

Corporate Ownership And Compact Costs

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Abstract

Using definitions borrowed from property law, this paper contends shareholders receive less than complete ownership because the contract written by the state is deficient. This suggests that an additional residual property benefit exists in the firm separate and apart from both equity-holders and bondholder claims. Thus, the value of the firm is $V = E + D + r$, where V , E , and D are the market values of the firm, equity, and debt, respectively, and r is a residual value. The authors refer to this "compact costs" since it stems from the state's faulty title document, and it explains investors paying a premium seeking corporate control.

"We are, however, reaching the point of rapidly diminishing returns from efforts that focus solely on stock prices. Further progress toward understanding the market for corporate control will be substantially aided by efforts that examine other organizational, technological and legal aspects of the environment in addition to the effects of takeovers on stock prices".--- M.C Jensen and R.S Ruback, (1983)

I. Introduction

This article draws on definitions commonly used in property law to explore contemporary stockholders' rights and powers derived from the possession of a stock certificate. The discussion then develops a theory to explain market incentives of investors seeking corporate control. Focus is on the relatively unexplored linkages between the type of property interest conveyed, the bundle of rights associated with that interest, and the value of that interest. That the contract written by the state on behalf of shareholders fails to transfer the entire ownership interest is the critical issue. As a title instrument to convey ownership interests to the shareholder, the share certificate is a seriously deficient ownership transfer device. There exists a residual property claim separate and apart from the equity claim. From this perspective, the value of the firm may be restated to include the summation of equity value, the bondholders' claim, and value of the residual interest. A vast literature in corporate control already exists, in fact its been called "a growth industry" (Jensen and Ruback, 1983, p.47). However, this paper suggests that much of the financial economics literature(1) should be viewed differently. The theoretical framework of modern corporate finance has ignored this important aspect of

corporate ownership and control.

Most assume the ownership of the corporation is vested in the shareholders. Shareholders' investment capital is contributed to the business enterprise and in return a stock certificate representing the equity ownership interest is received. But shareholders are not true owners in the strictest sense. For example, shareholders are given no right to contribute to the daily operations of the firm; as minority shareholders they can be shut out of closed corporations or forced out through corporate takeovers; and they have little recourse in dealing with inefficient management other than to sell their equity position(2).

As discussed later, management, not the shareholders, possess the necessary and sufficient characteristics, such as present possession and use, usually associated with the ownership concept. A degree of managerial autonomy or control can be considered an asset possessing value. Whether the resultant value of the firm is augmented or diminished, its impact is directly linked to managerial ability, attitude, and productivity. In a large corporation, a portion of the value of asset control is lodged in the claims of others besides the bondholders and shareholders.

An analysis of this issue has enormous implications to the disciplines of finance and law. This idea is developed by reviewing the legal conventions associated with the ownership agreement.

II. The Nature of Property Ownership: Legal Definition

Property ownership is a creation of the law. With the law there is property ownership; remove the law and property ownership ceases. Ownership of property is a set of relationships between an object and individuals, and it has no corporeality apart from the object of ownership. Specifically, ownership entails the right to custody, dominion, use, or disposal of the asset to the exclusion of others. In a legal usage, the term "owner" suggests a person or legal organization having control over assets with the right to enjoy and do with as pleased, even to spoil or destroy them(3).

Ownership clearly exists in various dimensions. A person enjoying all possible rights in an asset has absolute ownership. However, "absolute" is a misnomer since all possible rights over the object are subject to specific publicly and privately imposed limitations, including the sovereign rights to seize, tax, police, and regulate the rights of individuals' actions. The restrictions to enjoyment and limited usage are enforced so the asset's usage will not unreasonably injure other societal members.

Ownership rights divide into two categories, perfect and imperfect(4). Ownership is perfect when it is perpetual, and the owner of an asset in question is not encumbered with a third person claim. Ownership is imperfect when it terminates at a specific time or on a condition, or the asset is subject to a third person claim. The classic example of an imperfect ownership claim is the division in property law of an estate into a life estate and remainder. The owner of the life estate has the right to possession and use for a determinable period, namely the life of some named individual. At the death of that individual, the possession and use passes to the remainderman.

