Federalism and Corporate Governance*

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I. The Current Tensions

Corporate governance is the term currently used to describe corporate reform efforts, although it does not pertain to any single program of reform. Federalism, of course, is a much older term that refers to the relationship between federal and state law. The linkage of these old and new ideas suggests that it is fruitful to explore the role that federal law, or the federal government, plays in the regulation of the internal affairs of corporations and whether federal law should serve as a means of reforming corporate behavior or corporate law.

This Article will explore initially some of the impetus for corporate reform with particular attention to reform of the manner in which corporations are internally governed. The Article then will examine the prevailing law of corporate governance and the respective roles under present law that are performed by state and federal law. With this background, the Article then will comment upon the federalism issues under the existing arrangement and will examine some of the proposals for change. Finally, a suggested role for federal law will be offered.

It is difficult to define with any precision the phrase corporate governance. Corporate governance, as it will be used in this paper, relates to the rules that define the organization of the governing structure of the corporation.[1] In the main, this means the rules that determine who manages the corporation and by what process they manage. Historically, corporate governance might have been confined to the rules governing the board of directors because, until recently, all corporation statutes in the United States provided that the business of the corporation *shall* be managed by the board of directors.[2] The statutory rules prescribed the role of the board of directors relative to the shareholders.[3] Today, the identification of the governing body is more complex because we recognize a role for management, not a formal body acknowledged by statute, but nonetheless the dominant governing force.

New questions about the board's function have replaced such mundane subjects as the quorum required for board meetings and whether informal action may be taken or whether meetings may be held by conference call. Today the key questions include whether an audit committee and a nominating committee are needed, whether the board should be composed of a majority of outside directors, whether directors should perform the function of monitoring senior management, and what that function means.

Corporate governance also includes the subject of enforcement and remedies

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1. M. Eisenberg, The Structure of the Corporation 1 (1976).

2. Model Business Corp. Act Ann. 2d § 35 ¶ 3.03 (West 1971 & Supp. 1973); *see* Weiss & Schwartz, *Using Disclosure to Activate the Board of Directors*, 41 Law & Contemp. Probs. 63 (Summer, 1977).

3. Automatic Self-Cleansing Filter Syndicate Co. v. Cunninghame, [1906] 2 Ch. 34.

available to the governed—the shareholders. The governance scheme might also conceivably provide certain rights in favor of other groups or constituencies that are interested in the conduct of the corporation, such as employees and citizens of the community where the corporation functions.

Finally, I deem corporate governance to include the business judgment rule, which operates as a shield against liability of the governors. Equally important, the business judgment doctrine serves as a sword in the hands of managers, authorizing them to act for the corporation in particular respects.[4] The doctrine is related to the law of agency, which is also an aspect of corporate governance, but the business judgment rule's principles are uniquely adapted to the large, publicly owned corporation.

Corporate governance is not coextensive with corporation law—a broader subject. Corporation law includes the substantive rules that define the proper exercise of authority by corporate governors and creates the fiduciary duties and the duty of due care to which managers are subject. Corporation law also imposes certain limits on the corporation itself and not on those who manage it. And the law of corporations, as Professor Conard has taught us, is broader still.[5]

Why is so much attention paid to corporate governance and corporate reform at this time? It has been more than a generation since the inner workings of the corporation and the subject of corporation law have been scrutinized as they are today.[6] The American Law Institute Project, now formally known as "Principles of Corporate Governance and Structure: Analysis and Recommendations" ("ALI Project"), authorized by the Institute in 1981, has produced one tentative draft[7] thus far, plus a virtual firestorm of controversy over its initial recommendations.[8] Subsequent drafts are in the process of preparation. In addition, legislative proposals for fundamental corporate reform were introduced in Congress in the late 1970s[9], and hearings were held by several committees examining possible legislative reform.[10] The Securities and Exchange Commission, under the leadership of President Carter's Chairman, Harold M. Williams, assigned high priority to the subject of corporate governance.[11] Corporate governance has been the topic of numerous symposia[12] and

4. Hinsey, *Maldonado (N.Y.) v. Maldonado (DE): Which Prevails?*, Legal Times of Wash., Aug. 4, 1980, at 18, 20, col. 3.

5. A. Conard, Corporations in Perspective 3 (1976).

6. A. Berle & G. Means, The Modern Corporation and Private Property (1932).

7. (Tent. Draft No. 1 1982). Tentative Drafts Nos. 2 and 3 were published in 1984.

