressed at the turn of events and bewildered as to what to do. They seek out situations of partial failure, not because they are imbued with a desire to institute reforms which objective analysis shows to be needed, but because only circumstances of distress can stampede the uninitiated stockholder into surrendering himself into their hands... Their purpose is self-enrichment and the enlargement of personal power.

The resulting march of regulations over time makes for a vivid chronicle. In the early 1900s, the antitrust laws were enacted in part due to the vast suspicion caused by corporate raiders of the late 1800s. In the 1910s and 1920s, a broad reform of state corporate laws occurred, prompted in part once again by popular suspicion of financiers including corporate raiders. In the 1930s, new financial regulations were laid down based on populist suspicions of unstable financial markets and unscrupulous financiers; regulations aimed at raiders included the SEC's proxy rules, the banking laws, and the Bankruptcy and Reorganization Act of 1936. In the 1940s and 1950s, significant revisions of the proxy rules occurred with the aim of constraining raiders, until, by 1956, the rules imposed significant new costs on large-scale proxy contests. The tender offer era provoked new regulations including the Federal Williams Act, new state laws governing voting rights and hostile control transactions, and alterations in the Federal Reserve's margin requirements making contingent financing more expensive and difficult to use to fund hostile offers.

THE FORCES SHAPING THE NEXT ERA OF ENTREPRENEURIAL OVERSIGHT

The early 1990s have seen a sharp decline in the activity of corporate raiders. That decline can be attributed to the three factors just described. The recession drained corporate resources and, hence, has dramatically reduced the number of targets of potential corporate raids. New defenses, particularly poison pills, have made hostile cash tender offers difficult if not impossible, and much more risky and expensive. And the political backlash against the raiders of the '80s has both provoked widespread new regulations and created significant informal costs for anyone undertaking hostile initiatives.

The current constriction of entrepreneurial activity has led many observers to argue that the corporate control and corporate governance process as we know it have essentially been eliminated, wiped out by both changing ownership structure and the march of takeover regulation. In fact, of course, the historical record rejects this viewpoint, and suggests that the current lull in corporate raiding is temporary. The underlying incentives for entrepreneurial initiatives—the potential profits from revising inefficient corporate policies—remain unchanged. When the current macroeconomic recession ends and corporations emerge resource-rich once again, entrepreneurial activities will reappear.

The next era of corporate governance will be shaped by two broad forces: (1) the legal restrictions and political backlash against overtly hostile, financial corporate control initiatives, and (2) the new importance of large institutional investors in the structure of share ownership. Together, these forces will create a significantly changed dynamic in the governance arena.

The intensity of the political backlash against entrepreneurs that currently permeates the corporate control arena is remarkable. In no other era except perhaps the late 1800s have entrepreneurial initiatives provoked such a powerful reaction. The main source of provocation was, of course, the dominance of tender offers, and their effects on the rhetoric and politics of corporate governance during the 1980s.

Tender offers were a remarkably cheap, direct, and effective means for pursuing entrepreneurial initiatives. But they circumvented the "democratic," or "due process," approach to corporate governance to an unprecedented degree. They reduced the entire substantive debate over corporate policy to a matter of price per share—a salutary development for shareholders, but a disastrous one from the viewpoint of the broad political dialogue. In the tender offer era, raiders did not have to inform shareholders and the public about their substantive concerns with corporate policy; their entire purpose appeared to be financial manipulation with the aim of quick profit. And they were tremendously, and unprecedentedly, effective. The result was widespread suspicion of entrepreneurial tactics, coupled with a dramatic decline in public understanding of entrepreneurs' motives and objectives, even as entrepreneurial initiatives grew to began to challenge the very largest American companies.

Then came the large LBOs of the late 1980s, which represented perhaps a still greater affront to the political process. Like tender offers, they substituted an acquisition price for all substantive debate about the target corporation. But, unlike tender offers, they also removed the firm from the public arena and, thus, from any semblance of political accountability. To those steeped in a populist tradition that demands openness and democratic structure as remedies for the abuse of power, the LBO constitutes the ultimate manifestation of the arrogance of financial entrepreneurs.

