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### Making America Competitive

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# REVIEW ESSAY

## MAKING AMERICA COMPETITIVE

MICHAEL T. JACOBS, *SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA* (1991) (\$24.95, Harvard Business School Press, Boston, Massachusetts).

MARK J. LOEWENSTEIN\*

### I. INTRODUCTION

*Short-Term America* joins a growing list of books and articles exploring the causes of, and solutions to, America's declining economic fortunes.<sup>1</sup> This book starts from the widely accepted premise that American business is too short-term oriented, with corporate America sacrificing long-term projects and profitability for short-term gains. Jacobs, and many other critics, argue that the root cause of this phenomenon is that investors are overly concerned with the near-term prospects of the corporations in which they invest, making stock prices overly sensitive to short-term information (generally quarterly financial results).<sup>2</sup> Because the stock markets are so focused on the short-term, and corporate management is sensitive to stock market performance, management is highly motivated to maximize short-term results, even at the expense of a corporation's long-term interests.<sup>3</sup> This, in turn, has led to the decline of America's ability to

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1. See, e.g., JAY W. LORSCH WITH ELIZABETH MACIVER, *PAWNS OR POTENTATES: THE REALTY OF AMERICA'S CORPORATE BOARDS* (1989); LOUIS LOWENSTEIN, *WHAT'S WRONG WITH WALL STREET* (1988); John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance, The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

2. See MICHAEL T. JACOBS, *SHORT-TERM AMERICA: THE CAUSES AND CURES OF OUR BUSINESS MYOPIA* 37-38 (1991).

3. *Id.*

compete in the global economy, which has caused many of our current economic woes.<sup>4</sup>

Jacobs provides some support for his premise that American business is too short-term oriented, by noting the volatility and large volume of trading in the stock markets and citing surveys of "[t]he technology community"<sup>5</sup> and the Financial Executives Institute.<sup>6</sup> He also provides anecdotal evidence, stating that America has systematically abandoned capital-intensive technologies with long-term growth potential such as robotics, while our foreign competitors, principally the Japanese and Germans, have exploited these abandoned technologies to their long-term advantage.<sup>7</sup> After establishing, in a few pages, America's "business myopia,"<sup>8</sup> Jacobs spends the remainder of his book examining its causes (primarily the irresponsible investment policies of institutional investors and a weakness in our structure of corporate governance) and cures (a new way for institutional investors to invest and a reformation of corporate governance). Jacobs also discusses the effect of the cost of capital on business decision making and the weakness of United States banking, both noted briefly at the end of this essay.

As this essay will focus primarily on proposals to reform corporate governance, it will discuss only briefly Jacobs's underlying premise that the United States suffers from too much short-term thinking.<sup>9</sup> But it is important to reflect, at least momentarily, on this premise, because so much turns on it.<sup>10</sup> The premise that corporate America focuses too heavily on the short term is not without doubt. First,

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4. *Id.* at 7-8.

5. *Id.* at 8.

6. *Id.*

7. *Id.* at 12-13.

8. *Id.* at 8.

9. Even if corporate management was properly focused on long-term results, reformation of corporate governance might still be in order. Ever since Adolph Berle and Gardiner Means published their landmark book, *The Modern Corporation and Private Property*, in 1932, identifying the separation of ownership from control in the modern corporation, scholars have recognized that this separation is a source of potential economic inefficiency and shareholder abuse, because management is not accountable to the corporation's owners. See Gilson & Kraakman, *supra* note 1, at 873. Thus, increasing accountability might (depending on cost) increase the corporation's efficiency. *Id.* at 865.

10. The notion that corporate America is too short-term oriented is the launching point for much of the current debate in corporate governance and financial reform. It shapes, or at least affects, tax proposals, banking reform, federal fiscal policy, etc.

stock prices represent both long-term and short-term returns (appreciation and dividends) that shareholders can expect from the stock. It may be true that such returns are not "efficiently" incorporated into the stock price, or that many shareholders are concerned only with the near-term returns; but it does not follow that the stock price does not incorporate long-term returns or that shareholder preferences drive management investment decisions. While Jacobs attempts to deal with the effects of shareholder preferences on management, he discounts the fact that the long-term value of a corporation must be reflected in its stock price.<sup>11</sup> Since this is true, management can enhance corporate value with both long-term and short-term projects. The relative profitability of the available alternatives may, however, be of greater importance to the decision-making process.<sup>12</sup>

Second, the myopia premise runs counter to some empirical evidence suggesting that long-term thinking is very much alive in corporate boardrooms across America.<sup>13</sup> Third, there is anecdotal

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11. Jacobs justifies the rationality of stock prices in connection with takeover premiums, acknowledging that "[the stock market] may not fully appreciate long-term investment strategies, but it does not ignore them." JACOBS, *supra* note 2, at 108. Jacobs then cites a 1985 study demonstrating that share prices rise when major capital expenditures are announced. *Id.* This result would not be expected if investors ignored long-term profitability.

12. In this regard, the cost of capital, discussed *infra* in Section III, may be of far greater importance.

13. See ACADEMY INDUSTRY PROGRAM, NATIONAL ACADEMY OF SCIENCES, CORPORATE RESTRUCTURING AND INDUSTRIAL RESEARCH AND DEVELOPMENT (1990). See also OFFICE OF THE CHIEF ECONOMIST, SEC, INSTITUTIONAL OWNERSHIP, TENDER OFFERS, AND LONG-TERM INVESTMENTS (1985) (concluding that statistics do not support the charge that hostile takeovers prompt short-term decision making); John Pound et al., *Are Takeovers Hostile to Economic Performance?*, REGULATION, Sept./Oct. 1986, at 25, 28-30, 55 (refuting critics' charges that hostile takeovers are motivated by short-term thinking). These latter studies conclude that the takeover threats of the 1980s did not cause corporate management to be overly concerned with short-term results. Moreover, Pound et al. concluded, based on a study of research and development expenditures, that high or growing institutional ownership does not "force" corporate managers to prefer activities that enhance short-term earnings over long-term projects. *Id.* at 30, 55. See also Gary Hector, "Yes, You Can Manage Long Term," FORTUNE, Nov. 21, 1988, at 64 (citing both empirical and anecdotal evidence on the subject). But see Thomas L. Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. REV. 137, 184 (1991) ("Measuring empirically the time horizon managers of American corporations use in planning is obviously difficult. Although several studies relating to these issues have been undertaken, the results, perhaps not surprisingly, are in conflict."). While noting the conflicting studies, Professor Hazen concludes that short-term planning has been overly emphasized by corporate investors and managers. *Id.* at 205-06.

evidence that suggests American business actively engages in long-term planning and investment.<sup>14</sup>