8. The strongest and most comprehensive statement in opposition was issued by the Business Roundtable, and was prepared by the law firm of Weil, Gotshal & Manges. *See* Statement of the Business Roundtable on the American Law Institute's Proposed Principles of Corporate Governance and Structure: Restatement and Recommendations (February, 1983).

9. S. 2567, 96th Cong., 2d Sess. (1980).

10. *E.g.*, *Protection of Shareholders Rights Act of 1980: Hearings on S. 2567 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 96th Cong., 2d Sess. (1980); *Corporate Rights and Responsibilities: Hearings Before Senate Comm. on Commerce*, 94th Cong., 2d Sess. (1976).

11. Staff of Div. of Corp. Fin., SEC, Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess. Report on Corporate Accountablility (Comm. Print 1980).

12. *See* Commentaries on Corporate Governance and Structure: The ALI-ABA Symposiums 1977–1978 (D. Schwartz ed. 1979) (hereinafter cited as Commentaries); *National Conference on Corporate Governance and Accountability in the 1980's* (1981).

has received much scholarly attention,[13] which has increased since the publication of the ALI's first tentative draft.[14]

The present movement is the third serious effort at corporate reform during this century. In the early 1900s, active consideration was given to federalizing the law of corporations, and both Presidents Theodore Roosevelt and William Howard Taft made proposals.[15] The impelling force behind reform at that time was the increase in corporate concentration, symbolized by the creation of huge trusts in several basic industries. Some regulatory legislation and an increased determination by the government to enforce the antitrust laws emerged.[16]

Following World War I, a mood of euphoria about American business swept the country and scant attention was paid to reform. But after the Depression and the beginnings of the New Deal, interest revived in corporate reform. A vast amount of regulatory legislation was enacted, and Congress at least contemplated the possibility of federal chartering of corporations.[17] That idea, we are reminded, originated with James Madison at the Constitutional Convention and not with any radical politicians of the 1930s.[18] The Temporary National Economic Commission (TNEC) had a large agenda of proposed reforms, all of which were halted abruptly by the onset of World War II. No one explanation can suffice for the revived interest in basic corporate reform in the 1930s, except that most of the different strands of thought were Depression-related. That is, many believed that the business system had failed and that corporations needed fundamental changes. Berle and Means, as already noted, pointed to the separation of ownership from control, placing a worrisome amount of power in the hands of managers who were not effectively accountable for its exercise.

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13. *See* Dent, *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U.L. REV. 623 (1981); Earle, *Corporate Governance and the Outside Director—A Modest Proposal*, 36 WASH. & LEE L. REV. 787 (1979); Fischel, *Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Greene, *Edward F. Greene on Corporate Governance (The World of the'80's)*, 37 BUS. LAW. 228 (1981); Knauss, *Corporate Governance—A Moving Target*, 79 MICH. L. REV. 478 (1981); Letts, *Corporate Governance: A Different Slant*, 35 BUS. LAW. 1505 (1980); Parkinson, *The Modification of Directors' Duties*, 1981 J. BUS. L. 335; Sealy, *A Reply to Professor Kripke: The Negative, Not the Positive, Is the Real Issue of Corporate Governance*, 36 BUS. LAW. 1655 (1981); Small, *The Evolving Role of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353 (1979); Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 UCLA L. REV. 343 (1981).

14. *See* Bayne, *Lawyer and Corporate Governance: Conflict of Interest*, 26 ST. LOUIS U.L.J. 400 (1982); Fischel, *Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Greenough & Clapman, *The Role of Independent Directors in Corporate Governance*, 1982–83 CORP. PRAC. COMMENT 365 (reprinted from 56 NOTRE DAME LAW. (1981)).

15. Taft-Wickersham Federal Incorporation Bills, H.R. 20142 & S. 6186, 61st Cong., 2d Sess. (1910). *See* FEDERAL TRADE COMMISSION REPORT, COMPILATION OF PROPOSALS AND VIEWS FOR AND AGAINST FEDERAL INCORPORATION ON LICENSING OF CORPORATIONS AND COMPILATION OF STATE CONSTITUTIONAL, STATUTORY AND CASE LAW CONCERNING CORPORATIONS, WITH PARTICULAR ATTENTION TO PUBLIC UTILITY HOLDING AND OPERATING COMPANIES, S. Doc. No. 92, Part 69-A, 70th Cong., 1st Sess. (1934).