In this light, equity interests appear as a more imperfect form of ownership. The stockholder has no right to immediate possession or use of corporate assets or profits, but at best is a conditional, residual claimant.

III. The Shareholders' Rights in the Corporation

A. Legal - The enabling statutes

Shareholder ownership differs from either the ownership of sole proprietors in their businesses, or the general partners in their respective partnerships. Specifically, a corporate shareholder has no rights to the immediate possession, use, or routine disposal of corporate assets. Given the common assumption of shareholder ownership, shareholders' rights are remarkably restricted. Technically, shareholders can only elect the members of the Board of Directors and vote on

incidental matters the directors choose to petition prior to the annual meeting. Generally, shareholders' ownership rights include the right to vote, receive a cash return on their investment if the directors declare dividends, and share in the distribution of the assets upon liquidation of the company. Shareholders possess an insignificant influence on the day-to-day management of the corporation; routine management rests with employees entrusted with this task.

The "property rights" of ownership, in reality, are largely vested in the powers of the board of directors. Under Section 35 of the Model Business Corporation Act:

"All corporate powers shall be exercised by and under authority of, and the business and affairs of a corporation shall be managed under the direction of a board of directors."

Continuing in this section, each director is charged to:

"...perform his duties as a director...in good faith, in a manner he reasonably believes to be in the best interest of the corporation, (emphasis added)."

It is critical to note the enabling statute does not treat the shareholder as equivalent to a sole proprietor. The director isn't responsible to the shareholder, but rather to the corporation. A critical, but innocuous assumption suggests that what is beneficial for the corporation is also beneficial for the stockholder. However, the statutory purpose of the corporation is not explicitly related to the enhancement of the benefit of the shareholder. Rather, enabling statutes typically read, "Corporations may be organized for any lawful purpose"(5).

Similarly, many of the general corporate powers granted by the state are inconsistent with an enhancement of the corporation or the stockholder. The Model Act provides the following general powers for the corporation:

"..(f) To lend money and use its credit to assist its employees.; ..(m) To make donations for the public welfare or for charitable, scientific, or educational purposes.; ..(n) To transact any lawful business which the board of directors shall find will be in aid of governmental policy; ..(o) To pay pensions and establish pension plans, pension trusts, profit sharing plans, stock bonus plans, stock option plans and other incentive plans for any or all of its directors, officers and employees.(6)"

Berle and Means (1932) were among the first to note

these problems in the modern corporation. Because the beneficial use of corporate property can be legally transferred to diverse parties, it is difficult to claim the law presumes the shareholder is the sole beneficiary of the profits of the corporation. The exact preference in favor of the shareholder varies from state to state as a matter of common law. The tone of such cases as *Forinash vs. Daughtery*, 697 S.W. 2d 294 (Calf. App.), (1985) is decidedly more favorable to the shareholder than *Richie vs. McGrath*, 571 P.2d 17 (Kansas App.), (1977). However, as a general statement one can say that there is no legal condition that the ultimate fruits of the corporation will ever be awarded to the shareholder.

Many have characterized the corporate governance problem as "a separation of ownership and control". This paradigm is rejected. The right of use and control amounts to ownership. The facade of the shareholder as the owner of the corporation in a practical sense is stripped away.

The ownership in the corporation is fractured. Present possession and use is vested in one party, while a residual property interest exists in another. Although shareholders lack clear legal title in conformity to the common definitions of ownership, they do have some moral and equitable claims on the corporation. However, the exact nature of those claims is a matter of controversy. This is outlined below.