Finally, Jacobs never fully explains why shareholder myopia necessarily translates into management myopia. He suggests that management focuses on short-term results because they are easier to explain to shareholders: "corporations strive to produce predictable, consistent quarterly earnings because with disengaged owners, it is simply too difficult to explain unexpected results."<sup>15</sup> Ironically, this is at odds with another theme that runs throughout this book—that, as a practical matter, management is not accountable to the shareholders and cannot be replaced by them, because management controls the corporate election machinery.<sup>16</sup>

Jacobs dismisses the possibility that his underlying premise may be mistaken. He suggests that the economic literature to the contrary, which he does not even cite, is the product of "academics," and true only in theory.<sup>17</sup> As to the counter-anecdotal evidence, including American success in capital-intensive industries such as aerospace and pharmaceuticals, Jacobs responds that these are special cases with special explanations.<sup>18</sup> Further, he makes no reference to the voracious appetite of American investors for initial public offerings in the biotechnology area, where returns are highly speculative and long term.

What seems to be lacking in the area of corporate manager behavior is a different sort of research—research that studies what corporate managers think they are doing, how they go about deciding what projects to fund, etc.<sup>19</sup> All too many of the conclusions that

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14. See LORSCH, *supra* note 1, at 44 (citing the authors survey of Fortune 1000 directors, over 70% of whom cite long-term outcomes for the corporation as the most important consideration in corporate decision making); Hector, *supra* note 13. See generally GORDON DANIELSON & JAY W. LORSCH, *DECISION MAKING AT THE TOP 30* (1983) (discussing corporate managers' interests in perpetuating their companies).

15. JACOBS, *supra* note 2, at 38.

16. *Id.* at 83-95.

17. *Id.* at 9.

18. *Id.* at 13-14.

19. There is no dearth of fine books on corporate governance. See, e.g., CHARLES A. ANDERSON & ROBERT N. ANTHONY, *THE NEW CORPORATE DIRECTORS: INSIGHTS FOR BOARD MEMBERS AND EXECUTIVES* (1986); LORSCH, *supra* note 1; MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* (1971); STANLEY C. VANCE, *CORPORATE LEADERSHIP: BOARDS, DIRECTORS, AND STRATEGY* (1983); JAMES C. WORTHY & ROBERT P. NEUSCHEL, *EMERGING ISSUES IN CORPORATE GOVERNANCE* (1983). These books, however, tend to avoid the sort of research suggested in the text.

American business is too short-term oriented are reached without ever asking the actors who are involved. Even the surveys that Jacobs cites essentially ask people what they think other people are doing, not what they are doing.<sup>20</sup>

Recent work by two legal anthropologists, Professors John M. Conley and William M. O'Barr, studies institutional investors using anthropological methods consisting of intensive observation and open-ended interviewing.<sup>21</sup> This work suggests some conclusions about institutional investors and their investment horizon that are at odds with the conventional wisdom that institutional investors are too short-term oriented and are driving corporate management to "short-termism." This theme is central to the thesis of *Short-Term America*.<sup>22</sup> Jacobs may be right in his premise, but it seems that much additional analysis needs to be done in this area before we can be certain that the causes of America's lack of competitiveness are being properly diagnosed.<sup>23</sup>

## II. THE CAPITAL MARKETS AND CORPORATE GOVERNANCE

*Short-Term America* starts from the premise that many of America's companies are poorly managed, in large part because there is insufficient monitoring (indeed, virtually no monitoring) by the companies' shareholders.<sup>24</sup> Jacobs states that today's investor does not act like a responsible investor should: selecting companies based on their fundamentals, following the companies closely after investing in them, and thoughtfully exercising the right to vote the shares purchased.<sup>25</sup> Rather, according to Jacobs, the typical purchaser of publicly-traded stock is interested either in short-term results, and

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20. See JACOBS, *supra* note 2, at 8.

21. WILLIAM M. O'BARR & JOHN M. CONLEY, *FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING* (1992). An essay, based on the book has been published. John M. Conley & William M. O'Barr, *The Culture of Capital: An Anthropological Investigation of Institutional Investment*, 70 N.C. L. REV. 823 (1992).

22. Conley & O'Barr, *supra* note 21, at 839-41.

23. See LORSCH, *supra* note 1. Lorsch's work is similar to that of Professors Conley and O'Barr, but draws heavily on surveys and interviews of corporate directors. While quite valuable and useful, it is not a substitute for the more anthropological-type of study being suggested here.

24. JACOBS, *supra* note 2, at 10.

25. *Id.* at 31-39.

trades a stock based upon a company's short-term profits and losses,<sup>26</sup> or purchases a stock only because it is part of an index of stocks.<sup>27</sup>

The money managers for the nation's pension funds are guilty of both types of investment failures and are the villains in the book.<sup>28</sup> The performance of these money managers is under close scrutiny; if they fail to produce handsome quarterly returns, they are subject to being replaced. This reality, Jacobs asserts, causes money managers to eschew long-term investing: "Rather than investing long term in fewer companies that could be followed closely, money managers engage in active trading of broad portfolios, which is more likely to produce consistent quarterly results."<sup>29</sup> Ironically, neither this nor any other trading strategy has enabled money managers to outperform the market,<sup>30</sup> causing money managers to turn increasingly to indexing by investing in a broad range of stocks having an

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26. *Id.* at 31. Jacobs paints a picture of a legion of investors analyzing quarterly reports and then trading solely on the basis of those reports. If a corporation earns less in a particular quarter than analysts had expected, Jacobs would predict a large selling effort to commence. *Id.* at 37. There is no empirical basis for this assertion. Moreover, the "quarterly" phenomenon does not explain the daily trading volume in corporate stocks. Obviously, something more than the most recent earnings report is driving daily buy and sell decisions. Current information may be a signal to investors that their long-term assessment of a company's prospects were mistaken, and this may cause some traders to buy or sell the stock. Undoubtedly, short-term prospects of a company may stimulate trading in its stock, but other factors may predominate.

27. *Id.* at 54-57.

28. *Id.* at 50-51.

29. *Id.* at 51. It is startling that a money manager could achieve (or believe she could achieve) consistent quarterly results with more active trading. Intuitively, the opposite would seem to be the case—results would be more consistent with less trading. If it is true that money managers engage in active trading to achieve consistent results, and it seems to be true that they engage in active trading, it would be interesting to know the theory under which they are operating. For instance, if Company A reports higher than expected quarterly results, does the money manager acquire that stock, figuring that the next quarter will also exceed expectations, and cause yet a higher stock price, or does she sell, figuring the stock price has absorbed all the increase that the market will give it, and buy a stock that had disappointing earnings? The reader is left to speculate on what this means as a practical matter and accept the notion that money managers are churning stock to enhance short-term returns in their portfolios.