16. G. KOLKO, THE TRIUMPH OF CONSERVATISM, A REINTERPRETATION OF AMERICAN HISTORY, 1900–1916, 64 (5th printing 1967).

17. The principal bills introduced were S. 10, 75th Cong; 1st Sess. (1937) by Senator O'Mahoney, and S. 721, 75th Cong., 1st Sess. (1937) by Senator Borah. Hearings were held in 1937 on these measures. In 1938, President Roosevelt proposed the creation of the Temporary National Economic Committee (TNEC), which flirted with various notions of federal chartering. *See* J. SELIGMAN, THE TRANSFORMATION OF WALL STREET at 208–210 (1982).

18. J. MADISON, NOTES OF DEBATES OF THE FEDERAL CONVENTION 638 (W. Norton & Co. ed. 1966).

More important than the philosophical musings, many changes resulted from this concentrated effort, accomplished through a patchwork of regulatory statutes.

In the 1970s new advocates of fundamental corporate reform urged federal chartering, or at least an enhanced federal role.[19] These reform efforts were not brought on by economic failings, at least not at the start of the decade, but were mainly a social reform movement. Probably the most important group to focus on reform of the corporations was the consumer movement, led by Ralph Nader and others who sought to demonstrate the connection between ordinary business activity and a wide range of social problems, including unsafe products, pollution, and race and sex discrimination.

The reformers were a fringe movement until the revelation of widescale management improprieties relating to illegal political contributions and improper foreign payments.[20] In some cases, these improprieties reached the top levels of corporations. This moved the corporate reform efforts to page one of the newspapers and aroused the concern of the Securities and Exchange Commission and the Congress.

As the decade wore on, the public became increasingly disenchanted with the corporation as an institution, along with many other institutions in society and grew more critical of the economic performance of American corporations.[21] Frequently our corporate system was compared unfavorably with the Japanese system;[22] no longer was it heretical to criticize American big-business and big-business leaders. Cautious critics, led by SEC Chairman Williams, insisted that it was crucial to install more effective accountability mechanisms within corporations.[23] In sum, reform advocates have been impelled by perceived corporate shortcomings both with respect to societal obligations and economic performance. Theoretically, these criticisms appear to be inconsistent, but they may not be in a practical sense. Profit maximization, the corporate objective according to those who espouse increasing shareholder welfare, is not easily defined or recognized except by those who insist that market prices for stock faithfully measure value. Others contend that profit maximization is a long-term notion that enables managers to factor in broader community concerns

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19. Ralph Nader and his colleagues popularized the idea in 1976. R. NADER, M. GREEN, & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976). This well-publicized effort prompted congressional interest and Senate hearings were held. *Corporate Rights and Responsibilities: Hearings before the Committee on Commerce, U.S. Senate*, 94th Cong., 2d. Sess. (1976). Other academic writings also urged new federal law to govern corporations. Cary, *Federalism and Corporation Law: Reflections Upon Deleware*, 83 YALE L.J. 663 (1974); Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976).

20. SECURITIES AND EXCHANGE COMMISSION, REPORT ON QUESTIONABLE AND ILLEGAL PAYMENTS AND PRACTICES, SUBMITTED TO THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMM., 94th Cong., 2d Sess. (May 12, 1976).

21. Kroll, *Introduction by the Chairman*, in COMMENTARIES, *supra* note 12, at 30–31.

22. NEW YORK STOCK EXCHANGE, PEOPLE AND PRODUCTIVITY: A CHALLENGE TO CORPORATE AMERICA (1982); R. REICH, THE NEXT AMERICAN FRONTIER (1983); E. REISCHAUER, THE JAPANESE (1977).

23. Chairman Williams addressed this subject frequently. His speeches included the following: Corporate Accountability, Speech at Fifth Annual Securities Regulation Institute, San Diego, California (January 18, 1978); The Role of the Director in Corporate Accountability, Speech to The Economic Club of Detroit (May 1, 1978); Corporate Accountability and the Lawyer's Role, Speech to Section of Corporation, Banking and Business Law, American Bar Association (August 8, 1978); Corporate Accountability—One Year Later, Speech at Sixth Annual Securities Regulation Institute, San Diego, California (January 18, 1979); Corporate Accountability and Corporate Power, Fairless Lecture Series at Carnegie-Mellon University, Pittsburgh, Pa. (October 24, 1979); Corporate Accountability—A Look at Strategy, Speech at Rice University, Houston, Texas (August 8, 1980).

when making business decisions. So viewed, it is permissible in the conduct of business to use corporate resources to reduce such externalities as environmental burdens, unsafe products, discrimination, or other antisocial behavior. All of these undesirable side effects were the focus of corporate critics during the 1970s and were viewed as related, in part, to the largely unaccountable power which corporate managers wielded within their organizations.

