

PAYING LAWYERS, EMPOWERING PROSECUTORS, AND PROTECTING MANAGERS: RAISING THE COST OF CAPITAL IN AMERICA

RALPH K. WINTER†

INTRODUCTION

It is a safe generalization that no nation should increase the cost of raising capital except for compelling reasons. The lower the cost of capital to a nation's entrepreneurs, the more that will be purchased.¹ When further units of capital are added to a fixed number of units of other factors of production, the return to those

† Judge, United States Court of Appeals for the Second Circuit. This Article was originally presented as the Oliver Wendell Holmes Lecture at Harvard Law School, Cambridge, Mass., on October 13, 1992.

1. For some time, many commentators noted that America's cost of capital was high compared to that of its economic competitors. Richard Breeden, the Chairman of the SEC, and others have described America's high cost of capital as one of the economy's biggest problems. Richard Breeden, Speech at American Stock Exchange Conference (Oct. 15, 1990), in Fed. News Serv., Oct. 15, 1990, available in LEXIS, Nexis Library, Fednew File; see, e.g., Gary Hector, *Why U.S. Banks Are in Retreat*, FORTUNE, May 7, 1990, at 95, 95 (stating that the cost of capital for American companies was twice that of their West German and Japanese competitors during the period from 1983 to 1988).

More recent evidence indicates that America's cost of capital is not currently higher than the cost of capital for some of its competitors. See, e.g., *Capital Punishment*, ECONOMIST, May 23, 1992, at 71, 71 (discussing a recent study conducted by Richard Mattione, an economist with J.P. Morgan Bank, that found America's cost of capital to be lower than the cost of Japanese capital); Carl W. Kester & Timothy A. Luehrman, *The Myth of Japan's Low-Cost Capital*, HARV. BUS. REV., May-June 1992, at 130, 130; Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARV. BUS. REV., Sept.-Oct. 1992, at 65, 65.

It should be emphasized that the validity of the arguments made here does not depend upon the cost of capital in the United States being relatively high or low. Measures that increase the cost of capital without corresponding benefits are harmful.

other factors is increased. For example, hypothesize two complementary factors of production that jointly produce products. The first factor is capital, domestic and foreign. We assume it to be extremely mobile. The second factor, domestic labor, we assume to be fixed in amount. Governmental measures that reduce the cost of capital will increase the return to labor as each additional unit of capital purchased competes for the fixed units of labor. Governmental measures that increase the cost of capital will in turn diminish the return to labor.

It is self-evident to all who would look that societies whose governments facilitate the raising of capital thrive while those whose governments impair the raising of capital suffer. These propositions are supported by empirical evidence all over the planet. They are so obvious that their message can be learned even from the nightly television news, although it is not clear that the messenger understands it. These propositions need be restated only when one is in proximity to a great American university.

The international competition for capital is for high stakes. Trillions of dollars are involved. Moreover, the flow of capital among nations is independent of the desires of governments. Capital cannot be captured, hoarded, or reproduced; it must be attracted on a continual basis. The swiftness of modern communication² and the sophistication of international securities markets³ result in instantaneous responses to events affecting the return to investors. That these market responses are relatively immune from control by individual or even collective governments was recently demonstrated by the monetary disarray in the European Community.⁴

2. See Joseph A. Grundfest, *Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences*, 4 J. FIN. SERVS. RES. 349, 103-04 (1990).

3. A plethora of articles detail the increasing sophistication of both financial instruments and market participants. See, e.g., Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 401-04 (1992) (discussing the ways in which investors use swaps, options, or futures to achieve returns similar to those achieved through equity holdings); Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991); Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319 (1991).

4. During the latter half of September 1992, "massive movements of short-term capital have overwhelmed the attempts of central banks to defend [the European Community's Exchange Rate Mechanism (ERM)] parities with market intervention and/or changes in interest rates." *The Way We Were*, ECONOMIST, Oct. 3, 1992, at 71, 71. "[T]he ERM may be torn apart beyond repair" because of such tremendous volatility in the currency markets. *Enhancing European Equities: Europe's Exchange-Rate Shambles Has*

The character of a national legal system directly affects the cost of raising capital in that nation. For example, a principal deterrent to private investment in the former Soviet Union is the fear that its judicial system will not enforce contracts.⁵ Entrepreneurs in a nation with a legal system that lessens the return to private investment relative to other legal systems will have to pay more for capital, and will purchase less, than entrepreneurs in other nations. A nation's legal system is thus as much in competition with those of other nations as are, say, its automobile companies.

The theme of this Article is that the American legal system unnecessarily raises the cost of capital and thus retards economic growth. By "unnecessarily," I mean that there are legal rules and procedures that are inefficient because they raise the cost of capital but do not purport to further societal goals that outweigh the loss in efficiency. In fact, most of the areas of law that I intend to address purport to further, if anything, the efficiency of capital markets. Judgments about these legal rules and procedures entail a cost-benefit analysis that is exceedingly difficult. Such judgments also require observation over a period of time. If a rule or regulatory scheme endures over time, it is reasonable to assume that it survives either because it is efficient or because it benefits powerful domestic interests.⁶

There is, of course, virtually no legal rule in corporate or securities law that is not alleged by someone to raise the cost of capital. I am not here to debate the close cases, however, or even the cases in which we can be confident there are substantial benefits.⁷ It is my belief that the American legal system contains various bodies of law that raise the cost of capital to benefit powerful domestic interests. The bodies of law I have chosen to examine either expose investors to unjustified civil and criminal liability

Made Securities Markets Nervous, *ECONOMIST*, Sept. 26, 1992, at 91, 91.

5. See, e.g., Duncan Robinson, *Weak Russian Contract Enforcement Takes Toll on Companies from US*, *J. COM.*, July 31, 1992, at A4.

6. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 31, 217 (1991).

7. I am not going to address registration and periodic disclosure provisions. They may be inefficient, but an argument can be made that they are efficient. See generally *id.* at 276-314. My own view is that they will die of their own accord because they are inefficient enough that they deter foreign companies from choosing to register their stock in this country.

which benefits only the legal profession or shield corporate managers from the monitoring of their performance by equity investors and the threat of control changes.

I. UNJUSTIFIED EXPOSURE TO CIVIL AND CRIMINAL LIABILITY

Unnecessary civil or criminal liability diminishes the return to, and increases the cost of, capital. When a rule of liability is not efficient, the payment by firms of damages or fines unnecessarily increases the cost of doing business in the United States. Of course, many investors can diversify in part against those liabilities. They may invest in a broad range of companies that pay damages to each other, and investors' losses in some companies will be matched by gains in others. Even when diversified, investors still must pay the costs of determining the underlying liability—the costs of litigation. Moreover, the entrepreneurs whose companies purchase capital cannot diversify against unnecessary liability; they will not, at the margin, purchase capital, at least not in the country in question.

The second effect of unnecessary civil and criminal liability is that participants in the capital market, including intermediaries and managers, may be deterred from engaging in efficient conduct by the fear of such liability.

A. *Derivative/Class Actions*

Of course, even efficient rules of liability will misfire if the available enforcement procedures are inefficient; and a good starting point of analysis is the use of derivative and class actions to enforce managerial or corporate obligations. In these actions, the named plaintiffs are individual shareholders who bring actions on behalf of the corporation or on behalf of a class of shareholders. The plaintiffs are generally figureheads, however, because the real incentive for bringing such actions is the quest for attorney's fees.⁸ In theory, such actions vindicate legal rights that might otherwise go un- or underenforced when no single claimant has a sufficiently large claim to have an incentive to sue. But the costs of collective action in marshalling a large group of claimants are

8. See Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 7-8 (1991).

great, particularly because claimants who sit back may get a "free ride," benefitting from a victory without bearing any cost.

There is increasing evidence, however, that, under existing procedures, derivative and class actions substantially diminish the return to investors in American companies.⁹ First, studies by various scholars over the years have revealed that a large percentage of derivative and class actions are frivolous.¹⁰ Because even frivolous cases must be defended, investors must bear costs without any corresponding benefit other than a hope for deterrence. When a frivolous action cannot be dismissed on the pleadings, and discovery is taken, these costs may be substantial.¹¹

Because the motivation for bringing the action is the quest for attorney's fees, many such actions may be brought on the basis of their settlement value, which may be related more to the expected costs of defense than to the merits of the underlying claim.¹² One study has found that fifty percent of derivative actions that settle do so for no monetary recovery although an award of counsel fees is made in ninety percent of the settled cases.¹³ The studies also show that a large monetary award to the corporation or to the class is unusual.¹⁴ Some transactions, like public offerings, generate litigation whenever investors have lost an amount sufficient to support an award of attorney's fees.¹⁵ A study of public offerings in one industry thus found that where damages above a certain floor could be claimed and financially sound defendants were available, a class action based on allegations of misrepresentation

9. See, e.g., John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 673 n.9 (1986) (many such suits result in settlements that "benefit[] the attorneys more than the shareholders"). See generally Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 569-73 (1991); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORGANIZATION 55 (1991) (concluding that shareholder litigation, as an instrument of corporate governance, is weak, if not ineffective).

10. See, e.g., FRANKLIN S. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS (1944); Romano, *supra* note 9, at 56, 61.