30. The inability of pension fund managers to outperform the Standard & Poor's 500 (S&P 500) is widely known. Lest there be any doubt, a recent study by the Brookings Institute reconfirms this proposition. This study found that in 1989, for instance, 61% of actively managed pension funds had a return lower than the S&P 500. Josef Lakonishok et al., *The Structure and Performance of the Money Management Industry*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY 339 (1992).



overall performance will mirror the market's performance. Typically, an index fund will hold the stocks of the Standard & Poor's 500 and/or some other common measure of the stock market's performance, such as the Wilshire 5000, with the result that a fund will own the shares of hundreds of companies.

In terms of America's competitiveness, both short-term investing and indexing are evils, because in each case the investor is unconcerned with the company's fundamentals, the skills of its management, or its long-term prospects. This investor indifference, in turn, has caused corporate management to view the company's shareholders with indifference, or even contempt,<sup>31</sup> making it easy for management to adopt measures that entrench itself in power.<sup>32</sup> Surprisingly, Jacobs never links these inconsistencies. If corporate management is indifferent to the shareholders, why is it so driven to satisfy them by generating short-term profits at the expense of the long-term well being of the corporation? Jacobs recognizes one possible explanation, the threat of a hostile takeover, cannot provide the answer, as this threat has largely abated.

During the 1980s, hostile takeovers provided some market discipline for incompetent management. If a company's assets were not being employed to their greatest and best use, the market price of the company's stock would reflect this underutilization and provide an opportunity for a profitable takeover. The unavailability of financing, structural defenses adopted by companies (chiefly, though by no means exclusively, in the form of "poison pills") and changes in state laws have made the hostile takeover a much less common phenomenon. In any event, the market for corporate control was inefficient as a monitoring device, since relatively few companies were affected, while many (presumably) were poorly managed.<sup>33</sup>

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31. See, e.g., Sarah Bartlett, *Big Funds Pressing for Voice in Management of Companies*, N.Y. TIMES, Feb. 23, 1990, at A1, D5.

32. Most large, publicly-held companies now have in place "poison pills" that, in effect, make a hostile takeover impractical without the approval of the target board or judicial intervention. Other structural impediments that many companies have adopted to make a change of control more difficult to achieve include a staggered board of directors, in which only a third of the directors are up for election in a year, and so-called "shark repellent" charter provisions such as supermajority voting provisions, requiring a greater number of votes than the statutory minimum to approve mergers and other transactions that an acquirer might desire.

33. See also John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV.

Moreover, there is a good deal of empirical evidence indicating that the threat of a hostile takeover did not motivate corporate management to focus excessively on the short term.<sup>34</sup>

Jacobs has little regard for the corporate board of directors, the institution that is supposed to provide the monitoring and direction that he finds so lacking. He is correct, of course, in noting that the boards of large companies typically consist of chief executive officers (CEOs) of other large publicly-traded companies, presidents of highly visible nonprofit institutions and senior officers of the company itself.<sup>35</sup> The non-employee, or "outside," directors do not have the time or the incentive to take an active role in monitoring the performance of the company's officers.<sup>36</sup> The directors tend to be handpicked by the CEO and have little stake in the company they are directing (in either the form of stock ownership or otherwise).

This, then, is the principal problem that Jacobs seeks to address in *Short-Term America*—how to alter our patterns of investment and system of corporate governance so that there will be someone in place to monitor, and thereby improve, the performance of corporate management.<sup>37</sup> Corporate boards of directors, as currently constituted, are inadequate, lacking the incentive and the wherewithal to undertake the task. Shareholders, even those institutional investors who own large portions of their portfolio companies' stock, also lack the necessary incentives and resources to do the job. Moreover, in the case of shareholders, there are numerous laws and regulations that discourage the inter-shareholder communication that would be necessary for them to exercise their voting rights in a concerted fashion, were they so inclined.<sup>38</sup>

Against this backdrop, Jacobs proposes reforms that would, among other things, change the way institutions invest, directors are

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1145, 1192-95 (1984) (describing the deterrent impact of hostile takeovers); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1497-99 (1989) (noting the pitfalls of the takeover market).

34. See Pound et al., *supra* note 13.

35. JACOBS, *supra* note 2, at 81.

36. See generally LORSCH, *supra* note 1, at 23-30 (explaining the reasons for rejecting an offer of board membership).

37. JACOBS, *supra* note 2, at 225-31.

38. *Id.* at 83-95. See LOWENSTEIN, *supra* note 1, at 99-118. Responding to increasing concern in this area, the Securities and Exchange Commission (SEC) has proposed some modest reforms to facilitate inter-shareholder communication. Regulation of Communications Among Securityholders and Executive Compensation Disclosure, 57 Fed. Reg. 29,564 (1992) (to be codified at 17 C.F.R. §§ 240, 249).

elected, and executives are compensated. Each of these proposals has some merit and is worthy of comment.<sup>39</sup>

#### A. Institutional Investment Practices

Jacobs proposes that institutional investors pool a portion of their funds to create "investment partnerships" that would invest in selected corporations on a long-term basis, providing the sort of counselling that corporations currently lack.<sup>40</sup> Jacobs contends that

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39. Jacobs also suggests the necessity of major reform of our system of commercial banking and some minor changes in shareholder voting laws. JACOBS, *supra* note 2, at 10-11. With respect to the banking industry, reforms generally should be designed to encourage greater participation by the banks in the business of their commercial borrowers, thereby (hopefully) realizing some of the advantages of the German and Japanese banking systems, where banks provide oversight and guidance, as well as capital. *Id.*

With respect to shareholder voting, Jacobs proposes two changes (in addition to his proposals regarding the election of directors). First, he suggests that shareholders should be able to change the corporation's state of incorporation, by a majority vote. *Id.* at 99-100. Jacobs believes that states would then compete with one another to pass laws most favorable to the shareholders. *Id.* Second, Jacobs suggests that matters on which shareholders vote be determined by a plurality of the votes cast, rather than requiring that motions be passed by a majority of the shares outstanding. *Id.* at 89-90. The policy of this proposal is to reverse current law that, in effect, treats non-voted shares as negative, so that shareholder initiatives fail even when a majority of the shares voted favored the initiative. These are fairly minor matters that do not require lengthy comment.