The focus of the 1970s reform movements has been on reform of the governance process rather than on substantive law reform.[24] This response is unusual because historically, Americans have responded to problems by addressing the symptoms, not root causes.[25] The governance reforms that have been proposed, however, for the most part have reflected a hesitance to do more than tinker with the structure lest its economic efficiency be damaged; the reforms seek to operate within the system of privately owned and operated business and to minimize the role of government regulation or enforcement.[26]

Moreover, governance reform does not even require enabling legislation or any other kind of legislation on a federal or state level. Reform can be, and has been in part, voluntarily implemented on an individual basis or by the rules of self-regulatory organizations.[27] Efforts to compel specific reforms have uncovered deep resistance to even modest, mandated reform.[28] Reformers undoubtedly realize that insurmountable obstacles impede any grander program of reform. One barrier is the shareholder body itself, which is largely disinterested in the social side of reform and has not recognized a serious conflict of interests with managers.[29]

Governance reform efforts are mainly the work of lawyers, focusing on accountability as the objective. Economists, as a whole, have expressed considerable

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24. The Foreign Corrupt Practices Act, enacted in 1977, was an exception to this norm, since this Act prohibited certain types of payments. However, Part II of the Act, amending Section 13(b) of the Securities Exchange Act of 1934, is a governance reform measure because it requires that proper books and records be maintained and that corporations install effective internal control systems.

25. When broad structural reforms were suggested in the early 1900's arising out of monopolization, stiffer antitrust laws were adopted. *See* REPORT OF FEDERAL TRADE COMMISSION, COMPILATION OF PROPOSALS AND VIEWS FOR AND AGAINST FEDERAL INCORPORATE OR LICENSING OF CORPORATIONS AND COMPILATION OF STATE CONSTITUTIONAL, STATUTORY, AND CASE LAW CONCERNING CORPORATIONS, WITH PARTICULAR ATTENTION TO PUBLIC UTILITY HOLDING AND OPERATING COMPANIES, S. Doc. No. 92, Part 69-A, 70th Cong., 1st Sess. 9–11 (1934) (discussing hearings and analyses on federal incorporation questions during the early 1900's which eventuated in the Federal Trade Commission and Clayton Acts of 1914); G. KOLKO, THE TRIUMPH OF CONSERVATISM, A REINTERPRETATION OF AMERICAN HISTORY 1900–1916, 132–38, 261–67 (5th printing 1967) (discussing Sherman Act revisions and passage of the Federal Trade Commission and Clayton Act Bills).

26. The most radical idea that has been floated would provide for constituency representation on corporate boards. See the shareholder proposal submitted to General Motors in 1971, discussed in Schwartz, *Towards New Corporate Goals: Co-Existence With Society*, 60 GEO. L.J. 57, 60–61 (1971) (but opposed by the author, at 86–88). *See also* R. NADER, M. GREEN, & J. SELIGMAN, *supra* note 19, at 119–28. With the election of a union representative to the board of Chrysler in 1980, the idea looks less radical. In any event, other reform proponents have not favored it.

27. *See* Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1981).

28. STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATION" (Feb. 1983).

29. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL ST. 251, 278 (1977). *But see* Fraker, *Brawl in the Family at Superior Oil*, FORTUNE, May 30, 1983, at 70 (when stockholders sponsored a resolution, in the face of an entrenched Board and management, that offers to acquire 45% or more of Superior Oil's stock at above-market prices should be submitted to a committee of three independent directors. The resolution was modeled after a similar resolution proposed by dissident stockholders at NLT Corp., a Tennessee insurance company. *Id.* at 73).

skepticism about the effectiveness and utility of governance reform because they are more inclined to the notion that market forces, rather than governance forces or organizational structures, dictate the conduct of corporate managers.[30]

What are the goals of those who seek to reform corporate governance? Bayless Manning has demonstrated that reformers do not speak with one voice.[31] At one end of the spectrum are reformers who would use governance reform to introduce a new value scheme into the corporation or society as a whole. These reformers quarrel with the concept of the corporation as principally a means of maximizing profits through the efficient production of goods or services. Their reform agenda relates more to society's overall goals than to traditional corporate and investor objectives. These reformers are not the mainstream of the reform effort.

The mainstream of corporate reform accepts the corporation as a necessary and desirable vehicle for achieving economic goals. The reformers' quarrel is with managers, not the corporation. For the most part, lawyer-reformers do not advocate reform as a means of improving economic efficiency—a subject not within their expertise and not one that is customarily addressed through law. Their focus is on accountability, in order to constrain the abuse of power.

