

BOOK REVIEW

THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS. By Melvin A. Eisenberg. Boston and Toronto: Little, Brown and Company, 1976. Pp. xvi, 320. \$16.50.

*Reviewed by Larry D. Soderquist**

Though the major ideas in this book are not new—it is essentially a reorganization and update of four of the author's law review articles¹—the book is significant because the articles behind it were significant,² and because it gives their ideas new exposure in a more useful format. Notwithstanding the fact that the book draws together several distinct legal articles, its organization is logical and satisfying. Eisenberg's discussion begins with the legal role of shareholders, continues with access to the proxy machinery, follows with the roles of officers, directors and auditors, proceeds to corporate combinations, contractions and division, and ends with voting and appraisal rights in parent-subsidary complexes. The discussions of all of these topics are adequately connected and only occasionally does the genesis of the book show through.

The work is characterized by a straightforward and rigorous logic in which premises are clearly stated and the supporting facts carefully established. In the first two chapters, for example, Eisenberg analyzes two dichotomies, the understanding of which is essential to clear thinking about corporate structure. He points to a split between what he calls the "received legal model" and the "real-world model" of what a corporation is or should

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THE FOLLOWING CITATION WILL BE USED IN THIS BOOK REVIEW:

M. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (1976) [hereinafter cited as EISENBERG].

1. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489 (1970); Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CAL. L. REV. 375 (1975); Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1 (1969); Eisenberg, *Megasubsidiaries: The Effect of Corporate Structure on Corporate Control*, 84 HARV. L. REV. 1577 (1971).

2. One objective measure of significance is the frequency of citation. The articles listed in note 1 *supra* have together been cited at least sixty times by other legal scholars in law review articles and at least a dozen times by the courts. Subjectively, they can be viewed as major works in areas which have not received adequate attention.

be, and makes a distinction between the models based on whether a corporation is closely or publicly held. In the case of a closely-held corporation, he points out that the received legal model, in which the shareholders elect directors who manage the conduct of the corporation's business, bears little resemblance to reality. He also asserts that, since closely-held corporations are fundamentally different from publicly held ones, they ought to be governed by separate rules. These observations seem simple enough, yet they make fundamental points which are too frequently overlooked. Eisenberg lets the reader know precisely where he is being taken, and why. And if one disagrees with what is being said, such disagreement is almost automatically focused on a step in the author's argument rather than simply on his conclusion.

A good example of Eisenberg's care in establishing supporting facts is his drawing together of data from many sources, such as SEC studies on securities markets and institutional investors, IRS statistics on Subchapter S elections, information from stock exchanges, an analysis of a sample of Michigan franchise tax returns and a report of a subcommittee of the Senate Committee on Government Operations.³ Data from the above sources were collected by Eisenberg in an attempt to determine the number of American corporations having given numbers of shareholders and the corresponding degree of concentration of shareholdings in the largest corporations.⁴ These data are necessary for a clear-headed discussion of many of the questions which Eisenberg addresses, such as the interest of shareholders in corporate decisionmaking. It is noteworthy that most writers addressing similar questions have contented themselves with using considerably more limited data.

Much of what Eisenberg says concerning such topics as corporate combinations and contractions, and shareholders' voting and appraisal rights, are hard not to accept—if one agrees with his notions about the role of shareholders in public corporations. Therein, however, lies my major disagreement with Eisenberg.

I agree with his initial observation:

In wide areas of our economy a relatively small number of giant publicly held corporations have become so large, both in absolute size and in relation to their competitors, that they have freed themselves of

3. EISENBERG 38-56.

4. By analyzing his data and making some creative deductions, Eisenberg determined, for example, that while there are approximately 1,630,000 corporations in America with under eleven shareholders, there are only about 600 with over 10,000 and only another 1,200 with between 3,000 and 10,000 shareholders. EISENBERG 38-42. He also concluded that stock ownership in America is highly concentrated in the hands of wealthy individual investors and a relatively small number of institutions. According to sources cited by Eisenberg, for example, as of about 1971 over fifty percent of the stock held by individuals was held by family units whose income was in the first percentile, *id.* 52-53, and the fifty largest bank trust departments accounted for seventy-two percent of the common stock managed by all such departments. *Id.* 53-54.

servitude to the market and have become able to authoritatively determine, within broad limits, matters of such fundamental importance as the rate and direction of capital investment and technological innovation, and even price levels and degree of product differentiation.⁵

But we quickly diverge when he analyzes the schools of reform which advocate a solution to the problem by changing the shareholders' role; he refers to these schools of reform as "shareholder democracy," "client-group participation" and "managerialism."