B. Moral and Equitable Interest in the Corporation

Lacking a legally enforceable explicit contractual relationship, some legal scholars have sought to recover the profits of the corporation for the shareholder on moral and equitable grounds. The notion of the shareholder as a beneficial owner of the corporation has been advocated(7). This view originated in the earliest companies where the director was a trustee in the full technical sense. Going back 150 years in history when most companies were unincorporated, corporations were established by deeds of settlement, and incurred practically no official recognition. The deed characteristically recognized the directors as trustees of the firm's funds and property, and the courts naturally called them to account on a strict basis. This practice persisted as a result of general incorporation, even when property was owned by the company in its own right. By analogy, the directors of chartered and statutory corporations were deemed to be trustees(8). Sealy suggests that the concept of the director as trustee arose simply because, in the limited legal vocabulary of the day, there was no other word which the judges would wish to use.(9)

Bayne (1963) has been among the most vocal in this

account:

"The controleur has custody only, not ownership. The corporation is merely entrusted to an office, not given to an individual. The custodian must guard, guide and nurture the corporation as if it were his own, with full knowledge that it belongs to another."(10)

Bayne posits the notion of shareholder ownership of the corporate assets:

"In the theoretical -- but very real -- beginning of every corporation the shareholder owners in a deliberate appropriation entrust the corporate assets to the untrammelled dominion of that necessary top-level authority, the controleur. In acquiescing to this appropriation the controleur thereby assumes custody of the entity, with all its duties and rights. Technically, therefore, corporate control is a relation of total custody subsiding between the subjective term, the office of control, and the objective term, the corporate entity itself."(11)

Characterizing the corporation as a trust and the shareholder as its beneficiary, Bayne advocates the benefit-to-beneficiary rule:

"Because the dependence is total...the resultant responsibility is total... This total responsibility for the stewardship of another's assets is merely a collective noun describing a complexus of duties in regard to those assets. This complexus is the essence of the benefit-to-beneficiary rule. This in turn is only another way of saying that the custodian has a duty to care for the assets entrusted to him as if they were his own. This simple reasoning coalesces into one simple unqualified rule enunciated in the Restatement: 'The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary'".(12)

If the courts fully enforced a benefit-to-beneficiary rule there would be much less trouble equating the concepts of equityholder and owner. Unfortunately, the trust analogy has found a limited audience; therefore, the trust concepts, including the benefit-to-beneficiary rule, are strictly limited in application. A few cases exist in law corporate where control of the corporation is exchanged for some inducement, or control is being transferred(13). The prevailing rule of conduct for those in possession and control of corporate property is the business judgment rule, an important determinant limiting the legal exposure of corporate managers and directors. This concept is discussed in the following section.

IV. Management and Corporation Ownership rights

A. Legal Norm - The Business Judgement Rule

In matters other than the transfer of control, a very different standard is imposed upon the director. In "ordinary" business decisions excluding mergers, sale of corporate control, or asset liquidations, the discretion of the board of directors is not subject to legal challenge. The board and its managers are not held accountable for losses from "business judgments".

Three explanations seem to prevail for the adoption of this rule by the courts. Traditionally, the rule afforded some amount of personal legal protection and did not discourage individuals from serving on boards of directors ("limited liability"). Second, shareholders are considered risk-takers co-operating in a financial venture by employing a centralized management. Clearly, part of the risk arises from the efficiency of the managers employed. Finally, it can be argued that the courts are unsuited to address business-related decisions in the absence of the rule, not to mention the numbers of potential litigants. Proponents of the rule argue that management problems are subtle and difficult, and frequently their correct solution extends beyond an abstract, expert ability to encompass unique personal experiences gained within the context of the organization. Traditionally, corporate law holds that directors owe no special fiduciary obligation to individual shareholders.(14)

The enforcement of the business judgment rule is limited by the fractionalization of corporate ownership. Possession and the right to control are the primary elements of ownership. Without judicial recourse to enforce the benefit-to-beneficiary rule the value of share is reduced. Whether the division of ownership serves a legitimate societal need is an open question.