Lack of accountability is costly because it deprives the corporation of a disciplining mechanism over managers, which may result in a divergence of the goals of managers and the corporation (together with its shareholders). Again, economists might perceive some gain, in some circumstances, in leaving unreigned the entrepeneurial spirit of managers, subject to control by market constraints. One effect of the lack of accountability may be that the corporation will be less efficiently managed as managers grow complacent and slothful in their performance because they can thwart change and turnover and frustrate the operation of the market for control. Resources between managers and shareholders may be misallocated.[32] Insufficient regard may be paid to social responsibilities and the welfare of other constituencies of the corporation because managers may pay too much attention to short term profitability at the expense of long-term goals.[33] Economists refer to management inefficiency attributable to a lack of accountability as agency costs, although most economists do not prescribe governance reform as the means of dealing with the problem.[34]

These potential malfunctions are not necessarily prevalent among corporations but are more likely to breed in the absence of an accountability discipline and structure. The goal of most reformers is to reduce that likelihood. This goal is common to mainstream reformers; the particular emphases will vary.

Reform is often equated with federalism, meaning an increase in the power of

30. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982).

31. Manning, *Thinking Straight About Corporate Law Reform*, in CORPORATIONS AT THE CROSSROADS 9 (D. DeMott ed. 1980).

32. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1978).

33. *See, e.g.*, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, § 2.01 comment e, illustration 6 (Tent. Draft No. 1, 1982) [hereinafter cited as ALI PROJECT].

34. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

the federal government. Reformers believe that changes that may be necessary in corporate governance or corporate law cannot be achieved at the state level and must be accomplished by federal legislation. Today's reformers hold this view in common with their predecessors. Whether reform in corporate governance or corporate law is more effective at the federal level than at the state level is more properly an open question than a foregone conclusion. Both federal law and state law have shaped the governance of the corporation, although state law has been the main source. The existing allocation of roles now must be examined, along with the legal and policy issues that would allocate more of that power to the federal government.

II. Prevailing Law Of Corporate Governance

The prevailing arrangement for the governance of corporations dates from a decision made in Philadelphia at the Constitutional Convention. The founding fathers rejected James Madison's suggestions for a national law of corporations and consequently, Article I of the Constitution contains no reference to corporation law.[35] The power to govern the internal affairs of corporations belongs to the states.

Any state may create corporations pursuant to its general corporation law. Persons seeking to incorporate a business may select any state as the legal birthplace, and the corporation may then conduct business in all other states. Chaos does not reign because the act of incorporation in one state is accorded full faith and credit by all other states under Article IV of the Constitution. Since large corporations roam the land, it is necessary to determine a fixed point by which their governance arrangements will be judged. That is the role of the conflict of laws principle known as the Internal Affairs Rule.[36] Under the Internal Affairs Rule, which is recognized universally, the law of the state of incorporation applies to determine the validity of the internal arrangements of the corporation.[37] This rule extends to the corporate governance structure and to determinations of fiduciary duties as well.[38]

The principle of the Internal Affairs Rule is strong. Several years ago, the Supreme Court struck down the Delaware sequestration statute, which permitted quasi in rem jurisdiction over a nonresident director of a Delaware corporation by attachment of his stock in a Delaware corporation.[39] The case was a stockholder derivative suit concerning a Delaware corporation that did little business in that state and whose principal office was in Arizona. The issue concerned the fiduciary duty of managers. The Court struck down Delaware's jurisdiction, which had been obtained through the attachment and sequestration process, and observed, among other things, that Delaware simply had "nothing to do" with the case.[40] Nonetheless, the Court

35. J. Madison, *supra* note 18; *see also* Brabner-Smith, *Federal Incorporation of Business*, 24 Va. L. Rev. 159 (1937); Note, *Federal Chartering of Corporations: Constitutional Challenges*, 61 Geo. L.J. 123, 125–26 (1972).

36. *See* Restatement (Second) of Conflicts of Laws § 302 comment a (1971).

37. *See* Reese & Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 Colum. L. Rev. 1118 (1958).

38. Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947).

39. Shaffer v. Heitner, 433 U.S. 186 (1977).

40. *Id.* at 216.

held that Delaware substantive law would apply to the controversy, wherever the case was heard.[41] Thus, the reach of Delaware extended well beyond its borders, notwithstanding its lack of interest in the case.