The backlash that arose as a consequence of these transactions was remarkable by historical standards. A broad political persecution was ultimately aimed at the linchpins of the debt market—Drexel Burnham in particular—in which virtually every arm of the Federal Securities laws was used as a lever to constrain entrepreneurial financing. By 1990, as a consequence, raiders were in retreat, some were even in prison, and the financial market that spawned the booming entrepreneurial market of the 1980s lay in shambles.

As dramatic as the backlash against hostile transactions has been, it will be temporary in its effects. Similar backlashes have occurred before. They last only until memories dim and a new class of entrepreneurs arrive. In contrast, the second broad force affecting the evolution of corporate governance—the increased concentration in institutional ownership—is permanent. It will affect the dynamics of the market throughout the next generation of oversight activity.

Increased ownership concentration among major fiduciary investors, together with indexation, constitutes the most significant and dramatic transformation in equity markets to occur in the past half-century. Ownership is fast becoming more concentrated than at any period since the late 1800s. This is conferring upon major institutions both an unprecedented degree of voting power and the incentive to invest resources in making informed oversight decisions. As ownership continues to grow and becomes more long-term—both inevitable trends in the next 20 years—institutions will become virtually compelled to engage in active oversight, risking both economic and legal reprisals if they ignore their often unwanted role as swing voters.

The calculus of institutional monitoring is vivid. Consider, for example, an institution owning 1% of the Mobil Oil Corporation. The market value of this position is approximately $250 million. Now suppose that there is a proposed corporate event that has the potential to cause a 5% reduction in the value of Mobil's stock. The institution has an incentive to spend up to $12.5 million to research or act so as to prevent this event, no matter how diversified its portfolio. For an indexed fund, the calculus is straightforward; it cannot sell. But even for a non-indexed fund that could "churn" its Mobil holding in response to bad news, the economics are equally compelling. A decision to sell a block that large would ultimately give rise to transaction costs of at least 1% of the value, or $2.5 million. Thus, a fund dissatisfied with Mobil's performance would be better off spending hundreds of thousands—even millions—of dollars to create a change in policy than simply selling its stock.

Despite this compelling calculus, the growth in institutional ownership will not result in the transformation of governance to a centralized process, as many have predicted, in which institutions monitor public corporations in a manner similar to that found in countries like Germany and Japan. Such a transformation would be inconsistent with the broad American populist political sentiment that has always precluded the rise of a stable financial elite. It would also violate the American premise that governance of public and private institutions should remain an open and inclusive process predicated on decentralized power. The rules and regulations governing institutions already make such a process virtually impossible, by creating broad legal liabilities for active involvement with specific portfolio corporations. Should such a centralized process begin to emerge, moreover, it is likely that it would itself provoke a political reaction and more regulation—just as the current regulations were provoked by active institutional monitoring in earlier eras. The emergence of a centralized monitoring process has been predicted by reformers for over 100 years, but it has never come to pass.

[In the new "political" approach], institutional investors would deter excessively hostile and manipulative dissident initiatives; but, at the same time, they would provide management with carrot-and-stick incentives to seek active feedback from shareholders on corporate policy.

It is equally unlikely that institutions will often take the lead as activists in a decentralized, entrepreneurial monitoring, playing the role of active insurgents aimed at displacing a specific corporate management or reversing a specific corporation's policies. Four broad forces will constrain most large institutions from acting as insurgents. The first is once again the regulatory structure, which creates potential liabilities for fiduciaries if they pursue risky, confrontational activity at portfolio corporations. Second, as large financial players with significant political visibility and ties to the establishment, institutions face significant potential for political backlash from taking a leadership position in governance. At the least, they could lose valuable corporate clients by appearing to become raiders; at the worst, their actions could provoke sweeping new regulations aimed at constraining their activities. Third, most institutions do not have the relative expertise in the area of active entrepreneurship. Their focus is passive, risk-averse management of diversified portfolios, which is very different from the active, risk-seeking, underdiversified activities pursued by entrepreneurs. Fourth, and perhaps most important, institutions do not have the economic incentive to risk financial, political, or reputational resources on active monitoring. Faced with pressure to maximize returns, fiduciaries might undertake entrepreneurial activities if there were no alternative—that is, if no other market participants were willing to take the lead in instigating oversight activity. But the reality is precisely the opposite. The specialization fostered by the low costs, liquidity, and ease of entry in American financial markets guarantees that a class of entrepreneurs will arise to take those risks instead. This allows institutions to assume the role of referee rather than protagonist, facilitating active oversight while not risking retribution.