11. See Roberta Romano, *Directors' and Officers' Liability Insurance: What Went Wrong?*, in NEW DIRECTIONS IN LIABILITY LAW 67, 69 (Walter Olson ed., 1988) (stating that the cost of the average claim in a 1986 survey was \$1,988,200, excluding attorney's fees).

12. *Id.* at 69-70; Alexander, *supra* note 9, at 566-68.

13. Romano, *supra* note 9, at 61.

14. See, e.g., *id.* at 60-65.

15. See Romano, *supra* note 11, at 72.

or inadequate disclosure was brought on *every* occasion that the value of newly-issued stock was, within fifteen months after the offering, less than its offering price.¹⁶ Because some new issues will inevitably sell at prices lower than their offering prices even after the most meticulous and comprehensive disclosure, the incentive to bring at least some of these actions was probably not the merits.

Second, there is increasing evidence that settlement is inevitable where judgment on the pleadings or a quick summary judgment cannot be obtained, and that the amounts paid in settlement are in large part unrelated to the merits of the action.¹⁷ Weak actions may thus be overcompensated, and strong actions undercompensated. If so, fiduciary and other obligations will not be effectively enforced. Because enforcement of these obligations is the sole justification for such actions, this is serious criticism indeed.

The parties have powerful incentives to settle such actions. The defense may find settlement attractive to avoid costly pre-trial and trial proceedings.¹⁸ The defense will also want to avoid the irreducible risk of loss in even the weakest case that results from the inherent unpredictability of our judicial system.¹⁹ Management, moreover, rarely cares to assume the burdens and distractions of a trial.

Once a settlement offer with a significant fee is on the table, the temptation for plaintiffs' counsel to settle is powerful.²⁰ A larger recovery may be possible, but the percentage of the increase going to counsel fees is likely to diminish.²¹ Moreover, further proceedings will impose substantial out-of-pocket costs on plaintiffs' counsel, who will generally be financing the case.²² In

16. This study is the focus of Alexander's article. See Alexander, *supra* note 9, at 511-13.

17. See *id.* at 500, 514-15, 519; Romano, *supra* note 9, at 61.

18. Alexander, *supra* note 9, at 529-34.

19. See, e.g., Samuel R. Gross & Kent D. Syverud, *Getting to No: A Study of Settlement Negotiations and the Selection of Cases for Trial*, 90 MICH. L. REV. 319, 320 (1991) (stating that the "uncertainties of trial" provide some of the incentives "driv[ing] parties to settle").

20. See Romano, *supra* note 9, at 57.

21. Judge Friendly discussed this in his separate opinion in *Alleghany Corp. v. Kirby*, 333 F.2d 327, 338 (2d Cir. 1964), *aff'd en banc*, 340 F.2d 311 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966).

22. Alexander has observed that plaintiffs' firms usually absorb all out-of-pocket costs

such circumstances, plaintiffs' counsel will rarely decline a settlement providing a significant fee and risk actually losing the case.²³

There are thus compelling reasons for all parties to settle that are relatively extraneous to the merits of plaintiffs' claims. As a result, settlement values may reflect those reasons more than the merits of the underlying action. One study of a group of class actions found that most settlement values fell within a rather narrow range—20% to 27.5%—of the claimed damages.²⁴

Third, amounts paid in settlement in derivative actions and the costs of litigation are more often than not paid from insurance that was purchased by the corporation.²⁵ Viewing such cases in the aggregate, investors do not net any return over premiums paid.²⁶

In the case of class actions, a transfer from the corporation to a class of investors may take place.²⁷ However, some investors will suffer a loss from the indemnification of the defendants and the funding of the costs of litigation for all parties. Investors who are diversified against such transfers will suffer a net loss from the costs of the litigation. Investors who receive damages will benefit, but the amounts will not be great.²⁸

for the litigation and typically will not want to risk losing such an investment, as well as their expected profit from a settlement, on the risks inherent in a trial. For example, four plaintiffs' firms, including Milberg, Weiss, invested four million dollars in a lawsuit against Marathon Oil and lost at trial. See Alexander, *supra* note 9, at 537 n.156. To generate a regular and steady profit, plaintiffs' firms normally commence many cases with some settlement value, invest only a limited amount of time on each, and settle them all. *Id.* at 547.

23. *Id.* at 543-44.

24. In Alexander's study, six of the eight cases settled in this narrow range, with five of them falling in the even tighter range of 24.5% to 27.5%. *Id.* at 517. Her findings are significant because cases in her study involved damage claims based on mathematically precise computations. *Id.* at 515 n.55.

25. See Romano, *supra* note 9, at 57, 61-62. See generally Romano, *supra* note 11, at 68-70.

26. See Nancy Rutter, *Securities Class Action Scandal*, UPSIDE, Apr. 1990, at 18, 34 (stating that directors' and officers' insurance contributes roughly 50% to 80% of the settlement amount in securities class actions); see also Romano, *supra* note 9, at 55-56.

27. See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224, 260-63 (1988) (White, J., dissenting). The *Basic* decision held that shareholders who kept their shares must pay damages to shareholders who had sold the stock between October 1977 and December 1978.

28. Seventy-four percent of shareholder claims are settled without any payments made to the claimants. Romano, *supra* note 11, at 70. Also, any payments made to claimants are typically small. Derivative suits pay "[a]s a percentage of firm assets . . .

It is, of course, argued that the existence of derivative and class actions deters illegal conduct. This assertion cannot be tested in full, but existing data suggests that the deterrent effect is weak. Certainly, if the merits of claims asserted in derivative and class actions are frequently irrelevant to their initiation or settlement values, one would not expect the existence of such actions to have a deterrent effect beneficial to investors. To be sure, the existence of such actions may impel management to take steps to prevent such litigation. Such steps, however, are at a cost and of little benefit to investors.

The evidence thus suggests the following. Derivative and class actions extract a deadweight loss from investors. In most such actions, the corporation receives no benefit but pays everyone's legal fees. In some cases, a benefit is received but is either paid from insurance that was purchased by the corporation or offset by indemnification. Because settlement is guided only in small part by the merits of the underlying claim, derivative and class actions result in the overcompensation of weak claims and the undercompensation of strong claims. Investors thus also lose because fiduciary or statutory obligations—which I assume to be efficient—are not effectively enforced.

Present procedures are a cause of these problems. Rules of notice pleading followed by discovery expose investors to litigation that lacks merit but is expensive to defend. The requirement of judicial approval of derivative or class action settlements has failed to fulfill its purpose of protecting shareholders—busy trial judges cannot seriously test claims by all parties that a proposed settlement is fair.

What then is needed? First, we should require that derivative and class actions be pled with particularity—a result accomplished in the case of derivative actions in some jurisdictions through the demand requirement.²⁹ Second, in each such case, a judicial officer, such as a special master, should be appointed to make a judg-

much less (0.5 percent compared to 1.6 percent)" than do class actions. Romano, *supra* note 9, at 61. Also, "[t]he proportion of derivative suits with a cash payout to shareholders (21 percent) is significantly lower than that of class actions (67 percent)." *Id.*

29. See *Aronson v. Lewis*, 473 A.2d 805, 817–18 (Del. 1984) (holding that a plaintiff did not allege facts with sufficient particularity). *But see Alexander, supra* note 9, at 570 n.287 (noting that the procedural nature of such a requirement may adversely affect cases based on meritorious grounds).

ment at periodic intervals as to whether investors will benefit if the lawsuit continues. In a derivative action, if, at any time, the officer determines that the likely recoverable damages discounted by the probability of a finding of liability are not substantially greater than the likely costs to the corporation, then the action should be dismissed. In a class action, if the class is not the shareholders as a whole, the officer should determine whether the likely benefits to the class discounted by the probability of liability outweigh the likely costs of bringing the litigation; the officer should then monitor the case, including discovery, and guide its settlement. This procedure is itself costly, but it carries a hope that weak claims will be deterred or quickly dismissed, and strong claims will not be settled at inadequate amounts. If those goals were to be achieved, we might be justified in believing that such actions would act as effective deterrents of illegal conduct.

B. *The Increasing Importance of Criminal Law*

One can no longer teach or practice in the area of corporate or securities law without being attentive to the possible exposure of the corporation or its managers to criminal liability. This liability has become important for a number of reasons, including: new attitudes on the part of prosecutors, the substantial penalties that now may be levied on corporations under the Federal Sentencing Guidelines, the extraordinary breadth the federal courts accord the definition of fraud in the mail and wire fraud statutes, and the use of forfeiture as an adjunct to criminal RICO and money laundering prosecutions.

With regard to the size of fines to which a corporation may be subjected, the United States Sentencing Commission recently promulgated Guidelines for the sentencing of corporations convicted of crimes.³⁰ Although the size of a potential fine can be substantially diminished by proof that a corporation had in place prophylactic measures designed to ensure compliance with applicable law,³¹ the fines that may be imposed are substantial.³² However, prosecutors have in the past rarely sought to subject corpora-

30. See UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8 (Nov. 1991) [hereinafter GUIDELINES MANUAL].

31. *Id.* § 8C2.5(f) (allowing court to subtract three points from culpability score if defendant had effective program in place to prevent and detect violation).