Occasional exceptions to the Internal Affairs Rule have been created by statute. The most important is section 2115 of the California Corporation Code, which employs a formula to determine the applicability of some of the internal affairs rules of California, notwithstanding incorporation elsewhere.[42] The formula employs property, payroll, and sales factors to determine whether fifty percent or more of the corporation's activity is attributable to California, and requires that more than half of the voting stock be held by holders of record with California addresses.[43]

Despite some early holdings adverse to the broad reach of the statute,[44] it appears to pass constitutional muster.[45] The statute is consistent with an earlier, well-known California decision applying the California securities law to an attempt by a Delaware corporation to eliminate cumulative voting by compliance only with the Delaware statute.[46] While this type of transaction clearly comes within the scope of the internal affairs rule, the California statute required compliance with its law as well.

New York, in sections 1317–20 of the Business Corporation Law, also applies some of its internal governance provisions to certain foreign corporations doing business in New York, but this statute's reach is not as broad as California's statute's.[47] However, both the New York and California statutes rarely apply to other than a closely held corporation. It is the unusual publicly held corporation that meets the composite fifty percent tests of the California statute, and New York exempts corporations whose shares are listed on a securities exchange or when less than half the corporation's business in the last three years is attributable to New York. New York and California, in effect, apply local law to local corporations and have scant impact on the affairs of the larger corporations where more of the public interest in corporate governance lies.

One state, Delaware, has emerged as the leading state for the incorporation of larger corporations. Once its lead was clearly established, approximately seventy years ago, its continued leadership was virtually assured.[48] As the leading corporate jurisdiction, far more decisions interpreting and clarifying Delaware law have been rendered than with respect to any other state corporation law, and the growth rate of case law has increased exponentially, thus providing predictability in the application of the Delaware statute.[49] The Delaware bench and bar have gained experience in the

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41. *Id.*

42. CAL. CORP. CODE § 2115 (West 1984).

43. *Id.*

44. Louart Corp. v. Arden-Mayfair, Inc., No. C192091 (Super. Ct. Cal. Aug. 5, 1977) (order denying declaratory relief), April 25, 1978 (findings of fact and conclusions of law); Arden-Mayfair Corp. v. Louart Corp., 385 A.2d 3 (Del. Ch. 1978)(Delaware action dismissed for lack of jurisdiction over Louart).

45. Wilson v. Louisiana-Pacific Resources, Inc., 138 Cal. App. 3d 216, 187 Cal. Rptr. 852 (1982).

46. Western Airlines v. Sobieski, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961).

47. N.Y. BUS. CORP. LAW § 1317–20 (McKinney 1982).

48. *See* Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249 (1976).

49. H. HENN & J. ALEXANDER, LAW OF CORPORATIONS 185–86 (3d ed. 1983); Garrett, *The Limited Role of Corporation Statutes*, in COMMENTARIES, *supra* note 12, at 95.

interpretation of the statute, and the legislature understood the importance to Delaware of maintaining its leadership in this field.[50] Consequently, the statute has been kept up to date, and it has responded to criticisms and advances made in other states.[51] Thus, an understanding of the law affecting corporate governance of large corporations begins with an understanding of the Delaware statute.

Delaware law now provides that the business and affairs of the corporation shall be managed by or under the direction of the board of directors.[52] For large corporations, this means that the board's role is not to perform day-to-day managerial functions, although it is not affirmatively clear what it does mean. In all likelihood, the Delaware provision accords with the Business Judgment Doctrine, which recognizes the managerial responsibility of senior executives, the group known as management, a term not given any formal recognition in the corporate statutes of Delaware or any other jurisdiction.[53]

Delaware accords a minor role to shareholders. Of course, they elect directors annually,[54] and shareholders are free to nominate candidates for director,[55] but the all-important proxy statement, which is used to solicit the votes of widely scattered shareholders, is controlled by the board of directors with only minor access allowed to the shareholders.[56] Certain transactions require shareholder approval after the board has approved them, including such matters as amendments to the certificate of incorporation,[57] mergers or consolidations,[58] sales of assets,[59] or dissolution.[60] However, shareholders cannot initiate any of these transactions. The shareholders also have the power to amend the by-laws,[61] potentially a sleeping-giant power, because by-laws can be amended without approval of the board of directors and if enough shareholders agree, even without convening a meeting.[62] Moreover, the statute does not limit what provisions may be included in the by-laws.

Delaware, like all other states, permits shareholders to vote by proxy,[63] but neither statutes nor rules govern the procedure for solicitation of proxies. Judicial interpretation requires that the proxies not be misleading.[64]

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50. Between the years of 1899 and 1974, corporate revenues represented 5.2 (in 1960) to as much as 42.5 (in 1929) percent of Delaware's total state revenues in any one year. *See* R. NADER, M. GREEN, & J. SELIGMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS 535–37 app. (1976). In 1974, 251 of the largest 500 (50.2%) and 448 of the largest 1000 (44.8%) U.S. industrial corporations were chartered in Delaware. *Id.* at 502.