B. Economic Rational for Managerial Interest in the Firm

Given the discussion, it seems strange that introductory economics and finance textbooks claim that management's sole objective is to maximize shareholder wealth. This line of reasoning balances on the proposition that shareholders are the "owners" of the firm. Berle and Means'(15) offer an interesting counterpoint. They assert that capital suppliers, if given sufficient remuneration to ensure a supply of risk capital, have no reason to receive more of the profits. This is not at odds with the economic definition of equilibrium price for a factor of production, in this case, capital. They take an additional step, moving into a normative view of returns. Any additional profits are more effectively used to increase management's incentive to perform efficiently. Berle

and Means' argue further that it would be "economically wasteful" to distribute to all shareholders the greater percentage of the profits that are required to induce maximum efficiency on the part of these managing shareholders. Finally, they conclude that management would "hire" capital at this necessary minimal return rather than vice versa, as traditionally viewed.

C. History of the Corporation

To understand the terms and conditions which arise in the shareholder agreement, it is helpful to review briefly the history of the modern corporation. Explanations of the development of American corporations in the 19th century holds that entrepreneurs, or promoters, needed a mechanism to solicit capital from relatively large numbers of investors.(16) The chronicle of the large corporation commenced in the 1830s with large scale promotions of canal companies(17) and railroads. The financing vehicle followed from the most familiar organization known: the early ecclesiastical corporations whose spiritual purpose entailed administering property held by the church. According to Manne (1967) the basic organizational forms, vocabulary, and legal formula for the modern corporation existed in the 14th and 15th century. The contemporary economic justification obviously was much different, but the fund raising activities of the respective entities is analogous.

Given the economic justification, it not surprising the shareholder enjoys a very limited role in the actual management of company affairs since a principal task of the corporation is amassing capital from investors. The selection of management in this framework is a discrete economic service provided by the promoter. Hiring individuals to perform the management function, whether at the outset or later in life of a company, is a part of the entrepreneurial job.

A consequential legal norm of the corporation, its centralized management, descends from the premise of it as a capital raising device. Entrepreneurs of the early corporations never intended for outside investors to play a central role in organization or supervision functions. The promoters usually guided it far beyond the embryonic stage by the time they began marketing the equity securities. The promoters, in forming the corporation and marketing its shares, performed the entrepreneurial effort and periodically hired personnel to assist in its operation. Rarely does a company successfully enter the major capital markets at an embryonic stage. It is the entrepreneurs who normally select their managers, not the equity investors. The corporation is a legal entity to channel capital from investors, and convert it into productive resources.

Compartmentalizing management in such a framework serves simply to specialize various managerial functions, permitting the organization to operate more efficiently. Although it can be assumed that centralized management is merely a practical outgrowth of the early law's concern with large corporations, this is not an evolutionary necessity. There is no compelling analogy between representative government and the role of the investor in the corporation. In reality, no entrepreneur is likely to contemplate an election of managers by the providers of capital. Implicitly an agreement exists between three key power groups: the state, the entrepreneur, and the other stockholders.

V. The nature of the financing agreement

The agreement written by the state fixing the entrepreneur and shareholder in corporate law is quixotic in that the shareholder receives a limited bundle of property rights. Indeed, the bundle is much too small. Each share confers the right to receive dividends, if declared, and the right to participate in a proportional share of asset distribution upon dissolution of the corporation. Effectively, the shareholder agrees to receive a dividend having an uncertain amount and timing. The dividend payment is not secured by prior agreement. The shareholder has only a moral expectation of "fair" treatment derived from faith in the promoter. That an investor would invest in arrangement which is cum non contractus is remarkable.

It is questionable whether such a contract between two parties is enforceable at law absent statutory encouragement. The law of contracts generally requires that the term of a contract be definite. If an offer is indefinite (or vague) or if an essential provision is lacking, no contract arises from an attempt to accept it(18). Most contracts have explicit terms, and the conditions of performance are known. Although there are exceptions to the rule of definiteness, it is difficult to reconcile the degree of imprecision with the need for it for equity shares.(19) A lack of performance preciseness is crucial because it gives rise to a special type of economic costs. These costs, associated with a failure to specify a precise workable property right, is defined as "compact costs".