As to reincorporation (the technical term for changing the state of incorporation), the decision is generally left to a majority vote of the shareholders. A reincorporation is effectuated by creating a shell corporation in the state in which the corporation desires to reincorporate, and then merging the existing corporation into the shell corporation. The shell corporation is the surviving entity, with all of the assets and liabilities of the original corporation. Generally, a merger requires a vote of a majority of the outstanding shares of the corporation. *See, e.g.*, REVISED MODEL BUSINESS CORP. ACT § 11.03(e) (1984).

Although shareholders cannot generally initiate mergers, an improved system of corporate governance would seem to minimize this shortcoming and render it moot. If corporate governance remained unchanged, shareholders would enjoy little benefit from the ability to change the state of incorporation. Moreover, it seems unrealistic to expect that many reincorporations would take place, given the logistical difficulties of the process. Consequently, it is unrealistic to expect competition among the states for more "shareholder friendly" statutes.

As to the plurality vote proposal, Jacobs is a bit behind the times. A committee of the American Bar Association made such a recommendation in connection with its proposed revision of the Model Business Corporation Act in 1984, and that proposed revision is slowly becoming law throughout the United States. *See id.* § 7.25(c). In any event, this proposal, too, is minor in comparison to meaningful reform in corporate governance.

40. JACOBS, *supra* note 2, at 219-25.

by investing in several such partnerships, a pension fund will achieve both diversification and meaningful corporate ownership, satisfying two key investment objectives.<sup>41</sup> Most importantly, these newly-created investment partnerships, by virtue of their "ownership" role that contemplates board membership, will realize above-average returns on their investments.<sup>42</sup>

In essence, Jacobs is trying to duplicate the success of Warren Buffett with this proposal.<sup>43</sup> Buffett's company, Berkshire Hathaway Inc., is such an investor. Berkshire Hathaway is well-known for its technique of investing large sums of money in a few corporations and then playing an active role on the boards of those companies. As a result of its ability to pick good companies in which to invest, or its ability to provide valuable help to those companies, or both, Berkshire Hathaway has been able to realize above average returns for its investors. Naturally, Jacobs believes the success of Berkshire Hathaway is attributable more to its patience and good counsel than to its ability to select stocks.<sup>44</sup>

Regardless of whether Jacobs's assertion that Berkshire Hathaway's success is attributable to its post-investment activities is correct, one might reasonably wonder why more such investment vehicles have not emerged from Wall Street. If nothing else, Wall Street has a knack for providing new products to fill every conceivable demand. Wall Street's failure to produce investment vehicles resembling Berkshire Hathaway suggests that the nation's pension funds are not really interested in such a form of investment, despite its potential benefits.

Even assuming that the funds would invest in these new partnerships, there are some reasons to be skeptical of this proposal. Would the portfolio companies welcome their new partners? Would the investment partnerships be able to influence management? Who would monitor the management of the investment partnerships? Most importantly, is there any reason to believe that the organizers of these investment partnerships will have the skill of Warren Buffett? Buffett may be successful not only because he is a long-term investor who is able to command the respect of, as well as influence, corporate managers, but also because he has particularly good instincts in this area. Buffett is unique, and it is unlikely that there are many individuals possessing both his skill and instinct.

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41. *Id.* at 220-22.

42. *Id.* at 224-25.

43. *See id.* at 222.

44. *Id.*

As a practical matter, one must also wonder from where this cadre of super counsellors will arise.<sup>45</sup> By definition, the managers of investment partnerships must be astute investors and capable managers, able to monitor full time the companies in which they invest. These counsellors will have to be different from the individuals who currently serve on corporate boards as independent directors, who have already proven unworthy of the task. Thus, recycled CEOs, and the like, will be in little demand. And, this cadre will have to be large, as the nation's pension funds have several hundred billion dollars to invest,<sup>46</sup> and several hundred companies in which to invest.

Despite these criticisms, the idea is a good one. Whether or not America's corporations are being properly managed from a long-term perspective, it appears that there is something seriously wrong in America's boardrooms. A symptom of this disfunction is executive compensation, the extravagance of which suggests a callous disregard on the part of corporate boards toward their fiduciary duties. Executive compensation has risen dramatically over the past several years,<sup>47</sup> and this rise does not seem to be driven by market forces or explained by corporate performance.<sup>48</sup> CEOs of comparably large Japanese and German companies earn a fraction of what their American counterparts earn.<sup>49</sup>

The explanation of this phenomenon invariably focuses on the failure of the board of directors. Theoretically, the typical board

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45. The increase in pension fund assets and an increased interest in corporate governance on the part of pension fund managers has given rise to a growing industry of companies that consult with pension funds on matters of corporate governance and proxy voting. Companies such as Institutional Shareholder Services, Inc., Analysis Group, Inc., and Institutional Voting Research Service provide this type of consulting services.

46. Actually, pension fund assets now exceed \$2.5 trillion. James A. White, *Giant Pension Funds' Explosive Growth Concentrates Economic Assets and Power*, WALL ST. J., June 28, 1990, at C1. Institutional investors as a group control assets in excess of \$6 trillion. William Taylor, *Can Big Owners Make a Big Difference?*, HARV. BUS. REV., Sept.-Oct. 1990, at 70.

47. Compensation of CEOs has tripled over the last decade. See John A. Byrne et al., *Executive Pay*, BUS. WK., Mar. 30, 1992, at 52. Surveying the 1991 proxy statements of 350 large companies, a *Wall Street Journal* article concluded that median CEO pay, including salary, bonuses, and long-term incentives, was \$1.3 million in 1991. *The Boss's Pay*, WALL ST. J., Apr. 22, 1992, at R9 (Executive Pay Supplement) (compiled by Towers Perrin).

48. Graef S. Crystal, *The Great CEO Pay Sweepstakes*, FORTUNE, June 18, 1990, at 94; Michael C. Jensen & Kevin J. Murphy, *CEO Incentives, It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138.

49. *Fat Cats in U.S. Outearn Japanese*, JAPAN TIMES WEEKLY INT'L ED., Feb. 10-16, 1992, at C2 (Kazuko Takahashi trans.)

should be able to set the pay of its CEO at a fair amount. Generally, executive compensation is determined by a committee of the board that does not include employees of the company and is advised by an independent compensation consultant. But, it is doubtful that CEO pay that is determined in this manner is the best deal for the shareholders for several reasons. First, most board members owe their positions on the board, directly or indirectly, to the CEO whose compensation they are fixing. Of equal importance, many of these directors are themselves corporate CEOs and, therefore, have an interest in seeing CEO compensation rise.<sup>50</sup> Finally, the compensation consultant is often appointed by the CEO. Thus, the directors and the consultant have a built-in bias in favor of higher compensation for the CEO than he or she might be willing to accept.