32. See *id.* § 8C2.4(d) (creating a range of fines from \$5,000 to \$72,500,000).

tions to criminal liability.³³ The reasons for this are unclear. The incidence of corporate crime may be less than we think, or the prosecution of the executives directly responsible may be the most effective deterrent. Prosecutors may also be wary of initiating a complex prosecution that involves areas of the law with which their office is unfamiliar and risks the consumption of enormous resources. Finally, the lack of severe—and perhaps high visibility or video-friendly—penalties may have deterred prosecutors from embarking on such litigation. If so, the new Guidelines' provision of substantial penalties may well alter prosecutorial attitudes about indicting corporations.

If imposed, these fines will go to the bottom line and diminish the return to investors. Indeed, the very purpose of the draconian Guidelines is to expose investors to substantial losses so that they will monitor corporate managers' compliance with the law.³⁴ This is a straightforward theory, weakened by the persistent query of why prosecution of the responsible individuals is not a sufficient deterrent, and then thoroughly undermined by the fact that American law—as I describe later—makes it very difficult for investors to engage in the kind of monitoring contemplated by the Guidelines.

With regard to the statutory weapons available to prosecutors, they rank by analogy with hydrogen bombs on stealth aircraft. Foremost among them are the various federal fraud statutes—in particular, the mail and wire fraud statutes³⁵—which have been interpreted to criminalize a wide range of conduct involving conflicts of interest,³⁶ alleged misrepresentations,³⁷ or the failure of agents to inform alleged principals of certain facts.³⁸ The mail fraud statute was designed largely to keep mail-order houses hon-

33. Jed S. Rakoff, *The Corporation as Policeman: At What Price?*, N.Y. L.J., Jan. 9, 1992, at 3, 4 (“[C]urrent federal law provides a sweeping basis for prosecuting corporations Yet, until recently, federal prosecutors rarely made use of this weapon.”).

34. Stephen A. Saltzburg, *The Control of Criminal Conduct in Organizations*, 71 B.U. L. REV. 421, 430 (1991).

35. 18 U.S.C. § 1341 (Supp. III 1991) (mail fraud); *id.* § 1343 (wire fraud); *see also* 18 U.S.C. § 371 (1988) (conspiracy).

36. *See, e.g.*, *United States v. Silvaro*, 812 F.2d 754, 759 (1st Cir. 1987); *United States v. Bronston*, 658 F.2d 920 (2d Cir. 1981), *cert. denied*, 456 U.S. 915 (1982).

37. *See, e.g.*, *United States v. Gibbons*, 968 F.2d 639 (8th Cir. 1992); *United States v. Stout*, 965 F.2d 340 (7th Cir. 1992).

38. *See, e.g.*, *United States v. Margiotta*, 688 F.2d 108 (2d Cir. 1982), *cert. denied*, 461 U.S. 913 (1983).

est and to prevent swindlers from using the mails.³⁹ The expansion of the statutory prohibitions probably resulted from the desire of federal prosecutors to prosecute corrupt local officials who enjoyed protection from local prosecution. The underlying doctrine, however, which posits a duty of agents to inform their principals of material facts such as kickbacks, quickly spread to other areas, such as corporate governance.⁴⁰

Federal anti-fraud legislation has been construed to criminalize the failure of corporate managers, employees, or agents to give a meticulously accurate account to the corporation of their conduct on the corporation's behalf.⁴¹ This doctrine is not as desirable as it sounds. Proof of the existence of an obligation to disclose recognized by some other body of law, such as state fiduciary principles or federal securities law, is unnecessary;⁴² the jury can find that a federal obligation to disclose arose from the particular facts.⁴³ It is thus essentially a common law crime fashioned by individual juries. That no loss to the corporation was intended or occurred is not a defense.⁴⁴ Reliance by the principal on the absence of disclosure need not be proven. The prosecution thus need not show that the corporation or its shareholders would have acted differently had it or they known the facts.⁴⁵

All that need be shown to prove the crime is that "material" information was deliberately not disclosed by an agent to a principal. "Material" is given the broadest possible definition and specifically does not have to relate to any matter affecting share price.⁴⁶ Proof of a failure to disclose is in most circumstances sufficient for a prima facie case, the defendant's state of mind being a question of fact for the jury. Thus, the unexplained use of

39. See *McNally v. United States*, 483 U.S. 350, 356 (1987); see also *Durland v. United States*, 161 U.S. 306 (1896).

40. *United States v. Wallach*, 935 F.2d 445, 463 (2d Cir. 1991); *United States v. Weiss*, 752 F.2d 777, 783-84 (2d Cir.), cert. denied, 474 U.S. 944 (1985); *United States v. Siegel*, 717 F.2d 9, 14 (2d Cir. 1983).

41. See *Wallach*, 935 F.2d at 463; *Weiss*, 752 F.2d at 784; *Siegel*, 717 F.2d at 14.

42. *Siegel*, 717 F.2d at 23 (Winter, J., dissenting in part and concurring in part).

43. *Id.*

44. *Weiss*, 752 F.2d at 783-85; see also *United States v. Shareef*, 714 F.2d 232, 234 (2d Cir. 1983).

45. See *Wallach*, 935 F.2d at 463, 465; *Weiss*, 752 F.2d at 783-84.

46. *Siegel*, 717 F.2d at 14 (holding that the prosecution "need not show that direct, tangible economic loss resulted to the scheme's intended victims").

a small cash fund,⁴⁷ the failure of a company's books to reflect an investment,⁴⁸ and the failure of a lawyer to include a description of lobbying services in a bill where substantial legal work was done⁴⁹ all have been held to violate federal criminal fraud statutes.

The supposition that the beneficiaries of this body of law are investors is clearly a fiction. Shareholders care little about petty cash, do not concern themselves with the details of a firm's investments, and most decidedly have no desire to rummage through a lawyer's bills. Indeed, it is virtually impossible to argue that this essentially judge-made law is necessary to protect investors in light of the comprehensive state and federal regulatory schemes governing the conduct of corporate affairs,⁵⁰ including fiduciary obligations, the doctrine of waste, the regulation of accounting practices,⁵¹ and mandated disclosure of material information.⁵²

This body of fraud law has developed case by case as prosecutors either have sought to prosecute persons who had engaged in perceived improprieties that were not the subject of any particular statute or have tried to squeeze corporate managers for testimony about the criminal activities of third parties. In the cash fund case, the prosecutors hoped they were on the trail of corrupt Teamsters officials;⁵³ in the undisclosed investment case, they were after a CEO;⁵⁴ and in the case of the lawyer's bills, they were reportedly after a former Attorney General of the United States, who they thought might have acted improperly in recommending the allocation of government contracts.⁵⁵

In any event, courts acceded to the desire of prosecutors for the creation of amorphous crimes that would allow prosecutors to pursue hard-to-define improprieties—or conduct that was improper

47. *Id.* at 11.

48. *Weiss*, 752 F.2d at 781.

49. *Wallach*, 935 F.2d at 450–51, 460–61.

50. *See, e.g.*, DEL. GEN. CORP. L. § 144 (1991); N.Y. BUS. CORP. § 713 (1986); 17 C.F.R. §§ 240.14a–1 to 240.14a–14 (1992).

51. *E.g.*, 17 C.F.R. § 210.2–02 (1992) (accountants' reports).

52. 15 U.S.C. § 77e (1988); *id.* § 78m.

53. *United States v. Siegel*, 717 F.2d 9, 24 (2d Cir. 1983) (Winter, J., dissenting in part and concurring in part).

54. RICHARD M. CLURMAN, *TO THE END OF TIME* 111 (1992).

55. *See* Steven Brill, *Nightmare at Foley Square; An Open Letter to Bob Wallach's Prosecutor*, AM. LAW., July-Aug. 1991, at 3, 89.

only in the eyes of the particular prosecutor—or to pressure individuals thought to possess knowledge of other criminal activities. The creation of these crimes by the federal courts was not, I believe, an unconscious act. Rather, it was in part an act of faith and in part a desire to avoid seeming acquiescence in corrupt conduct. The act of faith was the belief that the effect of the unbounded doctrines they were creating would always be tempered by a prudential exercise of prosecutorial discretion. Civil RICO—of which more later—never entered their mind.

Prosecutors are also empowered with broad authority to forfeit the assets of businesses. RICO's forfeiture provisions authorize the government to forfeit corporate assets that are the proceeds, or derived from the proceeds, of a RICO violation or that represent the interest of an individual RICO violator in the firm.⁵⁶ Beyond seizing property, the government can become a proprietor, such as a partner in a firm.⁵⁷ Pre-trial restraints are available to secure the government's monetary interests.⁵⁸ Whether the forfeiture occurs pre-trial or post-trial is probably less important than the announcement in an indictment that the government will seek forfeiture. That announcement is likely to doom the firm because of its effect on potential investors, customers, or clients. In that event, innocent investors and employees will suffer.⁵⁹

Even more awesome are the government's civil forfeiture powers under the money laundering statute.⁶⁰ Any corporation that engages in a financial transaction involving proceeds from illegal activity with the intent to promote that activity is subject to forfeiture.⁶¹ The government need not prove that the defendant

56. 18 U.S.C. § 1963(a) (1988).

57. *Id.* § 1963(g)(5).

58. *Id.* § 1963(d).

59. See William Safire, *The End of RICO*, N.Y. TIMES, Jan. 30, 1989, at A17 (stating that the threat of pre-trial seizure of assets—"an abuse of prosecutorial power made possible by RICO—caused Drexel Burnham Lambert to settle with 'rough Rudy' Giuliani"); David A. Vise, *RICO Goes to Wall St.; Racketeer Law's Impact Felt Even Before Verdict in First Case*, WASH. POST, July 30, 1989, at H1 (describing Princeton/Newport Partners' forced liquidation "after nervous investors withdrew their capital from the firm after RICO charges were filed").