VI. The control block and the rewriting of the agreement

Because there is no legally enforceable agreement between the shareholder and the controleur of the corporation specifying the amount of cash flow remuneration that the shareholder shall receive for his investment, it becomes very difficult to value the share-

holder's contingent residual claim. Since the shareholder's cash flow rights are subject to the dividend declaration, the value of the shares is a function of the probability associated with the declaration of the dividend. However, any uncertainty can be greatly reduced if the share is part of a controlling block of stock. The owners of a controlling block have the power to rewrite the contractual relationships between the managers and the firm, effectively substituting the new majority stockholder for the entrepreneur.

The importance of the control block in the valuation of equity is recognized in both the legal literature and in the finance literature. The law has long recognized this and has allowed majority shareholders to derive a premium from the sale of a controlling block of stock. (Levy vs. American Beverage Corp., 265 App. Div. 208, 38 N.Y.S. 2d 517 (1942), Essex vs. Yates, 305 F.2d 572 (2d Cir. 1962). Tender offer legislation such as the Williams Act of 1968 was passed in part to insure a more equitable distribution on the "control premium". In the finance literature researchers repeatedly found a "premium" in connection with corporate takeovers(20). This vast literature is reviewed by Jensen and Ruback (1983). In general they conclude that "The evidence indicates that corporate takeovers generate positive gains, that the target shareholders benefit and that the bidding shareholders do not lose." (Jensen and Ruback, 1983, p. 5). The source of the gains is still not clear. Jensen and Ruback's statement "identification of the source of takeover gain has not yet occurred" is still true today.

Thus, the shareholder enacts a quasi-agreement in special conditions should his share of stock become part of a controlling block. The share has the power to elect the board of directors. The board of directors then has the power to limit the controleur's compensation to a competitive market equilibrium price for controleurs.

Any difference in price between a hypothetical share which is part of a controlling block and a share which is not part of a controlling block shall be called a compact cost(21). A differential exists because the law and the equityholder have failed to specify in an agreement the terms and amounts of his remuneration, a condition different from an agency relationship. In theory, the equityholder could have explicitly contracted a sum certain or a contingent contract schedule based upon sales or some other criterion, or entered into an agreement where additional property rights are retained in the corporation.

The paradigm raised here differs from Jensen and Meckling's (1976) explanation of Agency Costs. They

posit that every relationship involving agreement of joint effort is subject to violation of the agreement. Jensen and Meckling's Agency Costs envision a world similar to Bayne (1963) where both parties agree the shareholder is the owner of the corporation. They assume the manager was contracted to perform the same service as the original owner. Performance deviation from the contracted idealized self-owned state is then defined as agency costs. Jensen and Meckling tend to overemphasize the usefulness of monitoring, and ignore the deficiencies of the contracting agreement itself. Incentives to cheat is a marginality question where the degree of cheating is a function of the degree of managerial ownership, and the possibility of post-contractual cheating must be monitored. Although the possibility of post-contractual cheating is very real, this paper suggests historical and social contracts associated with the corporation do not clearly define the standards of performance. Furthermore, the price differential found in a corporate takeover is not due to the employment of an agent *per se*, rather it lies in an absence of an enforceable agreement, a by-product of the law, not an economic consequence of employing an agent.

Given this legal structure, it is not surprising to find that managers are not driven by the tenet of shareholder wealth maximization, for the law charges the directors to maximize the interest of the corporation, not the shareholder. Gordon Donaldson(22), in a study of 12 firms traded on the New York Stock Exchange, concluded that these managers were not driven by maximization of shareholder wealth, but rather the maximization of "corporate wealth". Although Donaldson expressed surprise at this finding, his conclusion follows directly from the given charge of the enabling statutes and the history of corporate law.

VII. The conflicting interests

Given the faulty nature of the social contracts associated with the corporation, it is inevitable that conflicts of interest arise, particularly with respect to precise property rights. Unfortunately, correct resolution of the corporate control problem is far from clear. Even the present state is seen through different sets of spectacles. For example, the uncertainties associated with dividend

can be analyzed in two ways. In the Bayne view, if shareholders are the owners of the corporation, failing to pay dividends but using the proceeds for purposes other than the benefit of the shareholder constitutes violation of an implicit agreement. The alternative view holds that shareholders are not owners of the firm and need merely be paid sufficient dividends to induce the use of their capital.