The executive pay scandal suggests that the CEO dominates or controls the board, rather than the reverse.<sup>51</sup> This relationship was frequently confirmed during the 1980s, when boards acted to preserve management's position in the face of attractive takeover offers<sup>52</sup> or approve management-initiated buy-outs that were not in the best interests of the company's shareholders.<sup>53</sup> Proposals changing the composition of the board of directors to increase the representation of those who would not be dominated by or beholden to the CEO would provide changes for the better. Jacobs's second proposal deals more directly with this.

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50. See LORSCH, *supra* note 1, at 18 (63% of all Fortune 1000 outside directors are chief executive officers of other corporations).

51. The Business Roundtable, which consists of CEOs of America's largest corporations, would institutionalize this relationship, at least according to its 1990 report on corporate governance. The Business Roundtable, *Corporate Governance and American Competitiveness*, Mar. 1990, at 13-14, reprinted in 46 BUS. LAW. 241-52 (1990). See generally Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 STETSON L. REV. 197, 221-24 (1991) (discussing the differences between the Business Roundtable's 1978 and 1990 reports and concluding that the 1990 report recommends increasing a CEO's authority, while decreasing a CEO's accountability to shareholders).

52. In many of these cases, the courts intervened to set aside, or at least question, the defensive action. See, e.g., Mark J. Loewenstein, *Toward an Auction Market for Corporate Control and the Demise of the Business Judgment Rule*, 63 S. CAL. L. REV. 65, 90-91 n.87 (1989) (containing a collection of these types of cases).

53. See, e.g., Minow, *supra* note 51, at 214-17 (noting some of the more egregious cases of management-initiated buy-outs). See also Mark J. Loewenstein, *Book Review*, 15 DEL. J. CORP. L. 135 (1990) (reviewing ARTHUR FLEISCHER, JR. ET AL., *BOARD GAMES* (1988)) (refuting the claim that boards of directors act independently from the influence of the corporation's management).

### B. Election of Directors

Jacobs proposes that shareholders be provided greater access to the corporation's proxy statement in order to facilitate the election of their nominees for directors. He implies that greater shareholder involvement in the election of directors is almost a panacea to the shortcomings in corporate governance: "With effective representation, all other issues will fall into place."<sup>54</sup> Jacobs makes two suggestions to allow for increased shareholder involvement in corporate governance. First, he proposes that SEC rules, which effectively prohibit large shareholders from coordinating their voting activities without full disclosure, be repealed.<sup>55</sup> Second, any "group" owning at least five percent of the outstanding stock of a company should be allowed to nominate "someone" to serve on the board and "provide a brief statement in the proxy as to why they have proposed this person for the board."<sup>56</sup>

These proposals are far too modest. There is no thought in these proposals about how large a representation, in terms of the *proportion* of board membership, that the "shareholders" ought to have. On a board of directors with fifteen or so members,<sup>57</sup> one might question whether one person is likely to have much influence. Moreover, given the propensity of boards to maneuver around reform, it is not unlikely that the size of the typical board would expand through bylaw amendment, diluting the effect of the new outsiders.

One might reasonably wonder why a five percent group of shareholders (or maybe a somewhat higher percentage) ought not to have the right to nominate a full slate of directors with corresponding access to the proxy statement.<sup>58</sup> Or, to take the proposal one step further, why not *limit* both the right to nominate directors and the right of access to the proxy statement to such shareholders? Management would then be foreclosed from nominating individuals to

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54. JACOBS, *supra* note 2, at 226.

55. *Id.* at 227-28.

56. *Id.* at 228. The proposal that a five percent shareholder be able to nominate directors is not a novel suggestion. See MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 117-21 (1976).

57. The average size of the board of directors for the Fortune 1000 companies is 13. LORSCH, *supra* note 1, at 19 (citing HEDRICKS & STRUGGLES, INC., *THE CHANGING BOARD* 2 (1987)).

58. See, e.g., George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881 (1989).

the board unless it owned, in the aggregate, the requisite percentage of shares.<sup>59</sup>

The implication of Jacobs's modesty is that he does not fully trust shareholders with the power to select the board. In this respect, he has much in common with most people proposing reforms in corporate governance. For instance, one popular proposal calls for the creation of shareholder advisory committees, which would consist of holders of large amounts of shares or their designees.<sup>60</sup> As characterized by one commentator, "[t]he purpose of the committees would be to provide a forum through which shareholders could communicate with board members and '[to] institutionalize a procedure for developing and communicating shareholder input.'"<sup>61</sup>

In addition to being modest, a shareholder advisory committee is likely to be ineffectual. Such committees would consist of the large shareholders, including representatives from the trust departments of large banks, public retirement plans and the College Retirement Equity Fund.<sup>62</sup> It is doubtful that many of these representatives would have the necessary expertise to make a meaningful contribution to the corporations that they would be advising. More importantly, would these representatives have access to the necessary information and would they devote the necessary time and resources to the position even if they had the requisite training and expertise? Given the free rider problem, would it be worth the time of any individual shareholder who owns a tiny percent of the outstanding stock to undertake this effort, especially when there is no assurance that the advice will have an impact on the ultimate decisions of the board and man-

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59. It is unfortunate, in my view, that so many shares of stock have been given outright to corporate management in recent years. These giveaways, which are part of executive compensation plans and intended to align management's interest with the shareholders', are ill-advised and excessive. They are ill-advised because increasing management's ownership interest in the corporation might well have the effect of encouraging management to be too conservative. The giveaways are excessive because, in some cases, they have had the effect of shifting significant control and staggering value to management, diluting the holdings of shareholders who paid cash for their ownership interest. *See, e.g.,* Coffee, *supra* note 1, at 16-24 (noting that management controlled firms are more likely to be risk adverse and that such firms tend to retain earnings).

60. *See* Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N.C. L. Rev. 1135, 1135-40 (1991).

61. *Id.* at 1139 (quoting proxy statement of Avon Products, Inc., at 25 (Mar. 30, 1990)).

62. *See id.* at 1175-87 app. A.



agement? These and other doubts about the proposal have led some commentators to conclude that the advisory committees would “merely formalize existing management-shareholder exchanges” already in place in many companies and add little else.<sup>63</sup>

The tentative nature of Jacobs’s proposal calling for shareholder advisory committees is also a common characteristic of the proposals of other prominent commentators. Focusing on the same problems discussed by Jacobs, Columbia University Law Professor Louis Lowenstein proposed that shareholders be empowered “to nominate, separately from the nomination of directors generally, a significant but still minority number of additional directors, e.g., 20-25 percent of the board.”<sup>64</sup> Lowenstein envisions that these “very independent” directors, as he calls them, would engage in an ongoing dialogue with management, sharing their insights into how the corporation might be better managed.<sup>65</sup>

Although these directors would be equal to the “regular” directors in terms of voting power and access to information, they might end up with the influence of a shareholder advisory committee. Bearing in mind that “outside” directors are regularly criticized for spending too little time on the job of directing, it is fair to ask whether these “very independent” directors would spend more time. Like the members of the shareholder advisory committees, the directors nominated by the large shareholders would have other, more pressing commitments than serving as “very outside” directors. Furthermore, even if they had the time, would they have the necessary expertise? The very idea that shareholders should nominate only one director (Jacobs’s proposal) or a quarter (Lowenstein’s proposal) of the board suggests some serious doubt about the capabilities and effectiveness of these “shareholder directors.”