60. 18 U.S.C. §§ 1956–1957 (1988 & Supp. III 1991); see Elkan Abramowitz, *Money Laundering: The New RICO?*, N.Y. L.J., Sept. 1, 1992, at 3 (discussing benefits to prosecutors of the money laundering statutes).

61. 18 U.S.C. § 1956(a)(1) (1988); 18 U.S.C. § 982 (Supp. III 1991).

knew that the conduct constituted specified unlawful activity.⁶² Although passed largely as a measure in the "war on drugs," the money laundering statute applies to proceeds from violations of the mail and wire fraud statutes.

However, exposure is one thing; actual resort to forfeiture in a way that harms innocent investors is another. The effect of forfeiture laws on investment in U.S. companies is probably *de minimis*. Forfeiture appears to have been sought in money laundering cases only in the instance of relatively serious crimes involving companies without innocent investors.⁶³

The use of RICO forfeiture is another matter. The government did seek pre-trial restraint and forfeiture under RICO of some of the assets of a small investment partnership, Princeton/Newport Partners, in the hope of obtaining testimony from some of its general partners against Drexel Burnham Lambert and Michael Milken.⁶⁴ The charges against the partnership were at best garden variety,⁶⁵ however, and violated Department of Justice Guidelines as to the use of RICO.⁶⁶ Indeed, on appeal, the United States Attorney's Office for the Southern District of New York took the position that the Department of Justice Guidelines were not binding on it, were not enforceable by the courts, and were, in any event, wrong.⁶⁷ In contrast, RICO forfeiture was not sought in the Pentagon fraud cases,⁶⁸ probably because the government did not care to destroy the defense industry, even though the crimes there were more egregious than any other white-collar crimes of the era.

62. 18 U.S.C. § 1957(c) (1988); 18 U.S.C. § 982 (Supp. III 1991).

63. See, e.g., *United States v. Swank Corp.*, 797 F. Supp. 497, 504 (E.D. Va. 1992) (involving millions of dollars and a defendant who is president and sole stockholder of corporation); *United States v. Gleave*, 786 F. Supp. 258, 262 (W.D.N.Y. 1992) (attempting to conceal over \$600,000 from trustee and creditors in bankruptcy proceeding).

64. See *United States v. Regan*, 858 F.2d 115 (2d Cir. 1988).

65. See *United States v. Regan*, 937 F.2d 823, 825, 829 (2d Cir.), *amended*, 946 F.2d 188 (2d Cir. 1991), *cert. denied sub nom. Zarzecki v. United States*, 112 S. Ct. 2273 (1992).

66. 3 U.S. DEPARTMENT OF JUSTICE, UNITED STATES ATTORNEY'S MANUAL, § 9-110.300-330 (1988).

67. Brief for Appellee *United States* at 64-65, *Regan*, 937 F.2d at 823 (No. 89-1591); see also *Vise*, *supra* note 59, at H1 (stating that "[p]rosecutors deny using RICO as a sledgehammer to try to force cooperation").

68. *Pentagon Fraud Unit's Work Resulted in \$8.3 Million in Fines, Restitution*, Daily Rep. Execs. (BNA) A16 (Feb. 2, 1987).

Forfeiture is thus more a brooding threat than an active deterrent to investment. Still, the power is vast, and the Department of Justice may not reliably control its use by individual prosecutors. Like sizeable fines under the Sentencing Guidelines, forfeiture is a video-friendly, attention-getting remedy, and the danger of its misuse persists. Moreover, a corporation faced with the possibility of forfeiture must settle with the government prior to indictment, or suffer bankruptcy, whereupon the merits of the government's case will be settled by competing bestsellers.

C. *Civil RICO*

RICO provides civil remedies, including treble damages and attorney's fees.⁶⁹ Civil RICO builds upon the doctrines of federal criminal law I have described. For civil RICO plaintiffs, the most useful provision of RICO is 18 U.S.C. § 1962(c). Section 1962(c) prohibits participation in the conduct of an enterprise through a pattern of racketeering activity. Anyone injured in their business or property by such participation has standing to sue.⁷⁰ "Enterprise" is defined broadly to include "any individual," "group of individuals associated in fact," and various specified legal entities.⁷¹ Proof of the existence of an enterprise is thus not difficult. "Pattern of racketeering activity" requires as a necessary condition proof of commission of two predicate racketeering acts.⁷² It also requires proof of continuity of the racketeering activity and of a relationship between the racketeering acts proven and a relationship between those acts and the conduct of the enterprise.⁷³ Racketeering acts consist of violations of specified federal criminal statutes—including mail and wire fraud and "fraud in the sale of securities"—and generic state crimes.⁷⁴

As I indicated earlier, mail and wire fraud precedents establish federal fiduciary obligations broader than those established under state law by the doctrine of waste. For example, an allegation of a failure to inform shareholders that a particular economy

69. See 18 U.S.C. § 1964(c) (1988).

70. *Id.*

71. *Id.* § 1961(4).

72. See *id.* § 1961(5).

73. See *H.J. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 241-42 (1989); *United States v. Indelicato*, 865 F.2d 1370, 1381 (2d Cir. 1989) (en banc).

74. 18 U.S.C. § 1961(1) (Supp. III 1991).

has not been taken advantage of, or that a particular perk, salary, or bonus is excessive, may well state a valid claim. The federal fraud doctrines involving a failure to inform do not include a business judgment defense. It is thus not difficult to allege a pattern of racketeering activity where periodic or repetitive conduct is involved, or to bring a RICO derivative suit alleging, for example, participation in a corporation's board of directors through a pattern of racketeering activity.⁷⁵ I do not, of course, mean to suggest that such an action, if pursued to judgment, would inevitably succeed. Rather, the point is that so long as the complaint survives a motion for judgment on the pleadings, the action must be defended, and, as described earlier, it will be settled entirely at investors' expense. Thus, the number of derivative suits is likely to increase over time as a result of civil RICO, and, if the criticism of derivative actions described above is even remotely legitimate, RICO derivative suits will be a further deadweight loss to investors.

The definition of mail or wire fraud is also sufficiently broad to allow rather ordinary commercial disputes to be pled as RICO claims. As one commentator has stated, "Civil RICO is potentially applicable to almost any commercial controversy, even one predicated on state law, such as a breach of contract claim. All that is required to 'federalize' a fundamentally state law claim is finding two suitable predicate acts . . . that can be said to form a pattern."⁷⁶ For example, any dispute over a contract that requires periodic performance and communication between the parties can support allegations of a pattern of racketeering activity involving misleading statements and failures to inform.⁷⁷ Indeed, the first civil RICO case to reach the Supreme Court would have been a garden variety contract action had RICO not been available.⁷⁸

One result of civil RICO is that its treble damages provisions have partially displaced common law rules concerning contract damages.⁷⁹ This has occurred without, as far as I know, any con-

75. See, e.g., *In re Par Pharmaceutical, Inc. Derivative Action*, 750 F. Supp. 641, 643 (S.D.N.Y. 1990); *Lode v. Leonardo*, 557 F. Supp. 675, 680-81 (N.D. Ill. 1982).

76. Gary P. Naftalis, *Civil RICO: Basic Applications*, in *RICO: CIVIL AND CRIMINAL LAW AND STRATEGY* § 2.02[4] (Jed S. Rakoff & Howard W. Goldstein eds., 1992) (footnote omitted).

77. *Proctor & Gamble Co. v. Big Apple Indus. Bldgs.*, 879 F.2d 10, 18 (2d Cir. 1989), cert. denied, 493 U.S. 1022 (1990).

78. *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 492, 498 (1985).

79. See Robert K. Rasmussen, *Introductory Remarks and a Comment on Civil*

scious decision that the common law measure of damages was inadequate. Similarly, the federal securities laws contain numerous provisions specifying rights of private action in carefully defined circumstances with particularized procedures and measures of damages. No one consciously decided that such remedies are inadequate, but RICO arguably authorizes a treble damages action for any securities law violation.

Civil RICO enhances the temptation to resort to litigation over every commercial dispute because the prospect of treble damages and attorney's fees is incentive to plaintiffs to bring actions that might otherwise not have been brought. Although some investors can diversify against civil RICO liability—but not against the costs of litigation—entrepreneurs at the margin will forgo raising capital to fund commercial activities subject to RICO claims. Civil RICO thus reduces the level of commercial activity in this country. None of this analysis is dependent upon a great number of civil RICO claims ultimately prevailing because the threat of treble damages and an award of attorney's fees creates incentives on the part of defendants to settle even those cases with little merit.

Although ordinary commercial disputes pled as RICO claims are now commonplace—the *Wall Street Journal* recently reported that there are 2,000 civil RICO claims pending against lawyers and accountants alone⁸⁰—they are just the camel's nose under the flap of the tent. Courts presently tend to scrutinize civil RICO claims with far more skepticism than they scrutinize criminal RICO charges. Nevertheless, rules within a single court that differ with regard to the elements of predicate acts and the existence of a RICO pattern depending on whether the action is civil or criminal must inevitably be reconciled—as has happened in *en banc* proceedings in the Second Circuit.⁸¹

Civil RICO continues to exist, based on the argument that persons injured by criminal acts should be allowed to recover damages for those injuries. However, as I noted earlier, the feder-

RICO's Remedial Provisions, 43 VAND. L. REV. 623, 636-37 (1990); see also EASTERBROOK & FISCHER, *supra* note 6, at 329-33.