51. *E.g.*, DEL. CODE ANN. tit. 10, § 3114 (Supp. 1982) (enacted July 7, 1977, by the Delaware General Assembly, just 13 days after the Supreme Court handed down its decision in Shaffer v. Heitner, 433 U.S. 186 (1977)); see Ratner & Schwartz, *The Impact of* Shaffer v. Heitner *on the Substantive Law of Corporations*, 45 BROOKLYN L. REV. 641, 644 (1979).

52. DEL. CODE ANN. tit. 8, § 141 (1983); *see also* MODEL BUSINESS CORP. ACT § 35 (1979).

53. *See*, A.L.I. PROJECT, *supra* note 33, § 3.01 (Tent. Draft No. 1, 1982).

54. DEL CODE ANN. tit. 8, § 211 (1983).

55. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1505 (1970).

56. *Id.* at 1502.

57. DEL. CODE ANN. tit. 8, § 242(b) (1983).

58. *Id.* § 251(c).

59. *Id.* § 271(a).

60. *Id.* § 275.

61. *Id.* § 109.

62. *Id.* § 228.

63. *Id.* § 212.

64. Campbell v. Loew's, Inc., 36 Del. Ch. 563, 134 A.2d 852 (1957).

Delaware courts have recognized that, notwithstanding the absence of formal statutory procedures as to the scheduling of meetings and the use of the proxy machinery, management may not abuse the corporate machinery to manipulate the timing of meetings[65] or the meeting process[66] to perpetuate their own control. The corporate machinery is not management's own tinker toy, but is exercised subject to equitable principles.

No rules prescribe the composition or organization of the board of directors, except as may be provided in the certificate of incorporation. Delaware permits, but does not require, cumulative voting[67] for the election of directors and staggered terms[68] for members of the board of directors. Committees with broad powers are sanctioned, but not mandated.[69]

Delaware allows informality in the manner in which both directors and shareholders act. Telephone board meetings are permitted, although some collegial action is required.[70] A majority of shareholders may act without a meeting,[71] a provision that is useful for majority-owned subsidiary corporations.[72]

Delaware adopted relatively modest antitakeover provisions at a time when many states provided strong defenses against an unfriendly takeover.[73] The constitutionality of the Delaware provision remains doubtful, however, in light of recent decisions.[74]

Delaware imposes fewer impediments to stockholder derivative suits than many states.[75] While this policy may appear to encourage litigation against management and directors, the main effect of the policy is to encourage litigation to be conducted *in Delaware* before a forum familiar with corporate cases and where the law is better defined than in other states. Delaware corporate counsel can more accurately forecast the outcome. While defendants may not relish stockholder litigation, they prefer a Delaware forum when the inevitable suit commences. Two corollary points should be noted: Delaware provides relatively favorable indemnification provisions,[76] and the

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65. Schnell v. Chris-Craft Indus. Inc., 285 A.2d 437 (Del. 1971). A more tolerant view of management's freedom to maneuver was taken in Mansdorf v. Unexcelled, Inc. 28 A.D.2d 44, 281 N.Y.S.2d 173 (1967).

66. Lerman v. Diagnostic Data, Inc., 421 A.2d 906 (Del. Ch. 1980); *see* Coalition to Advocate Publ. Util. Responsibility Inc. v. Engels, 364 F. Supp. 1202 (D. Minn. 1973).

67. DEL. CODE ANN. tit. 8, § 214 (1983).

68. *Id.* § 141(d).

69. *Id.* § 141(c). The powers of the executive committee, however, are specifically limited by the statute.

70. *Id.* § 141(i). At common law the requirements for directors' meetings were far tighter. *See* Baldwin v. Canfield, 26 Minn. 43, 1 N.W. 261 (1879).

71. DEL. CODE ANN. tit. 8, § 228 (1983).

72. Martin Marietta, a Maryland corporation, hoped to gain control of Bendix Corp., a Delaware corporation, by taking stockholder action immediately following the acquisition of 50% of the Bendix stock. If successful, it could remove the existing board of directors without cause and replace the directors with their own designees. Bendix, meanwhile, would have to await the minimum ten day period mandated by Maryland law before asserting its control over Martin Marietta, since Maryland law does not permit action without a meeting by only a majority of shares. Although the issue was not finally resolved by the Delaware Supreme Court, Martin Marietta's strategy was held by the Delaware Court of Chancery to run afoul of section 160 which prevents a more than majority owned subsidiary from voting the shares of its parent. Martin Marietta Corp. v. Bendix Corp., Civ. Action No. 6942, (Del. Ch. Sept. 21, 1982). Bendix at the time owned approximately 70% of the stock of Martin Marietta.