A more direct approach is set forth in a recent article co-authored by Martin Lipton and Steven Rosenblum, partners in a New York law firm well-known for advising corporations involved in control contests.<sup>66</sup> Lipton and Rosenblum believe that the specter of a possible

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63. Gilson & Kraakman, *supra* note 1, at 872.

64. LOWENSTEIN, *supra* note 1, at 209.

65. *Id.* at 210-11.

66. Lipton & Rosenblum, *supra* note 1. The authors are partners in the New York law firm of Wachtell, Lipton, Rosen & Katz.

takeover, among other things, has caused corporate management to become obsessed with short-term profitability in order to keep the stock price high.<sup>67</sup> To enable management to better focus on the long term, they recommend that the directors face the shareholders only once every five years, rather than annually.<sup>68</sup> The authors would combine this with a few other key reforms, including a change in the takeover laws prohibiting a change of control between “quinquennial” elections except under extraordinary circumstances,<sup>69</sup> and greater access to the quinquennial proxy statement for large shareholders.<sup>70</sup> Thus, the quinquennial election becomes a referendum on the success, or failure, of corporate management over the previous five years.<sup>71</sup> Presumably, shareholders will carefully study corporate results over the past five years, compare them to management’s plans and projections, and then decide whether a change of direction is in order.<sup>72</sup>

The Lipton-Rosenblum proposal, though interesting, is seriously flawed. It does not promise better or more effective monitoring from the board of directors because that institution would remain virtually unchanged. Lipton and Rosenblum express the hope that boards would be motivated to do a better job because they will face a “real” election after a period of time, motivating them to work more closely with the shareholders who vote in that election.<sup>73</sup> But the problem in corporate governance is not that directors lack the motivation to do well, but rather that they are not equipped to do well.

A somewhat more aggressive, and promising, proposal has been made by Professors Ronald Gilson and Reinier Kraakman. They propose the creation of a “core of professional directors.”<sup>74</sup> The Gilson-Kraakman proposal is similar to the Lowenstein proposal, in that it seeks to elect a minority of directors to a board; however, it departs from Lowenstein’s and other proposals by identifying a source for these directors. Gilson and Kraakman suggest that institutional

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67. *Id.* at 188, 208. Lipton and Rosenblum also believe that the short-term investing practices of institutional investors is an additional cause of corporate management’s short-termism. *Id.* at 205-13.

68. *Id.* at 225-30.

69. *Id.* at 225-26, 229-30.

70. *Id.* at 226.

71. *Id.* at 225.

72. *Id.*

73. *Id.* at 227.

74. Gilson & Kraakman, *supra* note 1, at 883.

investors, who already have the votes to elect directors, elect people who would *be in the business of directing companies*.<sup>75</sup> Although such a cadre of professional directors does not now exist, they speculate that one could be developed either by a clearinghouse organized by institutional investors or by the pioneering efforts of one or more institutions.<sup>76</sup> These professional directors would come from the business world (for instance, senior partners at major accounting firms) and would limit themselves (or be limited by the clearinghouse) to approximately six directorships each.<sup>77</sup> The aggregate pay from this number of directorships would be significant enough to induce qualified people to undertake this career.<sup>78</sup> Because each director would sit on the boards of several corporations, they would be independent of each individual corporation.<sup>79</sup> Most importantly, these professional directors would be dependent on, and accountable to, the shareholders who elected them.<sup>80</sup>

### C. *Executive Compensation*

Consistent with the theme of *Short-Term America*, Jacobs seeks to redesign executive and director compensation in order to enhance long-term corporate profitability. For instance, Jacobs recommends that senior executives receive roughly one-half of their compensation in long-term incentives such as restricted stock that would vest over a five year period if certain standards are reached.<sup>81</sup> Jacobs suggests that one governing standard might be whether the market price of the stock increases by twenty percent per annum.<sup>82</sup> If this condition occurs, twenty percent of the restricted stock would be allocated to the executive.<sup>83</sup> If the stock doubles over a five year period, all of the stock under the plan would vest.<sup>84</sup> This proposal is ironic. If annual vesting is based on stock price, and a large portion of the executive's compensation is tied to stock market performance, management might become even more short-term oriented, especially if it still views the investment community as short-term oriented. A

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75. *Id.* at 885-86.

76. *Id.* at 886-88.

77. *Id.* at 885-86.

78. Gilson & Kraakman, *supra* note 1, at 885.

79. *Id.* at 886.

80. *Id.*

81. JACOBS, *supra* note 2, at 241.

82. *Id.* at 242-43.

83. *Id.* at 242.

84. *Id.* at 243.

prospective investment that would not bear returns for five or ten years might become less attractive to an officer who is highly dependent on the stock price in a year or less. On the other hand, an investment with an immediate return, enhancing quarterly profits for the next eight quarters, might be more attractive if the manager is thinking about his or her own interests.

There is a second, fundamental problem with this proposal. This proposal ignores broader economic factors that heavily influence stock market prices. In a global economy, political upheaval in one part of the world can affect world-wide interest rates, which, in turn, can affect world-wide stock market prices. For example, the recent oil price shocks had a dramatic effect on a number of industries and stock prices. Stock market prices do reflect the fortunes of a publicly-held company over the long term. But, for these purposes, five years is not a long term. Similarly, this proposal ignores the effect of business cycles that even the best managed firms cannot avoid.

Finally, a proposal in which management is so heavily invested in the corporation can have negative effects for the company's shareholders. Shareholders are diversified in their investments and are generally risk neutral with respect to any individual investment. In comparison, corporate managers are heavily invested in both their personal wealth and human capital in the company for which they work. If the firm fails, they have far more to lose than the typical diversified shareholder.