80. *Limit of Anti-Racketeering Law Is Main Issue in High Court Case*, WALL ST. J., Oct. 13, 1992, at B1.

81. *United States v. Indelicato*, 865 F.2d 1370, 1381 (2d Cir. 1989) (*en banc*); *Beauford v. Helmsley*, 865 F.2d 1386, 1389 (2d Cir. 1989) (*en banc*), *cert. granted, judgment vacated, and case remanded*, 492 U.S. 914 (1989).

al law of fraud was fashioned not as a comprehensive definition of criminal acts but as an amorphous body of law empowering federal prosecutors to pursue individuals selected as targets on the basis of criteria having little to do with fraud in any conventional sense. Most decidedly, the federal law of fraud was intended to be tempered by prosecutorial discretion—indeed, was intended to be used sparingly—and was not to be available for wholesale use by civil litigants, as it is under civil RICO.

D. *The Overbreadth of Doctrine and the Lack of Bright Lines*

It is also the case that prosecutors, regulators, and the courts rarely show any appreciation of the need to avoid overbroad and amorphous doctrine and to craft legal rules with bright lines as a means of reducing the cost of capital. Overbreadth and uncertainty deter beneficial conduct and breed costly litigation.

The culture of prosecutors in these areas of law is to seek rules that are palpably overbroad so that they have a broad arsenal of weapons to use against suspected wrongdoers. In *Chiarella v. United States*,⁸² prosecutors sought a rule that anyone who traded on the basis of information not available to other traders was guilty of insider trading. But unequal information in capital markets is ubiquitous. Were people not able to trade on superior information, the pricing of securities would be inaccurate. The rule desired by the prosecutors thus would have rendered capital markets less, rather than more, efficient. It would, however, have afforded prosecutors vast discretion.

In *United States v. Mulheren*,⁸³ the government, having failed to prove that the defendant had for a quid pro quo manipulated stock prices at Ivan Boesky's behest—acts that were criminal—sought on appeal a ruling that buying stock solely with an intent to cause its price to increase was illegal manipulation.⁸⁴ That such a rule would be loony mattered less to the prosecutors than that it would convict this defendant and arm prosecutors with yet more discretionary power.

82. 445 U.S. 222 (1980).

83. 938 F.2d 364 (2d Cir. 1991).

84. *Id.* at 368–69; see John C. Coffee, Jr., *The Meaning of "Mulheren"*, N.Y. L.J., July 25, 1991, at 5 (arguing that courts should focus on evidence of criminal intent in cases of white-collar crime).

Legal rules and remedies that cause targets to fold without a trial are considered optimal by prosecutors. Fraud charges and forfeiture are the prosecutors' apple pie and baseball. They understandably believe that they can be trusted to limit the application of overbroad doctrine to those who truly are wrongdoers.

Matters are not that simple, however. First, as discussed, overbroad criminal law doctrine is available to civil litigants under RICO. Second, such unchecked power—and it is enormous, raw power—is very troubling in a democratic society. Even if prosecutors are an unusually fair-minded segment of society, at least isolated prosecutorial abuses are inevitable. In busy offices, individual prosecutors may be relatively unsupervised. Moreover, federal prosecutors are trained to be trial lawyers who can get convictions and may be entirely ignorant of the working of capital markets. As well, as demonstrated in the Princeton/Newport Partners case,⁸⁵ the Department of Justice may not be able to control individual prosecutorial decisions.

Third, overbroad doctrine tends to deter beneficial activity and to undermine capital markets. Concerns about overdeterrence appear not to figure in prosecutorial decisions to seek judicial approval of overbroad doctrine. What prosecutors often do not realize is that overdeterrence in regulating capital markets, in contrast to overdeterrence in controlling other kinds of crime, will deter activity that we wish to encourage. For example, if a person who was near a drug transaction but not part of it were convicted of a narcotics offense, it would be a miscarriage of justice and a personal tragedy. We do not, however, consider overdeterrence with regard to proximity to drug transactions as somehow decreasing desirable conduct. At best, it would offend an abstract right to loiter in a truly marginal fashion. Overdeterrence of white-collar crime in capital markets is different in that it will often decrease activity we hope to encourage. For example, conviction of a person for insider trading when the information was not obtained by illegal conduct would be more than a miscarriage of justice and a personal tragedy. It would also decrease desirable conduct: it would also deter others from trading on information similarly

85. *United States v. Regan*, 937 F.2d 823 (2d Cir.), *amended*, 946 F.2d 188 (2d Cir. 1991), *cert. denied sub nom. Zarecki v. United States*, 112 S. Ct. 2273 (1992); *see supra* text accompanying notes 64–67.

obtained, which would make the pricing mechanism of capital markets less efficient.

Prosecutors using laws that regulate capital markets should be as obliged to consider the effect on capital markets of the precedents they set as they are to detect and prosecute criminal conduct. The present relentless drive to increase the discretionary power of individual prosecutors moves in entirely the wrong direction.

A similar culture often infects the conduct of regulators of capital markets.⁸⁶ They too want ample authority to snare those whom they perceive to be wrongdoers and to pursue the regulatory policy agenda.⁸⁷ They fear that bright lines mean loopholes and circumvention of the underlying regulatory policy. The argument that small first steps are appropriate, that rules that prove to be underinclusive can later be broadened, often does not appeal to regulators. Regulators, and prosecutors as well, may have a short-term view because they cannot guarantee their ability to alter the rules at a later time. In other cases, regulators' belief that certain kinds of conduct are undesirable may be firmer than their reasoning as to why that is so. Consider insider trading. The SEC and the Congress have taken many steps to eliminate insider trading.⁸⁸ Unfortunately, they have failed to promulgate a definition of the conduct that they believe must be eliminated at all costs.⁸⁹ The reasons for this failure are sharp disagreements and confusion over why insider trading is bad; definition of the conduct to be prohibited cannot, of course, proceed without a common understanding of why it is undesirable. A failure to define

86. See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 26 (1991) (stating that "the [SEC] jealously seems to preserve the largest degree of discretion to sanction conduct that it determines, after the fact, to have been improper").

87. "The SEC . . . has failed to promulgate rules outside the area of tender offers but its decisions have continued to march, in the eyes of one commentator, to the beat of its own drummer." *United States v. Chestman*, 947 F.2d 551, 576 (1991) (Winter, J., dissenting), *cert. denied*, 112 S. Ct. 1759 (1992).

88. Many commentators have discussed the weapons available to the regulators, which include criminal and civil measures such as injunctions, disgorgement, and treble damages. See, e.g., Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 *DUKE L.J.* 960 (discussing, *inter alia*, treble damages sanction).

89. "[T]he SEC has, apart from Rule 14e-3, foregone the opportunity to use its rulemaking power to define what insider trading is." *Chestman*, 947 F.2d at 572 (Winter, J., dissenting).

the conduct prohibited is not only unfair, but, moreover, may deter beneficial conduct.

Finally, the courts also indulge in drawing rules that are not accurate guides for conduct. In *Basic, Inc. v. Levinson*,⁹⁰ for example, the Supreme Court dismissed as meritless the argument that bright lines should be drawn, where feasible, to guide corporations in complying with certain disclosure obligations. That case involved the circumstances in which a corporation must disclose the existence of negotiations regarding a merger with another company. Because this is a recurrent problem under the federal securities laws, it would have been possible to fashion a rule that gave considerable guidance to companies as to when such negotiations should be disclosed. The lower federal courts had done just that, holding that disclosure was required only after an agreement in principle had been reached. The Supreme Court rejected that approach and adopted the amorphous rule that disclosure is required when the magnitude of the event discounted by the probability of its occurrence would be of significance to investors.⁹¹

The Court reasoned that any bright line would be underinclusive, overinclusive, or both.⁹² In essence, the Court held that whether a matter need be disclosed or whether a particular disclosure is adequate must be determined *ex post*. There is logic in that position, but it fails the reality test. Where the law is deliberately unclear, a corporation cannot know whether it must disclose until a court rules. Moreover, where the law is deliberately unclear, any disclosure made regarding ambiguous events, such as merger negotiations, will arguably be misleading or inadequate. The corporation, no matter how sincere its desire to comply with the law, will thus face a costly class action whether it discloses or not, as long as a claim of damages sufficient to support a significant award of attorney's fees can be asserted. The number of class actions has increased dramatically since *Basic*, in part because it failed to appreciate the value of bright lines.⁹³

90. 485 U.S. 224 (1988).

91. *Id.* at 238-29 & n.16.

92. *Id.* at 238-41.

93. The Supreme Court's adoption of a "fraud on the market" theory in *Basic* may be at least partially responsible for the dramatic increase in securities litigation in the years since the decision. See Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 663 (1992).

It is, moreover, exceedingly doubtful that investors receive any benefit from being protected by a vague underinclusive or overinclusive rule. Once a legal rule regarding disclosure is in place and understood, investors, or at least the professionals who set share prices, will adjust their thinking to that rule.