"Shareholder democracy" has the objective of increasing shareholder power, and, in Eisenberg's discussion of it, one quickly senses his receptiveness to this basic idea: "[H]owever unhealthy may be a de facto self-perpetuating oligarchy, it is only the shareholders' role that prevents something which seems even worse, that is, a de jure self-perpetuating oligarchy."⁶ He does admit, though, that the failure of today's giant corporation to match national economic and social goals will not likely "be resolved by increasing shareholder power, since it seems fair to assume that most shareholders are at least as interested in profits as is management."⁷

Giving a formal role in corporate decisionmaking to such groups as labor, consumers and suppliers, which is described as "client-group participation," is, Eisenberg points out, one way that some reformers see of making corporate conflicts with national economic and social goals less likely. He turns away from the idea, however, on several practical grounds: first, such groups do not have the required decisionmaking skills, and their interests conflict with those of the corporation (mainly the interest in profit-making); second, there is no feasible way to allocate votes to the groups; third, since many suppliers and consumers are themselves giant corporations, giving them a voice would further increase the concentration of power in the economy; and finally, other ways of dealing with the corporation, such as labor negotiations, may be preferable to a client-group.⁸

"Managerialism" is viewed by Eisenberg as advocating increased management power; he feels that this school is based on the theory that only management can balance the interests of shareholders, client-groups and the public since shareholders are only interested in profits and client-groups in themselves.⁹ He disposes of "managerialism" in large measure by a detailed discussion of the arguments of Bayless Manning, which were made in a review of J.A. Livingstone's *The American Stockholder*.¹⁰

5. EISENBERG 18.

6. *Id.* 19.

7. *Id.*

8. *Id.* 21-24.

9. *Id.* 25.

10. Manning, *Book Review*, 67 *YALE L.J.* 1477 (1958). I cannot resist noting that in some respects what follows is a review of a review of a review.

Professor Manning postulated a voteless model of the corporation, one which would take account of what Berle and Means had long ago found to exist: "a virtually omnipotent management and an impotent shareholdership."¹¹ The model would, Manning said, "proceed from the facts of the modern corporate institution and be accommodated to them, rather than to a bucolic and obsolete image."¹² In the model, what the shareholders would "own" would be their shares, not the corporation, and the holders would not vote. Manning saw four requirements for the working of the model: full disclosure to shareholders, and perhaps also to a judicial or administrative agency, of management's business conduct; supervision by some public agency of management's behavior in conflict-of-interest situations; an efficient market for disposing of shares; and a continuation, and perhaps an extension, of the business judgment rule.¹³ As Eisenberg points out, Manning did not intend that his model be incorporated into law, and did not contemplate that voting stock be changed by legislative fiat into non-voting stock. Instead, he hoped—among other things—to steer us away from the "wishful pretense that the shareholders' vote is or can be an effective restraint,"¹⁴ encouraging us to look for sensible reforms. Eisenberg, however, rejects this model because he does not accept the notion of an "impotent shareholdership."

The voteless model, Eisenberg says, is based on two premises: first, that shareholders in publicly held corporations have no interest or expectation of participating in the election of directors and voting on structural decisions; and second, that the managers of such corporations, if left to their own devices, generally would make structural decisions on the basis of considerations other than their own self-interest.¹⁵ The second premise, as Eisenberg convincingly demonstrates, is surely inaccurate.¹⁶ But few managerialists, and certainly not Manning, would believe it accurate. The whole thrust of legal thought on the subject is that no one—no lawyer or judge or anyone else—can be trusted in a conflict-of-interest situation. It is difficult to perceive the basis on which legal theorists would make an exception for corporate executives.

The first premise noted by Eisenberg, asserting the lack of shareholder interest in, and the absence of any expectation of, participation in corporate decisions, is widely accepted. I have already described the efforts of Eisenberg in attempting to establish the number of American corporations having

11. *Id.* 1485. The Berle and Means work was, of course, A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

12. Manning, *supra* note 10, at 1490.

13. *Id.* 1490-91.

14. *Id.* 1493.