The tension between the incentive to become involved and protect value, and the broad political and legal costs of such active involvement, will thus lead institutions to become more active but adopt a wide variety of compromises. The precise compromise adopted by each institution will depend on its size, client and beneficiary base, governance structure, and the preferences and expertise of its own managers. Some institutions will be content to remain entirely passive, sitting on the sidelines and voting on entrepreneurs' initiatives. Others will engage in quiet behind-the-scenes negotiations with management while avoiding the limelight. A few will undertake full-fledged entrepreneurial initiatives at specific corporations. These will typically be smaller, less-diversified, "value" investors, whose organizational structure more closely resembles that of raiders than that of large private and public pension funds. Indeed, two major proxy contests of the past two years—those at Cleveland Cliffs and XTRA—were undertaken by aggressive, less-diversified institutions.

Underlying these diverse strategic responses will be one almost universal organizational change. Large fiduciaries will take steps to ensure that, when necessary, they can engage in expert analysis and monitoring of specific corporations. Some institutions will develop the necessary expertise internally; others will seek and retain outside experts who can supply the needed expertise on a case-by-case basis. Either way, the legal and economic consequences of their ownership positions will leave institutions with little choice but to adapt their organizations so as to become expert voters and monitors. With increasingly significant ownership stakes, individual institutions will find themselves in the (often unwelcome) position of swing voter. The resulting legal, regulatory, political, and economic pressure will spur the development of new institutional capabilities and expertise.

VICIOUS CYCLE OR SUSTAINABLE PROCESS?

In the next few years, as entrepreneurs invent and apply new tactics, oversight activity will gain momentum once more. Insurgency will proliferate, begin to be aimed at larger corporations, and steadily become more confrontational and less friendly, just as has occurred in previous eras. Managements will then begin to perceive a new threat, and intermediaries will begin to invent new defensive tactics. At this stage—one which is really already underway—there will be a significant fork in the road. Two very different evolutionary paths will open up.

The first path is the same, well-trodden one of previous eras: increasingly extreme raider tactics, management opposition, political backlash, and new regulation. This is the outcome predicted by the broad history of corporate control. The themes underlying management response and political backlash are already evident. The first is suspicion of the power and goals of institutional investors, who, in the grand populist tradition, will be cast as manipulative, secretive, short-term, and seeking differential advantage over small stockholders. The second is interference in corporate affairs. Managements will argue that the new, incremental attempts to generate debate about corporate policy constitute meddling that distracts corporate executives from their day-to-day responsibilities and lessens efficiency.

The second path is different. It is a unique potential outgrowth of the current politics, laws, and ownership structure in the governance arena. That path is compromise and moderation, based on a "bargain" between management, insurgent investors, and institutions. Such a politically-sensitive, but still fundamentally market-based, solution could ultimately result in a sustainable, moderate, but effective process of corporate control. I call the resulting process "political" not just because it involves negotiation and compromise, but also because the oversight dynamic would more closely parallel that in the public-sector arena.

The political approach to corporate control would have three elements. Insurgents would undertake more moderate initiatives, aimed at securing board representation or changes in specific corporate policies rather than sudden shifts in ownership or control. Managements would respond by opening up their governance structure in incremental ways to solicit feedback from large, long-term institutional holders and thereby make the corporation more responsive to signals from capital markets. Institutional investors would act to enforce both sides of the bargain through their voting decisions and active participation in the policy arena. They would deter excessively hostile and manipulative dissident initiatives; but, at the same time, they would provide management with carrot-and-stick incentives to seek active feedback from shareholders on corporate policy.

In the short term, such a set of compromises is likely to obtain by default, simply because of the current political and legal environment in the corporate control arena, which militates strongly against any form of full-force hostile initiative. In the longer term, its enforcement will depend upon the active efforts of institutional investors.