II. PROTECTIONISM

Our present legal system contains a web of rules protecting corporate management from monitoring by shareholders, from competition in the market for management control, and from the enforcement of ordinary fiduciary principles. These rules affect corporate performance adversely and constitute a deadweight loss to those who invest in American business, thereby increasing the cost of capital.

A. *Limits on Institutional Investors*

Where shareholders are large in number and geographically diffuse, the cost of collective action in monitoring management performance is prohibitive.⁹⁴ Where such monitoring does not occur, management enjoys considerable leeway, because it can retain its positions notwithstanding subpar performance, at least until the price of the stock renders a takeover by purchase of a control block feasible. The point at which management must be wary of a hostile takeover depends in turn on the legal system surrounding the market for management control. Of that, more later.⁹⁵

One method of overcoming the collective action problem is for a substantial block of stock to be acquired in one hand. A large shareholder can monitor management directly, or several large blocks acting in concert may work to the same end.⁹⁶ However, as Professor Roe has noted, American law places substantial restrictions upon the acquisition by institutional investors of large blocks of stock in particular companies.⁹⁷ Commercial banks thus

94. See EASTERBROOK & FISCHER, *supra* note 6, at 66-67; MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* 53-57 (1965).

95. See *infra* Section B.

96. See Clifford G. Holderness & Dennis P. Sheehan, *The Role of Majority Shareholders in Publicly Held Corporations*, 20 J. FIN. ECON. 317, 333-45 (1988).

97. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 16-31 (1991) [hereinafter Roe, *Political Theory*]; Mark J. Roe, *That Menace, the*

may not hold equity shares,⁹⁸ and mutual funds⁹⁹ and insurance companies¹⁰⁰ are subject to a variety of laws limiting the percentage of stock they may hold in any particular corporation.¹⁰¹

There are also legal rules that place limits on concerted action by large shareholders or groups of shareholders. Federal proxy rules have long limited communications among more than ten shareholders.¹⁰² The SEC recently adopted regulations liberalizing this restriction, but the new regulations have been criticized as ambiguous and possibly cosmetic.¹⁰³ Under Rule 13d-5, shareholders constituting more than five percent of a class of stock may not agree to vote together without registering their actions with the SEC and disclosing considerable information, including their plans.¹⁰⁴ Worse yet, any group of institutional investors acting in concert may be treated as a ten-percent shareholder under section 16(b) of the 1934 Act and thus be severely restrained in their trading in the company's stock—a substantial intrusion upon the institution's normal trading.¹⁰⁵

Small Shareholder, WALL ST. J., May 21, 1992, at A12 [hereinafter *Roe, That Menace*]; see also Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 551-56 (1990); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1313 (1991).

98. 12 U.S.C. §§ 24, 335 (1988); *Roe, Political Theory*, supra note 97, at 17-18.

99. 15 U.S.C. § 80a-5(b) (1988) (fund may not advertise itself as diversified if it owns more than ten percent of any one company or if it places more than five percent of its unregulated assets in the stock of one company); I.R.C. § 851(b)(4)(A)(ii) (1992) (limiting tax breaks to nondiversified funds); *Roe, Political Theory*, supra note 97 at 19-22.

100. See, e.g., CAL. INS. CODE §§ 1198-1199 (limiting insurance company's investment in one corporation to ten percent of the insurance company's assets); N.Y. INS. LAW §§ 1405(a)(6), (8), 1705(a)(2) (McKinney 1985 & Supp. 1990) (establishing a similar limit of two percent); *Roe, Political Theory*, supra note 97, at 22-23.

Pension funds, another source of institutional investment and potential monitoring, are also subject to such restrictions. See ERISA § 407, 29 U.S.C. § 1107 (1988) (limiting acquisition and holding of employer securities by certain plans).

101. To the degree that they inhibit the formation of large blocks of shares, such restrictions also deter takeovers and impair the discipline and monitoring of capital markets, as described in Section B.

102. See 17 C.F.R. § 240.14a-2(b)(1) (1992) (now codified at 17 C.F.R. § 240.14a-2(b)(2)); see generally John C. Coffee, Jr., *SEC "Overregulation" of Proxy Contests*, N.Y. L.J., Jan. 31, 1991, at 5.

103. See 57 Fed. Reg. 48,276, 48,290-91 (1992) (to be codified at 17 C.F.R. § 240.14a-2(b)(1)); John C. Coffee, Jr., *Proxy Contests: The Shape of the Future*, N.Y. L.J., Oct. 1, 1992, at 5 ("Well-intended as this new exemption [14a-2(b)(1)] is, the barriers to open communication among shareholders remain considerable and uncertain.").

104. 15 U.S.C. § 78m(d) (1988); see also Rule 13g, 15 U.S.C. § 78m.

105. Groups subject to Section 16(b) must disgorge profits from purchases and sales

These rules, which appear not to have counterparts in the legal systems of our major competitor nations,¹⁰⁶ thus impede equity holders from monitoring management performance.¹⁰⁷ By reducing the incentives for corporate management to perform efficiently, these restrictions lessen the return to investors in American companies relative to the return to investors in companies in other legal systems.

These restrictions may also affect the temporal perspective of investors. Holders of large blocks of stock in a company are in a better position to demand and acquire high-quality information about the company than are shareholders with insignificant blocks. Large shareholders may demand and acquire access to all of a company's books and its personnel; others must rely on publicly disclosed data. The quality of information in turn affects the amount by which investors will discount a future expected return for risk. Because risk increases with time, increasing the quality of information in the possession of investors will ratchet investments in a longer-run direction; decreasing the quality of information will ratchet investments in a shorter-run direction. As Professor Roe has noted, therefore, the policy of impairing the acquisition of large blocks of stock may be one source of the frequently heard complaints about the short-run outlooks of American institutional investors.¹⁰⁸

Earlier, I mentioned that the Sentencing Guidelines provide for draconian fines against corporations that violate certain regula-

of stock within six-month periods. The statute includes "any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted." 15 U.S.C. § 78p; Exchange Act Release Nos. 34-26333, 35-24768, 1988 SEC LEXIS 2380 (Dec. 2, 1988); see Symposium, *Mutual Funds as Investors of Large Pools of Money*, 115 U. PA. L. REV. 669, 677-78 (1967).

106. See Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89, 97-99 (1990) (comparing operation of U.S. capital markets to foreign markets operating under different regulatory regimes, specifically Japan); Roe, *Political Theory*, *supra* note 97, at 10-11.

107. MELVIN EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 46, 50-51 (1976) (only one-third of largest industrial companies have a stockholder with a ten-percent ownership interest); Roe, *That Menace*, *supra* note 97, at A12:

In America, none of the largest 15 publicly traded companies in the U.S. has a financial institution or group that owns as much as 20% of the company's stock, and only rarely does a financial institution own more than 1%. But in Japan, every one of the country's largest companies is controlled by a group of financial institutions that hold an aggregate of 20% of the company's stock.

108. Roe, *Political Theory*, *supra* note 97, at 12-15, 54-57.

tory statutes.¹⁰⁹ The theory of the Guidelines is that because the fines must ultimately be borne by investors, the investors will cause the corporation to take prophylactic measures.¹¹⁰ Yet, were a group of institutional investors to act in concert in pursuing that goal, they would encounter the restrictions described above.

B. *Restrictions on the Market for Management Control*

As a result of the restrictions on the creation of, or concerted action by, large blocks of shareholders, the American corporate system more than the systems of other nations has come to rely on the market for management control and on the threat of hostile takeovers for monitoring corporate performance. However, the market for management control is almost certainly less efficient than direct monitoring by equity holders. Because institutional investors are barred from holding large blocks of shares in corporations, the market for management control is necessarily thin.¹¹¹ Although the popular press uses terms like "merger-mania"¹¹² and the like, the number of actual or potential takeovers in any given year is not large relative to the number of corporate businesses. Moreover, the information costs of a hostile takeover are high.¹¹³ One reason that LBO firms that deal only in friendly

109. See *supra* Section I(B); see also *SEC v. Drexel Burnham Lambert* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. June 20, 1989) (Drexel eventually paid \$660 million in fines). See generally MODEL PENAL CODE § 2.07(1)(c) (corporate crimes); Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practice in the Federal Courts, 1988-1990*, 71 B.U. L. REV. 247 (1991).

As severe as these penalties are, they are more restrained than originally planned. Anxious to portray itself as "tough on lawbreakers," the Sentencing Commission's preliminary draft of the guidelines set fines as high as \$364 million and allowed for a corporate "probation" under which courts would assume control of the daily operations of the firm. Tracy Thompson, *Corporations Face Stiffer Sentencing: Panel Gets Tough on Lawbreakers*, WASH. POST, Nov. 8, 1989, at B1.

110. Saltzburg, *supra* note 34, at 430. See generally 18 U.S.C. § 3553(a)(2)(B) (1988) (directing the sentencing court to consider "the need for the sentence imposed to afford adequate deterrence to criminal conduct"); Jeffrey S. Parker, *Criminal Sentencing Policy for Organizations: The Unifying Approach of Optimal Penalties*, 26 AM. CRIM. L. REV. 513, 523 (1989).

111. David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 708-09 (1987); Roe, *Political Theory*, *supra* note 97, at 55.