Thus, the solution to the ownership dilemma is not simple. The correct public policy doesn't necessarily suggest giving the shareholders additional incidents of ownership. Restated in a marginality context, it assesses whether the benefits of the additional capital raising is offset by a decreased level of managerial performance. It is not altogether clear that the present system has survived because of its superior incentives for managerial performance.

VIII. Conclusions:

The present arrangement for equity gives shareholders limited enforceable ownership claims to the benefits of the corporate enterprise. The arrangement is essentially one of cum non contractus, which is contrary to the typical definition of asset ownership. In a very real sense, the ordinary, minority shareholder is deprived of any enforceable incidents of ownership as a result of the nature of states' general corporate enabling laws, and the courts adopting the business judgment rule and failing to adopt an enforceable benefit-to-beneficiary rule.

However, when a share of stock becomes part of a controlling block, deficiencies surrounding the limited ownership nature of stock are ameliorated, causing its imputed value to increase for an investor seeking control. The difference in value between a share of stock with full ownership rights and associated with a controlling block, and a share of stock unassociated from a controlling block is called a compact cost. The value of the firm is $V = E + D + r$, where V, E, and D are the market values of the firm, equity, and debt, respectively, and r is a residual value. The existence of compact costs is an important explanation of investors offering a premium in the market for corporate control.

Endnotes

1. Finance literature argues the value of the firm is the summation of the market values of its equity and debt. See Brigham and Gapensky (1988), p. 11, and Ross and Westfield (1988), p. 13.
2. The problems of separation of the custody of an object from its intended beneficial user has a long and checkered history in the property law. England had ordinances dealing with variations of this problem as early as 1388. Berle and Means (1933) were the first to acknowledge the problem caused by the "separation of ownership and control" in the modern corporation.
3. See for example, the Civil Code of California Section 654 which defines ownership as "...the right of one or more persons to possess and use a thing to the exclusion of others."

4. For a distinction between perfect and imperfect ownership, see Civil Code, Louisiana Article 490 and *Maestri vs. Board of Assessors*, 110 La. 517, 34 Southern Reporter 658.
5. Section 3 Model Business Corporation Act.
6. Section 4 of the Model Business Corporation Act.
7. See Keeton (1952), Bayne (1963), and Sealy (1967).
8. One of the first cases to adopt this stance was *Charitable Corp vs. Sutton* (1742), 2 Atk. 400, where Lord Hardwicke held the directors of the Charitable Corporation guilty of breach of trust.
9. Sealy (1967), p. 84.
10. Bayne (1963), p. 22, and p. 32.
11. Bayne (1963)
12. Bayne, (1965), p. 543, and p. 557.
13. One of the more famous cases is *Heckmann vs. Ahmanson*, 214 Cal Rptr 177 (Cal. Ct. App. 1985) a greenmail case involving Walt Disney productions.
14. This needs to be distinguished from their duties to the corporation.
15. Berle and Means (1932), p. 342-344.
16. See Manne (1967), p. 259.
17. Carosso, Vincent P., (1970).
18. The topic of vague or indefinite contract is discussed in most texts in business law, including Anderson, Fox, and Twomey (1987); and Corbin (1952).
19. See *Illinois Commerce Commission vs. Central Illinois Public Service Co.*, 25 Ill App 3rd 79, 322 NE 2d 520 for a discussion of the limits and issues of definiteness.
20. Our search of the literature showed there were more than 25 event studies dealing with takeovers; including Jarrell and Poulsen (1987); Bradley, Desai, and Kim (1983); Jerrell and Bradley (1980); and Dodd and Reback (1977); all of which deal with tender offers.
21. The covenant cost is also referred to as a minority shareholder discount which is most profound in closely held corporations.
22. Donaldson (1984).

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