It might seem that active work to enforce a political process of corporate control would amount to pure altruism on the part of institutions who would be better off spending their time and resources elsewhere. But, in fact, the opposite is true: enforcement of the bargain is perfectly in keeping with institutional incentives. Enforcement requires no more than that institutions make informed voting decisions—something they must do in any event. Moreover, adopting voting policies consistent with the political approach is in the best interest of institutions caught between maximizing portfolio returns and minimizing political backlash from supporting raiders. By supporting measured oversight, institutions can capture the benefits of entrepreneurial initiatives, while escaping the backlash that will occur if corporate governance activity once again turns contentious and extreme.

As in all compromises, none of the direct protagonists in the corporate control arena will entirely like this bargain. Many dissidents will welcome institutional support on incremental initiatives, but be frustrated at not being able to mount full-scale contests for complete control of targets. Similarly, many corporate managements would prefer a system with no feedback—no discomfiting questions or activities by shareholders—to one that encourages that activity so long as it is not extreme. Each side will exhort institutions to abandon the compromise and throw their support wholly behind that side's cause.

Over time, however, both entrepreneurial investors and management as a class will be helped by the emergence of a political approach to governance. Entrepreneurs who focus on influencing corporate policy and securing incremental change will less often be annihilated by legal and political backlash, and indeed will also less often be wiped out economically by betting it all on the wrong company. Similarly, managements who open up corporate governance structures to allow investor input will gain an early warning system—one that alerts management to problems before raiders appear. In so doing, managements will increase their ongoing political capital with major investors and thus maximize shareholder support for existing policies.

ENTREPRENEURIAL TACTICS UNDER THE POLITICAL MODEL

A clear evolutionary path exists for the tactics of active corporate oversight, if they are to be effective yet also escape the political backlash of previous eras. In the short term, this evolution will begin simply because the current atmosphere demands a more measured approach. In the long term, the evolution will be sustained only if such an

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approach is actively supported by both institutions and corporations.

At the broadest level, the new approach to entrepreneurial oversight must be premised on an explicit rejection of traditional, hostile tactics. Initiatives can be contentious in the political sense—involving active disagreement—but cannot appear predatory, manipulative, or coercive. Initiatives must also be based on substantive debate, inclusion, and respect for due process to escape the broad suspicion of purely financial plays. They must seek to downplay or even avoid publicity, so as to limit the potential for the appearance of conflict. They will less often seek to secure quick and full acquisition or control of targets.

A first broad tactical arena where new tactics can and will emerge is the proxy contest. Under the political model, proxy contests will shift toward serious debate of substantive corporate policies. They will be longer than the contests of the past decade, because the smaller stakes of entrepreneurs and the more highly politicized atmosphere of institutional decision-making will lead entrepreneurs to devote more time and care to building their own reputations and image in the public arena. Contests will also become more informationally sophisticated, so as to facilitate real debate rather than hostile name-calling. Protagonists will borrow overtly political tactics from the public-sector voting arena. Dissidents will seek to build their own stature by enlisting reputable third parties in support of their cause, seeking public endorsements, and nominating independent director candidates of national stature. In all of these varied respects, proxy contests will become more like those of the 1950s—the pre-tender-offer era—which resembled national election campaigns in their scope, strategy, and tactics.

A second broad arena where new tactics will emerge is acquisitions. In pursuing takeover bids, entrepreneurs will attempt to pursue good-faith "negotiated" acquisitions that are premised on sensible and convincing substantive reasons for effecting the combination. Entrepreneurs will develop, and make active efforts to publicize, a well-articulated strategic plan for the corporation, and then use the plan to generate political support. When launching their bids, they will take their case to major institutions to emphasize their own legitimacy and accountability, and to allow institutions to escape the charge that they tender their shares mechanically for short-term gains. Tender offers will become rehabilitated, but will shift dramatically to become political rather than financial devices, used as an alternative form of voting referendum. Instead of seeking to take down offers quickly and coercively, acquirers will leave offers open and let shares accumulate, using their record to demonstrate the correctness of their position. This political use of the tender offer mechanism, so different from its original tactical use as a quick and semi-coercive way to acquire shares, was on prominent display in the AT&T-NCR battle earlier this year.