15. EISENBERG 29.

16. *Id.* 30-34.

given numbers of shares and the degree of concentration of shareholdings in the largest corporations.¹⁷ His findings are impressive and put the discussion on a solid base. In using his data, he assumes that the extent to which a shareholder in a public corporation is interested in, and possesses an expectation concerning, participation in corporate decisions is proportional to the size of his shareholdings. Since he concludes that ownership of both large and small corporations is highly concentrated, with a very large proportion of the largest corporations' shares being held by financial institutions, his assumption leads him to the conclusion that those who he considers the important shareholders—the institutions—are interested in participating in corporate decisions, and expect to do so. He gives some examples of institutions voting against management and giving consideration to non-routine proxy statements, and finally indicates that he supports a shareholder oligarchy: “[G]iven a choice between highly concentrated institutional shareholdings and highly dispersed individual shareholdings, the former seems preferable, because that alternative at least gives some hope of a check—a countervailing force—to management”¹⁸

I neither think we have anything like a shareholder oligarchy, nor believe we should tolerate one if we did. Though the institutional concentration of shareholdings is widely recognized,¹⁹ there is little support for Eisenberg's conclusions as to their voting role.²⁰ I surmise that some of Eisenberg's examples of their active voting role—even Eisenberg's obviously extensive research did not turn up many—are anomalies or can be understood as manifestations of standardized positions which institutions have decided to take in all proxy votes (such as to vote against anti-takeover provisions). There is clearly in existence among professional investors a cult of management—the idea that one “buys management.” And there should be. Considering that institutions perceive their duties as running to their “beneficiaries” rather than to fellow shareholders, they could hardly justify holding a corporation's shares after deciding its management was not meeting their expectations. The accepted idea of “support management or sell out” seems not only inevitable for these institutional shareholders, but sensible.

17. See notes 3-4 *supra* and accompanying text.

18. EISENBERG 61-62.

19. See, e.g., INSTITUTIONAL INVESTORS AND CORPORATE STOCK—A BACKGROUND STUDY (R. Goldsmith ed. 1973); SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. NO. 92-64, 92d Cong., 1st Sess. (1971).

20. Because of certain securities law problems, relating mainly to fears of restricting their ability freely to sell a corporation's securities and of being subjected to a greater risk of Rule 10b-5 liability, institutional investors avoid representation on corporate boards of directors. See, e.g., Vanderwicken, *Change Invades the Boardroom*, FORTUNE, May 1972, at 156, 285. One wonders if those same concerns are not responsible for a more general unwillingness to become too involved in corporate decisions.

Heavy institutional concentration of stock ownership has, of course, a strong influence on management. Executives are eager to please, and chary of falling from the grace of, those who can make stock prices plummet on the first hint of change in corporate fortunes. And with institutions, "fortunes" are defined purely in terms of profits. Corporate managers receive the institutions' message clearly enough without the institutions taking an interest in corporate votes: keep profits rolling at all costs—irrespective of national economic or social goals or the interests of client-groups.

Pressure for the highest possible profits, coupled with the market volatility which comes from the concentration of holdings in often fickle hands, imposes a greater strain than society in general—and corporate managers in particular—should have to put up with. The problem would only intensify if institutions, in addition to demanding profits, wished also to tell managers how to make the profits. It is only because they do not use their voting power that we can allow them to have it.

We should allow institutional and other shareholder voting rights for the simple reason that they have them now, since the price of change (in terms of legal obstacles alone) is altogether too great. And Eisenberg is correct on client-group voting: it is not feasible. But we should not continue to allow national economic and social goals to be thwarted and client-groups' interests ignored²¹ by a single-minded and rapacious push for profits. What should we do about it?

We should first recognize, by legislative enactment or judicial action, that each client-group of a corporation (such as labor, customers, suppliers, persons in the communities in which it operates, the public in general, shareholders and other investors) has a right to have the corporation look out for its interests.²² Profits are important to all these groups, and corporations must pursue them, but not without considering the costs to each client-group. That some constituents, such as labor, would have enough power to push the corporation into concessions does not make them any less a client-group. The corporation should still balance the interests of all its constituents the best it can—for example, by sometimes giving to labor what it could avoid giving and by sometimes fighting unions when they demand more than their fair share of the corporate largess.

How fair is this to shareholders? As Manning suggested, their interests are taken care of in large measure by disclosure and a well functioning market.²³ Since he wrote in 1958, the Securities and Exchange Commission

21. The public in general is, in fact, one of a corporation's client-groups, so that national economic and social goals are also a client-group interest.