112. See, e.g., Deirdre Fanning, *The Executive Life*, N.Y. TIMES, Jan. 13, 1991, at C23.

113. See Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 6-7 (1982) [hereinafter Easterbrook & Fischel, *Auctions*]; Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1178 (1981) [hereinafter

transactions have prospered—although the so-called friendly transactions may be the result of threats from elsewhere—is that LBO firms may be afforded full access to company books and personnel by the targets.¹¹⁴ Hostile acquirers are afforded no such luxury.

Also, even this backstop method of monitoring management is impaired by many legal restrictions. The Williams Act, by delaying consummation of tender offers, serves to alert target management to the possibility of a takeover and to give it time to mount defensive measures.¹¹⁵ By requiring offerors to disclose information about themselves, their resources, and their intentions, the Williams Act forces offerors to share costly information with competing acquirers.¹¹⁶ For example, the very fact that a hostile offeror regards a particular company as a target for a takeover is itself information that is extremely valuable and costly to produce. Moreover, the Williams Act contains provisions requiring equal payment to all tendering shareholders¹¹⁷ and a pro rata acquisition of tendered shares,¹¹⁸ requirements that impair an offeror's ability to bargain for large blocks of stock.

There are also numerous state laws that impose various kinds of restrictions on those seeking to acquire control of a corporation. These laws have been passed at the behest of local corporate management,¹¹⁹ and the bulk of empirical studies suggest that

Easterbrook & Fischel, *Proper Role*].

114. See, e.g., GEORGE E. ANDERS, *MERCHANTS OF DEBT: KKR AND THE MORTGAGING OF AMERICAN BUSINESS* 26-27 (1992) (describing one company's decision to allow KKR access to the company's "most sensitive internal data").

115. 17 C.F.R. § 240.14e-1(a) (1992) (requiring that tender offers be held open for at least 20 business days); *id.* § 240.14e-1(b) (requiring the offer to stay open an additional 10 days if the terms of the offer change).

116. *Id.* § 240.13d-1(a) (requiring beneficial owners of more than five percent of a class of equity securities to disclose their backgrounds, sources of funding, and purposes of their acquisitions, including any plans or proposals regarding control of the issuer); *id.* § 240.14d-4(c) (requiring disclosure to shareholders, including prompt disclosure of any material changes). Such regulation decreases the returns on, and thus the frequency of, investor monitoring and hostile bids. See generally Gregg A. Jarrell & Michael Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371 (1980); Jonathan R. Macey & Jeffrey M. Netter, *Regulation 13D and the Regulatory Process*, 65 WASH. U. L.Q. 131 (1987).

117. 17 C.F.R. § 240.14d-10.

118. *Id.* § 240.14d-8.

119. Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 136-38 (1987).

they have caused the value of affected corporations to be diminished by billions of dollars.¹²⁰

Congress has also imposed low visibility restrictions on junk bonds, securities that often facilitate takeovers and the creation of new companies. Savings and loan associations were forced to sell all their junk bonds at the bottom of the market. Amendments to the Internal Revenue Code tax the exchange of junk bonds for other securities during corporate reorganizations,¹²¹ and, finally, the Federal Reserve has sought to limit use of junk bonds by regulation.¹²² Junk bonds are not an obvious item for regulation in the name of investor protection. They are high-yield instruments purchased by the most sophisticated of investors, and many studies reveal them to be profitable.¹²³

A final aspect of the American legal system that raises the cost of capital is management's freedom from any fiduciary obligation to refrain from defensive measures against hostile takeovers that always involve a substantial premium over market price. This was hardly an inevitable development. According to well-established doctrine, where corporate directors or officers may benefit from a corporate transaction, courts will independently scrutinize the fairness of that transaction.¹²⁴ Based on this doctrine, courts could easily have held that when a hostile tender offer has been made, target management, which stands to lose either its jobs or

120. EASTERBROOK & FISCHER, *supra* note 6, at 197-98, 209-11; Roberta Romano, *The Genius of American Corporate Law* (Jan. 12, 1993) (working paper, on file with Yale Law School).

121. See Patricia L. Bryan, *Leveraged Buyouts and Tax Policy*, 65 N.C. L. REV. 1039, 1043 & n.21 (1987).

122. See Securities Credit by Persons Other than Banks, Brokers, or Dealers, 12 C.F.R. § 207.112 (1992) (explaining that "shell corporations" may not issue debt securities to finance more than 50% of the purchase price of a takeover); Bank Holding Companies and Change in Bank Control; Capital Maintenance; Supplemental Adjusted Capital Measure, 51 Fed. Reg. 3976, 3977-78 (1986) (to be codified at 12 C.F.R. pt. 225) (proposed Jan. 31, 1986) (proposing risk-based capital requirements linking primary capital to categories of assets judged to have varying default risks); Monica Langley et al., *Changing the Rules: Attacking Junk Bonds, Fed Becomes a Player in the Takeover Game*, WALL ST. J., Dec. 9, 1985, § 1, at 1; Nathaniel C. Nash, *U.S. Regulators Want Banks to Cover Risky Loans Better*, N.Y. TIMES, Jan. 16, 1986, at A1.

123. See, e.g., Marshall E. Blume & Donald B. Kleim, *Lower-Grade Bonds: Their Risks and Returns*, FIN. ANALYSTS J., July-Aug. 1987, at 26; John J. Curran, *Fewer Jitters About Junk Bonds: The Risks of Default on the Low-Rated Securities, New Evidence Suggests, Are Slim in Relation to the Fat Yields*, FORTUNE, Apr. 29, 1985, at 337, 340.

124. *Fliegler v. Lawrence*, 361 A.2d 218, 219 (Del. 1976). See generally LEWIS D. SOLOMON ET AL., *CORPORATIONS, LAW AND POLICY* 713-14 (2d ed. 1988).

its freedom in running the company, may not do more than give its views to shareholders as to whether to tender their shares.¹²⁵ Alternatively, courts could have allowed management to conduct a fair auction of the company. A debate over the desirability of auctions is ongoing¹²⁶—although outpaced by Delaware decisions—and the courts would have had to fashion rules governing the conduct of such auctions. Nevertheless, even the opponents of auctions would agree that the alternative position is far superior to the law as it has actually developed.

Delaware courts have generally allowed management to engage in defensive measures that amount to a restraint on the alienation of shares. In *Unocal Corp. v. Mesa Petroleum*,¹²⁷ the Delaware Supreme Court held that where management reasonably perceives a takeover to be a threat to corporate policy, it may engage in defensive measures proportional to the perceived threat.¹²⁸ Subsequent decisions allow the use of defensive measures such as poison pills, without a shareholder vote, even where no actual hostile tender offer has been made.¹²⁹

The explanation for these decisions—to the extent any is given—is that the proposed transaction is a fundamental corporate change, for which management has some responsibility under the business judgment rule.¹³⁰ However, the business judgment rule is intended to benefit shareholders by deterring overcautious behavior by management, not to allow management to override shareholder decisions as to their best interests. Controlling who may own shares of a corporation is not a decision regarding the

125. This passivity thesis is described by Easterbrook & Fischel, *Proper Role*, *supra* note 113, at 1201.

126. See, e.g., Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Lucian A. Bebchuk, *The Case for Facilitating Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) [hereinafter *Bebchuk, Tender Offers*]; Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. ECON. & ORGANIZATION 27 (1991); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 869–75 (1981); Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982) [hereinafter *Gilson, Seeking Competitive Bids*]; see also EASTERBROOK & FISCHEL, *supra* note 6, at 209–11 (listing additional sources).

127. 493 A.2d 946 (Del. 1985).

128. *Id.* at 955.

129. See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1349 (Del. 1985).

130. *Unocal*, 493 A.2d at 954; see Easterbrook & Fischel, *Proper Role*, *supra* note 113, at 1194–95.

conduct of the business. Indeed, the view that management can prevent shareholders from selling their shares, particularly at a premium over market price, is based on an unspoken assumption that the corporation is an entity with interests that diverge from those of its shareholders.

Most seem to agree that corporate management may not engage in defensive measures solely to retain control and its position in the company.¹³¹ One vice of *Unocal*, however, is that it failed to recognize that any lawyer with moderate skills can create a corporate record justifying defensive measures. There is virtually no way for a court to distinguish between defensive measures generated by a desire to retain office and defensive measures generated to preserve a corporate policy without regard to who retains office.¹³²

Nevertheless, after *Unocal*, the Delaware Supreme Court for a time seemed ready to force management, when it engaged in defensive measures, at least to auction the firm.¹³³ As I have noted, there are respectable arguments, pro and con, as to whether encouraging auctions is an efficient policy; those arguments have, however, become largely irrelevant in light of a Delaware decision allowing corporate management to "just say no."

In *Paramount Communications v. Time Inc.*,¹³⁴ Paramount sued to cause Time's board to redeem a poison pill so that Time's shareholders could accept Paramount's \$200 all shares, all cash offer. Time's board had refused to redeem the pill, based on its view that a combination with Warner was more valuable than a combination with Paramount. The Delaware Supreme Court held

131. See Bebchuk, *Tender Offers*, *supra* note 126, at 24 ("All the participants in this exchange agree that management should be barred from obstructing tender offers."); Easterbrook & Fischel, *Auctions*, *supra* note 113, at 2-3 (explaining that Gilson and Bebchuk agree "that defensive stratagems for the purpose of preserving the target's independence . . . reduce investors' wealth"); Gilson, *Seeking Competitive Bids*, *supra* note 126, at 52 ("Taken together, our respective articles demonstrate that there is no coherent justification for allowing target management to engage in defensive tactics that may deprive shareholders of the opportunity to tender their shares."). Even Delaware courts give at least lip service to this.