In addition to traditional takeovers and proxy contests, a new kind of entrepreneurial activity could arise in the governance arena as a consequence of heightened institutional ownership. Entrepreneurs can undertake initiatives aimed purely at exerting pressure for specific changes in corporate policy. In the new era, with its highly concentrated ownership and highly sensitized corporate politics, it will in many cases be sufficient just to provide information about inadequate corporate policies and thus spur debate. This will provoke change because corporations, seeking to raise capital from major institutions and always cognizant of the possibility of a voting or acquisition threat, will have to refute insurgents' arguments or eventually make the proposed changes.

Entrepreneurs could also potentially design and employ a wide variety of informal tactics to build support for corporate change, borrowing once again from the public voting arena. For example, they could revive the age-old concept of the shareholder committee in updated form, appointing a group of independent experts to study and report on corporate policy. Such a committee can function much like a shadow cabinet in a parliamentary system, issuing reports, speaking with shareholders, and generating a well-articulated alternative platform for corporate policy. This may prove to be a more effective way of promoting change than representation on the corporate board, because outside committees would be free to communicate their views and ideas, while board members immediately face constraints due to their position as corporate insiders. Late in 1990, Carl Icahn formed such a committee at USX Corporation. Three months later, the result was a significant restructuring—a result Icahn had sought unsuccessfully through other, traditional corporate control tactics for almost five years.

Even more informal and low-cost non-voting possibilities exist. Entrepreneurs can distribute reports to shareholders. They can hold extensive conversations and seek to get their message out through the press. They can submit director nominations to the corporate nominating committee—as did activist Robert Monks at Sears in 1991—and place pressure on the corporation to respond by offering shareholders the chance to vote on the proposed nominees. They can hire an industry expert to meet with shareholders and offer the expert's services to the corporation. Each of these actions is very inexpensive compared to the traditional proxy contest of the past. But each, like good political tactics, can mobilize support, put pressure on management, and thereby begin to generate momentum for change.

A shift away from voting contests to year-round monitoring where entrepreneurs continually raise questions about corporate strategy could ultimately constitute the most profound change in entrepreneurial oversight to materialize in the next decade. Much as American politics has changed in the past 30 years, revolving less around formal election contests and more around constant interaction with well-financed and active interest groups, the new corporate governance environment could give rise to a class of insurgent investors who act as lobbyists rather than opposition candidates. They could make proposals, communicate with investors and analysts, meet with management, and eventually bring about change—all without ever filing a proxy statement, making a shareholder proposal, or nominating a director candidate. Such initiatives will also have strong political appeal, creating an even more substance-and-debate-based oversight process, and further distancing entrepreneurs from the financially-based, gain-control-by-force tactics of the past two decades.

Ultimately, corporations will respond to these changes by themselves adopting significant shifts in their strategy for dealing with large investors. Rather than seeking to erect new barricades, corporations will begin to build new bridges to the institutional investment community, changing their investor relations process so as to create a more direct link between financial market concerns and internal corporate decision-making. Most institutions will welcome these overtures, because their underlying political sensitivity will lead them to prefer compromise with corporations over sponsorship and support of insurgents, if such compromise is offered. A few maverick CEOs have already begun to take this approach. At Lockheed Daniel Tellep has put in place an ambitious program to reach out to institutional investors. At Ceridian Corporation (the restructured Control Data Corp), the board has invited its top ten institutional holders to attend one of its regular meetings. In the coming decade, the more far-sighted executives will begin to embrace the opportunities inherent in this approach without the prodding of a dissident initiative.

As yet, it is not clear that these kinds of nonconfrontational, compromise trends will turn out to be the new equilibrium in the market for corporate control of the 1990s. There is a natural tendency for both entrepreneurs and corporations to press for maximum advantage. If this happens, a renewed cycle of entrepreneurial offensives and corporate defenses will build through the decade. But if these moderate trends do indeed prevail, a unique opportunity looms to build a more sustainable process of corporate oversight, marked by more measured tactics, less political backlash, and, ultimately, greater long-term economic effectiveness. The emergence of such a political model would truly constitute a significant and salutary change in the American entrepreneurial oversight system.

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