22. This basic idea goes back at least several decades. See, e.g., Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

23. See Manning, *supra* note 10, at 1490-91.

has become increasingly active and has required more and more disclosure. With composite tapes and the expected advent of a central market, one expects the market for shares to function even more efficiently. These measures, coupled with the threat of SEC enforcement action, the requirement that management consider the interests of shareholders as one of its client-groups and the fact that the major interest of shareholders—profits—is at least of some interest to all corporate constituents, should satisfy the needs of shareholders. Getting down to the “bottom line,” as people interested in investments usually want to do, what would all this do to an investor’s chance of making money in the stock market? Perhaps nothing. Gains or losses are determined simply by the difference between buying and selling prices: prices would go up and down as usual.

One senses that a formal recognition of client-group rights may be welcomed by many corporate directors and executives. While the traditional learning continues to be that directors must represent the shareholders’ interest and not those of client-groups,²⁴ certain directors and others in the business community do not agree: “[A]ccording to a new concept that is gaining ground both within and outside the corporate community, directors should have a broader role: they should become answerable to the public at large, or to various segments of it.”²⁵ And a recent study by Brenner and Molander published in the *Harvard Business Review* indicates that business executives put customers first on their list of groups to whom the corporation is responsible; shareholders ranked a distant second.²⁶ Formalizing the rights of the various corporate client-groups would allow directors and executives to be honest with themselves and the outside world about those interests which are weighed in their decisionmaking. Also, if competitors were all working under the same rules, institutional shareholders and others would probably have less success in pushing for profits to the detriment of other possible corporate goals. That certainly should be welcomed by harassed managers.

All this is not so very radical. It is nothing more than an extension of developments which have occurred over the last few decades. The shareholders were at one time the corporation’s only legally recognized client-

24. See, e.g., *Corporate Director’s Guidebook*, 32 BUS. L. 5 (1976). This work was prepared by the Subcommittee on Functions and Responsibilities of Directors, of the Committee on Corporate Laws, Section of Corporation, Banking and Business Law, of the American Bar Association. On this subject it says: “[T]he role of the director is to monitor . . . the conduct of the business and affairs of the corporation in behalf of those who invest in the corporation. The director should not be perceived as, or perceive himself as, a representative of any other constituency, either private or public.” *Id.* 32.

25. Vanderwicken, *supra* note 20, at 157. See also *id.* 158-59.

26. Brenner & Molander, *Is the Ethics of Business Changing?*, HARV. BUS. REV., Jan.-Feb. 1977, at 57, 69.

group. When Henry Ford wanted, among other things, to lower the price of the Model T in order to share his company's profits with the public, the Michigan Supreme Court would have none of it:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself²⁷

In keeping with that philosophy, charitable contributions were, for example, forbidden by corporations unless a fairly direct corporate benefit could be shown. These restrictions no longer exist. In light of cases like *A.P. Smith Manufacturing Co. v. Barlow*,²⁸ upholding a contribution to Princeton University where the benefits were only those which accrue to society generally, and statutes specifically giving corporations the power to "make donations for the public welfare or for charitable, scientific or education purposes,"²⁹ the anti-contribution rule has long since been left behind. It should be noted that in changing the rule, legislatures and courts, in effect, recognized corporate client-groups other than shareholders. With the business world coming to agree with Henry Ford, as the Brenner and Molander study indicates, it would not be a revolutionary step for courts and legislatures to move a bit further and recognize client-groups more fully.

To truly grant a right, a means for enforcing that right must also be provided. Client-groups' rights should be enforceable in the same way that shareholders' rights are—by class and derivative actions. Obviously management should be given much discretion in balancing interests, and so long as it makes a good faith effort, the business judgment rule should protect it. In fact, for honest managers operating in good faith, the proposed model may offer more security than the present one, since they clearly would have more leeway in making decisions affecting the various client-groups than they now have in taking actions affecting shareholders.

I thus have a number of crucial reservations about Eisenberg's arguments. These do not detract, however, from the value of his book. His positions, including the ones just criticized, are all ably advocated, and his careful research and laying of foundations always gives the reader the chance to put those foundations to his own uses. Those who disagree with Eisenberg may be his most grateful readers.

27. *Dodge v. Ford Motor Co.*, 204 Mich. 459, 507, 170 N.W. 668, 684 (1919).

28. 13 N.J. 145, 98 A.2d 581, *appeal dismissed*, 346 U.S. 861 (1953).

29. 1 MODEL BUS. CORP. ACT ANN. § 4(m) (2d ed. 1971); *see, e.g.*, DEL. CODE ANN. tit. 8, § 122(9) (1974).