For these and other reasons,<sup>85</sup> corporate managers tend to be risk averse. This course of conduct is quite often contrary to the shareholders' interests. For instance, a risk averse attitude may cause a manager to avoid leverage and finance growth through internally-generated funds.<sup>86</sup> This attitude also discourages managers from investing in risky, long-term projects, when the alternatives assure the continued viability of the firm. Moreover, risk aversion creates an incentive for corporate managers to diversify the firm, investing in other businesses in order to reduce the manager's loss resulting from business cycles. Each of these courses of action is, or may be, adverse to the long-term interests of shareholders. Yet each is an

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85. For example, managers risk their jobs while shareholders merely risk their investment. Moreover, managers risk personal liability in the event of corporate failure or financial distress. Coffee, *supra* note 1, at 17-19.

86. Corporate directors and senior management face potential liability that shareholders do not. *See id.* at 21.

understandable consequence of corporate managers' risk aversion. Jacobs's proposal would only exacerbate this phenomenon because his solution increases the manager's stake in the firm.<sup>87</sup>

If it is true that managers are risk averse in relation to shareholders and this risk aversity negatively affects shareholders, it would seem prudent to modify the compensation in order to close the differential. Such a compensation arrangement would assure the manager long-term employment, some incentive compensation based on meeting long-term goals and some disincentives for undertaking policies that seek to minimize the manager's personal risks, such as unnecessary corporate diversification. But these anticipated results may be too much to ask of a compensation arrangement. What this suggests is that corporate managers need a strong counter-weight in the decision-making arena and that there is no substitute for a board of directors or some other monitoring arrangement that will assume more of the authority and responsibility for the direction of the corporation.

To boost this sense of responsibility, Jacobs proposes that outside directors be compensated solely in corporate stock, in order to align the directors' interests with those of the shareholders.<sup>88</sup> But implicit in this proposal is the assumption that compensation, and specifically stock compensation, would motivate individuals to serve on corporate boards *and* affect their decision-making process. Unfortunately, there is empirical evidence that neither compensation nor stock ownership motivates individuals to accept corporate directorships.<sup>89</sup> If this is true, then paying directors solely in corporate stock would be unlikely either to attract directors or influence their decisions.

Even assuming that stock would motivate outside directors to make the sort of decisions that better reflect the long-term interests of the corporation, large amounts of stock may be required to accomplish this goal. Outside directors, after all, tend to be wealthy

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87. Another aspect of the Jacobs's proposal is that the amount of the executive's base compensation be reduced drastically—he suggested a base of \$250,000 annually for the CEO of a large publicly-held company. JACOBS, *supra* note 2, at 241. This might make the executive even more risk averse, as the stock portion of his compensation becomes relatively more significant to him.

88. *Id.* at 243.

89. See LORSCH, *supra* note 1, at 26. In fact, the survey of Fortune 1000 directors conducted by Professor Lorsch disclosed that compensation was the second least important reason (among nine) for accepting a directorship, and major stock ownership was the least important. The intellectual stimulation and exposure to new ideas were the most important factors. *Id.*

individuals whose primary source of income is outside of the corporation. Because these individuals would naturally value stock lower than cash, and because by definition the amount of stock would have to be material in relation to the director's personal wealth, the cost to the corporation may be significant.

On the other hand, it may be that a lesser amount of stock would be sufficient to give directors a psychological identification with the corporation that is currently lacking. One commentator has speculated that stock ownership would "strengthen the directors' sense of purpose and their resolve to work actively together."<sup>90</sup> The proposal is not costly and is unlikely to do any harm. It is, therefore, worth trying. Again, however, this proposal is not a substitute for more meaningful reform in the composition of corporate boards.

### III. THE COST OF CAPITAL: A SUBSIDIARY CAUSE OF SHORT TERMISM?

A second cause of business myopia, discussed at some length in the book, is one that is long-standing: the cost of capital in the United States exceeds the cost of capital for our competitors.<sup>91</sup> Here, Jacobs is on well-plowed ground; much has been written on the relative cost of capital in the United States and abroad, and this literature fairly consistently concludes that the cost of capital, particularly equity capital, is higher in the United States.<sup>92</sup> Jacobs seeks to explain why equity capital is more expensive than debt<sup>93</sup> and why American companies face a higher cost of equity capital than foreign competitors.<sup>94</sup> Jacobs also discusses his own view that American

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90. *Id.* at 177.

91. JACOBS, *supra* note 2, at 11-16.

92. See Albert Ando & Alan J. Auerbach, *The Cost of Capital in Japan and the United States: A Comparison*, 2 J. OF THE JAPANESE & INT'L ECONOMIES 134 (1988); Ted Fikre, *Equity Carve-Outs in Tokyo*, 15 FED. RESERVE BANK OF N.Y. Q. REV. 60 (1991); Robert N. McCauley & Steven A. Zimmer, *Explaining International Differences in the Cost of Capital*, 14 FED. RESERVE BANK OF N.Y. Q. REV. 7 (1989); James M. Poterba, *Comparing the Cost of Capital in the United States and Japan: A Survey of Methods*, 15 FED. RESERVE BANK OF N.Y. Q. REV. 20 (1991) (citing B. Douglas Bernheim & John B. Shove, *Taxation and the Cost of Capital: An International Comparison*, in CHARLES E. WALKER & MARK A. BLOOMFIELD, *THE CONSUMPTION TAX: A BETTER ALTERNATIVE?* (1987)); George N. Hatsopolous & Stephen H. Brooks, *The Cost of Capital in the United States and Japan* (paper presented at the International Conference on the Cost of Capital, Harvard University, Kennedy School of Government, Nov. 19-21, 1987)).

93. JACOBS, *supra* note 2, at 173-74.

94. *Id.* at 174-78.

companies are under-leveraged, exacerbating our competitive disadvantage.<sup>95</sup>

Tax laws are a major factor in making equity more expensive than debt. As Jacobs notes, under the United States tax laws, earnings of American companies distributed to shareholders are subject to double taxation—unlike earnings of companies in Germany and Japan.<sup>96</sup> Because an American corporation can deduct interest payments on debt, but not dividends, it faces a higher after-tax cost on equity than debt, even assuming that a provider of equity requires the same return on investment that a provider of debt required.<sup>97</sup> Since equity is riskier than debt, however, the problem is compounded because the equity investor requires a higher return than the debt financier.<sup>98</sup> Jacobs seems to be on firm ground with this theory.

But Jacobs goes further, arguing that American corporations face a higher cost of equity than foreign corporations and use relatively too much of it.<sup>99</sup> According to Jacobs, American investors require a higher rate of return on their equity investments in United States corporations than do foreign investors when investing in their corporations because, in short, American investors view their equity investments to be riskier than foreign investors view their equity investments.<sup>100</sup> To compensate for this greater risk, American investors naturally require a higher rate of return than their foreign counterparts. Jacobs believes that American investors have this negative view because of their minimal role in corporate governance, which regards corporate management as being “distant” and relatively unaccountable to the company’s shareholders.<sup>101</sup> This lack of communication, and resulting distrust, translates into a perceived risk for the investor in the United States.

