I. INTRODUCTION

The common law principle that directors owe a primary duty to their corporation and a secondary duty to the shareholders of that corporation has been gradually eroded by the federal securities laws so that directors are charged with owing duties to shareholders, with the corporation and other corporate constituents relegated to a lower status. Further, the shareholder primacy model has become the dominant model in scholarship theories with regard to the firm, although other models have been proposed and debated. Under the shareholder primacy model, shareholders are considered the "owners" of the corporation and therefore given rights at the expense of other corporation constituents. In reality, shareholders have a property interest in their shares, not in the corporation's assets. Further, they have no access to the corporation's assets and no right to direct or control the disposition of those assets. The notion that shareholders are "owners" sometimes expresses the notion that they are the residual claimants on the corporation's assets. This concept also is flawed.

Modern institutional investors do not necessarily behave like owners of corporate property. Although some institutions supply patient capital to corporations and hold shares for the long term, many institutions are short-term traders or invest in the equity markets through passive index funds. Nevertheless, the shareholder primacy norm has been strengthened and reinforced by the Sarbanes-Oxley Act of 2002. In the wake of recent corporate scandals, institutions have been demanding more rights, for example, more rights with respect to the nomination of corporate directors. In view of these demands, this Article will inquire as to whether large shareholders should obtain any such rights without also acquiring duties to the corporations in which they invest, and to other shareholders.

Shareholders do not generally owe any duties to one another or the corporations in which they own shares. There are two exceptions to this proposition. Controlling shareholders owe fiduciary duties to minority shareholders, although the theoretical basis for this exception is not entirely clear. Some courts have imposed fiduciary duties upon shareholders in close corporations akin to the duties partners owe to one another. Can either of these theories be extended to fit the role of institutional investors in a large public corporation, or is the role of the institutional investor different? Institutional shareholders are not investing their own capital, but the capital of others to whom they owe fiduciary duties. There is a potential and sometimes an actual conflict between the beneficiaries of an institutional investor and the shareholders and other constituents of corporations in which they invest. On the other hand, institutions have a duty to invest assets of their beneficiaries prudently and such prudence may benefit the financial structures and operations of portfolio companies.

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In the 1980s and 1990s, equity came to trump all other corporate constituencies. Further, institutional investors became much more heavily invested in equity than had previously been customary. They therefore pressured corporate executives to think like shareholders and be compensated in equity and, in addition, pressured corporations to report ever increasing earnings. These pressures in the context of the "irrational exuberance" of a bull market led to financial machinations at many public corporations. When the bull market collapsed, the exposure of serious financial fraud at Enron and other companies led to the passage of Sarbanes-Oxley. Because the mandate of the Securities and Exchange Commission (SEC) is investor protection, however, investors became the beneficiaries of Sarbanes-Oxley rather than objects of further regulation. This Article will argue that Sarbanes-Oxley will not prevent future Enrons as long as it is administered pursuant to a shareholder primacy norm because investors as well as corporate managers and directors need to be appropriately regulated.

The shareholder primacy norm replaced managerialism, but it has been challenged by state corporate constituency statutes and by some competing academic theories, in particular, the nexus of contracts theory, the team production theory, and the director primacy norm. Although each of these theories has merit, it is unclear whether any of them would lay the foundation for curbing executive abuses for the benefit of the corporation as a whole. If a duty to the business enterprise in which institutions invest was imposed upon institutional shareholders, some of the pathologies which led to the 1990s stock market bubble might be better addressed.

Investors are protected by the federal securities laws in order to encourage capital formation and the efficient allocation of capital in the national economy. Unfortunately, institutional investors and their portfolio managers do not appear to have done an adequate job of analyzing corporate earnings and balance sheets in the 1990s despite the disclosures required by the federal securities laws. Although the errant behavior of corporate managers and their advisors should not be excused, institutional investors should also bear some of the blame for the 1990s stock market bubble and its inevitable collapse. Some of their questionable investment practices can be corrected by focusing on the fiduciary duties they owe to their own beneficiaries, but certain obligations to the corporations in which they invest and the shareholders of those corporations could also be considered.