132. *But see* Robert M. Daines & Jon D. Hanson, *The Corporate Law Paradox: The Case for Restructuring Corporate Law*, 102 *YALE L.J.* 577, 604 (1992) (review essay) (proposing a legal rule that would distinguish loyal from disloyal management resistance).

133. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

134. 571 A.2d 1140 (Del. 1990).

that it was not a breach of the Time board's fiduciary obligations to refuse to redeem the pill.

The facts of the case were rather egregious. Once the Paramount offer had failed, Time's shares dropped to \$66, a massive loss to Time's shareholders.¹³⁵ In addition, the court ignored clear conflicts of interest in Time's management. At all times, the sticking points in the Time-Warner negotiations were questions as to who would retain office and at what salaries. As finally negotiated, the merger with Warner included employment contracts for Time's management that had not been part of the Paramount offer. Moreover, the deal had originally been fashioned as an exchange of shares, and Time's representatives had bragged to the President of the United States and the United States Senate that the new corporation would not be laden with debt.¹³⁶ However, once Paramount's bid was launched, Time had to fashion the deal as a purchase of Warner to avoid a vote by Time's shareholders. The result was precisely a debt-laden corporation with a weakened financial structure. Finally, although Time attempted to justify the merger with Warner as necessary to preserve its "culture" of journalistic integrity and independence,¹³⁷ the merger agreement failed to contain terms that guaranteed continuation of the Time tradition of isolating Time Magazine's editor-in-chief from corporate pressure or influence.¹³⁸

The Delaware court held that, in such circumstances, management is free to pursue defensive measures that prevent shareholders from selling their shares to a buyer willing to pay well above existing market price.¹³⁹ The rationale of the decision rejects as unreliable the pricing of capital markets. The court thus stated that "it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock."¹⁴⁰ The court also suggested that management might reasonably conclude—and act on the conclusion—that

135. CLURMAN, *supra* note 54, at 246.

136. *Paramount*, 571 A.2d at 1145-47.

137. *Id.* at 1143 n.4, 1148.

138. CLURMAN, *supra* note 54, at 203-04.

139. *Paramount*, 571 A.2d at 1148-50.

140. *Id.* at 1150 n.12.

Time's investors were ignorant in believing that Paramount's \$200 offer was preferable to Time's purchase of Warner.¹⁴¹

The court was correct that there are many ways to value investments,¹⁴² but the valuation often depends on the purpose for which the valuation is being made. In an eminent domain proceeding involving a piece of property for which there is a very thin market, one may have to engage in considerable speculation and rely on the judgment of experts who can offer only fair guesses. Where there is a market of ready buyers and sellers, the market price, which reflects buyers' and sellers' present understandings as well as future expectations, should prevail. Any notion of value that ignores the views of ready buyers and sellers—so-called “intrinsic value”—has been rightly described as “earth is flat” reasoning.¹⁴³

Time's problem was not that its shareholders were obtuse. Time's problem was that the entire capital market—investors everywhere—valued the Time purchase of Warner as worth less than the merger with Paramount. Otherwise, the price of Time's shares would have risen above \$200 as canny investors bought from Time's ignorant shareholders.

Certainly, expert testimony is not a substitute for a readily ascertainable market price. One expert in the *Time-Warner* litigation predicted a post-merger share price low of \$133 (\$67 off) and a high of \$402 in 1993 (miracles can happen).¹⁴⁴ In fact, a prediction of a high of \$133 would have been overly optimistic. Another analyst, employed by an investment group that was the largest shareholder of both Time and Warner, opined that the Time-Warner merger was more valuable than the Paramount offer.¹⁴⁵ Meanwhile, the group itself was dumping its Time shares.¹⁴⁶

As Delaware law now stands, investors are free to sell their shares at the going market price. However, if a shareholder wants to sell to a buyer seeking control and offering a premium of fifty

141. *Id.* at 1148, 1153.

142. *Id.* at 1150 n.12.

143. EASTERBROOK & FISCHER, *supra* note 6, at 207.

144. CLURMAN, *supra* note 54, at 246 (prediction of Bruce Wasserstein, Time's investment banker).

145. *Id.* at 247 (opinion of Gordon Crawford, of the Los Angeles-based Capital Group funds).

146. *Id.* at 231.

percent above market price, management may prevent the sale. What a country.

III. CONCLUSION

In conclusion, derivative and class actions survive in their present form even though there is little evidence that they benefit investors either through monetary recovery or the deterrence of management from fiduciary breaches or other illegal acts. The only explanation for their survival appears to be the profits they provide to the legal profession. Even more so, civil RICO appears to exist largely to benefit lawyers. Without any conscious intent or evident purpose, civil RICO has displaced well-established common law rules regarding damages, federalized a wide range of state law claims, and perhaps supplanted established federal securities law remedies. Civil RICO reduces the return to investors by increasing legal costs and imposing unnecessary liability, thereby decreasing the level of commercial activity. It is proving, however, to be a fount of work for lawyers.

Harsh sentences under the Guidelines, overly broad definitions of federal criminal laws, and the power to impose forfeiture also exist largely for the convenience of one segment of the legal profession, namely prosecutors. Some commentators state that Congress tends to throw money at problems.¹⁴⁷ When it lacks money and is under pressure to act, it also throws prosecutors at problems and creates areas of discretionary power far in excess of any demonstrated need. Between the breadth of the fraud and money laundering laws, probably every business in the United States could be the subject of at least a partial forfeiture proceeding for essentially trivial conduct. Even a partial forfeiture may doom the company, injuring innocent investors and employees. Overbroad doctrine, moreover, may deter beneficial conduct. The failure of prosecutors, regulators, and the courts to seek legal rules with bright lines also raises the cost of capital by generating costly litigation.

The policy of fragmenting shareholders and preventing concerted action by them exists largely for the benefit of corporate managers who can, as a result, avoid effective monitoring of their performance. As Professor Roe has said, these restrictions may

147. See, e.g., Roe, *Political Theory*, *supra* note 97, at 45-53.

have been adopted in the name of decreasing economic concentration, but their continued existence is due to the political power of corporate management.¹⁴⁸ Of course, restrictions on monitoring cannot bestow immortality on a business; an inefficient management can only prolong the business's decline. In the interim, however, as in the case of General Motors, much wealth is lost, and the lives of many ordinary citizens dependent on the firm are disrupted. There are methods of circumventing the barriers to monitoring, notably the emergence of LBO firms that take over control of companies, but such methods are costly and the freedom of management to thwart hostile takeovers has lessened their effectiveness.

Restrictions on takeovers, such as the Williams Act and state anti-takeover laws, and restrictions on junk bonds, shield corporate management from competitive processes. At the same time, the freedom of management to employ defensive measures that prevent shareholders from accepting hostile tender offers also benefits corporate management and diminishes the return to investors.

Of course, there are also ways to contract around decisions like *Time-Warner*. A legal system that announces that management can thwart investors' decisions to sell on the ground that investors are ignorant cannot be expected to attract capital as easily as a legal system that allows investors to act on their own judgment. To put it bluntly, investors are not as dumb as the Delaware Supreme Court thinks. Investors who know in advance that they may be deprived of the opportunity to sell their shares at a premium will pay less for such shares. Moreover, were a state to emerge with established law preventing such defensive measures, it might attract corporate chartering business from Delaware. Finally, one way of contracting around decisions like *Time-Warner* is to invest in companies that are not subject to the American legal system.

What must be done? Derivative and class actions must be made to pay their way, as it were. Some mechanism, perhaps along the lines I suggested earlier,¹⁴⁹ must be adopted that weeds out meritless claims at the threshold, prevents claims that

148. *Id.*

149. *See supra* text accompanying note 29.

cannot benefit investors from going forward, does not overcompensate weak claims, and does not undercompensate strong claims.

It is probably too late in the day to hope for a narrowing of doctrine under the mail and wire fraud statutes. However, we might at least seek to narrow legislation authorizing forfeiture to situations in which innocent investors will not be injured.

Civil RICO should be repealed or limited to injuries suffered at the hands of inherently criminal organizations. Prosecutors must adopt detailed guidelines as to the circumstances in which capital market regulations will be enforced through criminal proceedings, which must be followed by individual prosecutors.

The acquisition of large blocks of stocks in companies should not be restricted. The threat to the American economy is not domestic economic concentration; it is poorly performing companies. Caselaw permitting management to take actions that restrain the sale of shares by shareholders should be overturned. I am optimistic about this. Delaware is a premier corporate state and its caselaw is thus very disappointing. Nevertheless, Delaware is the only state with a caselaw that allows management such freedom to thwart shareholders' desire to sell to a hostile offeror. That caselaw is not entirely consistent with existing law regarding management's fiduciary obligations in situations in which it may profit from a corporate transaction. It also is based on a wholly invalid notion that a corporation has an intrinsic value separate from the valuations of ready buyers and sellers. Indeed, Delaware's Supreme Court is far more hostile to takeovers than its legislature, and a prior Delaware decision that emphasized the notion of intrinsic value in a different context has become irrelevant through legislative action. If other states decline to follow *Time-Warner*, the Delaware court may reconsider. In any event, a legal regime that is so obviously at odds with the welfare of investors is not likely to survive long.