Jacobs may be correct in his view that the American system of corporate governance is in need of reform, but it is entirely unclear how this relates to the relative cost of equity capital. German and Japanese shareholders, who are the counterparts that Jacobs has in mind, are at least as distant as their American counterparts and, in many respects, more so. In Japan, major corporations participate in

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95. *Id.* at 192-93.

96. *Id.* at 173-74.

97. Jacobs, *supra* note 2, at 173.

98. *Id.* at 174.

99. *Id.*

100. *Id.* at 12, 15-16.

101. *Id.* at 192.

affiliations, called "keiretsu," in which stock is cross-owned by members of the keiretsu, and corporations' executives sit on one another's boards. The "public" shareholders who might trade the corporation's stock (as opposed to the members of the keiretsu, who are not active traders), have virtually no influence on the corporation's management or direction.<sup>102</sup> Public shareholders in Japan place their trust in the management to a far greater extent than American shareholders, who at least retain the possibility of a proxy contest and a hostile takeover. Yet, according to Jacobs, the Japanese shareholders seem to feel that the corporate structure places them less at risk than American shareholders.<sup>103</sup>

Similarly, in publicly-held German corporations (which are rare because most are not publicly held), the outside shareholder is somewhat distant. The "owner" function is exercised by large banks that, as a practical matter, control the large German corporations through substantial equity ownership and the appointment of directors.

Even assuming that German and Japanese corporations trade at higher multiples of price to earnings than American corporations (thereby signifying that equity investors require a lower rate of return and are willing to assume greater risk), it is difficult to draw many conclusions from this fact alone. It may simply be that a larger portion of American corporations could be classified as mature institutions where slower growth may be expected. The fact that Apple Computers is selling for thirteen times trailing earnings, while Microsoft is selling for thirty-three times, may relate more to the relative growth prospects in the computer hardware industry, as compared to the software industry, rather than to the relative managements of the two companies. Again, the reader is asked to accept a notion that seems somewhat questionable: that the cost of equity is higher in the United States (tax considerations aside) because foreign cor-

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102. Indeed, most Japanese corporations schedule their annual shareholders' meetings on the same day, making it impossible for most shareholders to attend more than one meeting. Once there, moreover, the opportunity for a shareholder to influence the course of the meeting, much less the direction of the corporation, is minimal, at best. See Christopher L. Hefel, *Corporate Governance in Japan: The Position of Shareholders in Publicly Held Corporations*, 5 U. HAW. L. REV. 135 (1983).

103. See JACOBS, *supra* note 2, at 66-69.

The enormous decline in Japanese share prices over the past two years (July 1990 to July 1992), during which the Japanese Nikkei average declined approximately 51%, while the U.S. S&P 500 increased approximately 14%, sheds at least some doubt on the notion that Japanese equities are somehow viewed more favorably than American equities.



porations have a better management structure than American companies. That is not to say that American corporations are, on average, as well managed as their foreign competitors, but rather that the relationship between cost of equity and management structure is likely to be a subtle one. Such subtleties are largely ignored in *Short-Term America*.

Finally, Jacobs suggests that the cost of capital problem is exacerbated because foreign companies have a higher proportion of debt, which is cheaper than equity.<sup>104</sup> As noted above, providers of equity demand a higher return than providers of debt because their risk is greater. Equity holders are residual claimants, realizing a return only after prior claimants, including debt holders, have been satisfied. Jacobs provides no support for the claim that American companies are relatively under-leveraged,<sup>105</sup> but a possible reason provided is that debt is too risky for American companies because creditors in the United States are less willing to work with their customers than are Japanese and German banks.<sup>106</sup> Presumably, American banks are less patient and less supportive than non-American banks and, therefore, American companies are less willing to take on considerable debt.<sup>107</sup>

If, as appears to be the case, the cost of capital is higher in the United States than abroad, then equalizing the cost may restore American industry to competitiveness. Jacobs, however, does not believe that is the case at all. Indeed, the chapter on capital costs follows the longer section of the book discussing institutional investing and corporate governance. Jacobs believes that capital costs are a secondary cause of America's short-termism. Of course, there is no

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104. *Id.* at 16.

105. Other commentators have opined that U.S. corporations are over-leveraged. *See, e.g.*, Lipton & Rosenblum, *supra* note 1, at 211 (stating that "[t]he focus on the short term has also led to the over-leveraging of our economy").

106. JACOBS, *supra* note 2, at 146-47.

107. It would appear that determining the proper amount of debt is a difficult decision for any corporate manager and that special problems arise for corporate managers in publicly-held companies. When the manager's most important asset is his job with the firm, he is likely to be more risk averse in comparison to the shareholders. The manager cannot afford for the firm to become financially insolvent. Insolvency would put his job at risk as well as any investment that he might have in the firm. By comparison, shareholders are likely to be diversified and would prefer more risk than managers. *See* Coffee, *supra* note 1. Suffice it to say, if Professor Coffee is correct in his assessment, then the relevant inquiry is not the form of corporate management per se, but rather the risk preference of those making the management decision, be they senior managers, or outside directors.

easy way to determine to what extent America's current economic malaise is attributable to the cost of capital, but, a closer examination of the evidence that management is not short-term oriented suggests that the cost of capital looms as a larger cause.

#### IV. CONCLUSION

*Short-Term America* is an ambitious book, exploring more topics than are discussed above, and suggesting thoughtful solutions to the problems identified. Like any highly ambitious project, it is open to many criticisms, some of which have been identified in this essay. This book's greatest contribution is the recognition that America's lack of competitiveness may be attributable to many different causes and the realization that there are no simple solutions to these problems. Other recent work has over-emphasized the importance of corporate governance reform to the exclusion of needed reforms in the banking industry and in laws affecting capital formation in general.<sup>108</sup> This book, however, fails to identify changes that would truly make a difference in the area of corporate governance. Jacobs seems to assume that directors who are nominated directly by shareholders, rather than the board's nominating committee, would somehow be better directors. The failures of directors, however, are probably as much attributable to the structure of the board as to the identity of its members. Little can be expected of a board of directors as long as board membership is a part-time position, led by senior corporate management. The role of the board will be different only when it can lead management, not vice versa. This will only happen when the board has the means and the incentive to undertake such a role.

Thus, the sort of tinkering suggested by Jacobs and others will not make a meaningful difference. What is called for, if anything, is a more radical change. The work of Gilson and Kraakman, calling for the creation of a cadre of professional directors, is a step in that direction.

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108. See *supra* note 1.