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V. THE TROUBLE WITH INVESTORS

... When the federal securities laws were first enacted, many policy makers believed that full disclosure was not a sufficient federal remedy for the excesses of the 1920s. William O. Douglas argued that industry needed "constructive planning and organization conditioned by the requirements of the public good .... That in essence means control over access to the market." The United States never embraced this kind of central planning, and given the failures of communism and socialism in other countries, that was probably fortunate. The United States long had faith in the ability of the market to efficiently allocate capital. This meant that investors were expected to analyze the disclosures mandated by the SEC and direct capital to the
corporations able to use that capital. Of the many social contracts that were broken in the 1990s, this expectation that investors, and particularly institutional investors, with the money and professionalism to choose good investments, would do so for the benefit of the national economy, failed. The inability or unwillingness of investors to assess relative corporate values and invest their capital efficiently and wisely should give pause to the notion that greater shareholder power is the solution to the problems of the financial markets. Why should shareholders obtain more rights unless they assume greater obligations?

The activist institutional investors have large holdings in corporate equities and are politically influential. There is some evidence, however, that other investors, including other institutional investors, "are not particularly interested in corporate governance issues." If institutional investors do not solicit their own beneficiaries as to their views, and they certainly do not solicit the views of other investors or owe them any duties, it seems inappropriate for them to obtain rights that are not accorded to investors generally. If such rights are accompanied by greater obligations, new difficulties could emerge.

Imposing obligations to a business enterprise or other shareholders upon institutional investors would be a tricky business. Such a duty could include a duty to monitor the soundness and fairness of a corporation's capital structure, but in some situations such a duty could involve a conflict of interest. First and foremost, institutional investors should be concerned about their duties to their own beneficiaries, and if these duties were to come into conflict with a duty to the corporation in which the institution is a shareholder, it is not clear how such a conflict could be resolved.

Although the obligation of institutional investors to invest prudently and then monitor their investments can best be enforced by those who regulate such institutions for the benefit of protected groups, such regulators vary in their concerns and regulatory mandates. Banking regulators are concerned about safety and soundness for the benefit of depositors and insurance regulators are concerned about safeguarding the interests of policyholders. The SEC is concerned about mutual fund shareholders and conflicts of interest between funds and their advisors. The Pension Benefit Guaranty Corporation and the Department of Labor are concerned about the solvency of corporate-defined benefit pension funds in order to safeguard the interests of retirees.

Although none of these regulators have responsibility for the efficient allocation of assets in the national economy, and perhaps such regulation would not be welcomed in a capitalist system, more rigorous enforcement of prudent investor-type principles might have the side benefit of making institutions invest more wisely. In addition, mechanisms to encourage institutional investors to hold securities for the long term might be considered by policy makers. This might particularly be applicable to pension funds and endowment funds that should, in theory, be looking at the long term.

The problems of speculative and short-term trading by institutional investors is not new, but the possible creation of a federal right to nominate directors on management's proxy and thus change existing state law does raise some new issues. If institutions win the right to make shareholder nominations, what duties should they then have to other shareholders? Majority shareholders
have duties to exercise due care and deal fairly with minority shareholders because they control the board of directors. If favored institutions begin to nominate and cause the election of directors in opposition to the selection by an existing board, such institutions should, in appropriate cases, be held to the same kind of duties that are imposed on controlling shareholders. They should undertake to monitor the directors they propose and remain shareholders for the duration of the terms of office of such directors. They should monitor corporate capital structures to prevent unfair recapitalizations. Further, they should be prevented from using any power to nominate directors in conflict of interest situations. In the case of labor union pension funds, this could be treacherous ground because they may be more interested in labor issues than shareholder issues.

The serious abuses of trust by some corporate managers and directors during the late 1990s and into the next century have led to a clamor for reform that seems to now have its own momentum. But perhaps those activist institutions that are demanding greater rights as shareholders should be more cautious. If they obtain some of their wishes, they may find that with new rights come new responsibilities and liabilities.