73. DEL. CODE ANN. tit. 8, § 203 (1983).

74. Edgar v. MITE Corp., 457 U.S. 624 (1982).

75. DEL. CODE ANN. tit. 8, § 327 (1983). No security for expenses is required, unlike, for example, New York. N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1982).

76. DEL. CODE ANN. tit. 8, § 145 (1983).

business judgment rule, the meaning of which lawyers could debate inconclusively for days, probably has received more interpretations in Delaware than in the remaining states combined.[77]

While some state laws differ in minor respects from the pattern of Delaware law, the substantive provisions of Delaware law prevail throughout the land.[78] California requires cumulative voting[79] and provides for extraterritorial application of its statute.[80] In most respects, however, despite their more regulatory tone, the California statutes differ only moderately from Delaware's in their corporate governance provisions. Connecticut amended its corporate statute several years ago to require corporations to have an audit committee of the board of directors composed of three outside directors.[81] No other state has followed suit.

Corporations whose shares are listed on the New York or American Stock Exchanges also must comply with certain provisions of the listing agreement with the Exchange under which their shares are listed. The Exchanges have broadened the power of shareholders to participate in certain transactions and require shareholder approval for the issuance of shares that would dilute the existing voting power by 18½ percent.[82] The New York Stock Exchange requires an audit committee composed primarily of independent members.[83] The New York Stock Exchange also requires a certain number of outside directors on the board.[84] Certain transactions that have the effect of a change in control also must be approved by shareholders.[85] The thrust of the Exchange rules is to constrain management's power to engage in self dealings in certain specific respects. The stock exchanges are regulated, to an extent, by the Securities and Exchange Commission, and they are not completely free to amend their rules,[86] as will be discussed in section III of this Article.

Four major defects may be identified in the prevailing law of corporate governance. First, state corporation statutes lack focus.[87] Perhaps it is implicit that management must single-mindedly keep its eye on the shareholder interest, but cases have allowed enough slack in that rule to create substantial doubt.[88] At the same time, no governing principle has replaced the notion of profit maximization.[89] Probably

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77. Arsht, *The Business Judgment Rule Revisited,* 8 HOFSTRA L. REV. 93 (1979); Veasey & Manning, *Codified Standard—Safe Harbor or Uncharted Reef: An Analysis of the Model Act Standard of Care Compared with Delaware Law,* 35 BUS. LAW. 919 (1980).

78. Competitive conditions compel states to copy the leader. For example, when Michigan adopted a new corporations law in 1972, its principal sponsor boasted that the law would "out-Delaware Delaware." Downs, *Michigan to Have a New Corporations Law?,* 18 WAYNE L. REV. 913, 914 (1972).

79. CAL. CORP. CODE § 708 (West Supp. 1984).

80. *Id.* § 2115.

81. CONN. GEN. STAT. ANN. § 33-318(b) (West Supp. 1984).

82. N.Y.S.E. LISTED COMPANY MANUAL § 312.00 (1983); AMEX COMPANY GUIDE §§ 712-713. The American Stock Exchange speaks of 20%, but unpublished interpretations have commonly read this to mean approximately 18½%.

83. N.Y.S.E. LISTED COMPANY MANUAL § 303.00 (1983).

84. *Id.*

85. *Id.* § 312.00

86. Securities Exchange Act of 1934 § 19(b)(1), (c), 15 U.S.C. § 785(b)(1), (c) (1982).

87. J. W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION 162-64 (1970); B. MANNING, *Discussion and Comments on Papers by Professor Demsetz and Professor Benston* in ECONOMIC POLICY AND THE REGULATIONS OF CORPORATE SECURITIES 81 (H. Manne ed. 1969); Schwartz, *A Case for Federal Chartering of Corporations,* 31 BUS. LAW. 1125, 1138, 1141 (1976).

88. Schlensky v. Wrigley, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968).

89. A.L.I. PROJECT, *supra* note 33, at § 2.01.

corporate managers think that their role is to balance different interests, and they seek to do this.[90] It is possible, although not easy, for the law to provide some guidance in this respect, but state law, certainly state statutes, does very little.

Second, the prevailing legal system lacks an adequate internal mode of accountability. Shareholders cannot do this effectively, and statutes do not contemplate otherwise. The law addresses neither the composition nor the function of the board of directors. Until fairly recently, all statutes described the board's function as managing the business and affairs of the corporation, but this description was almost totally fictional as applied to large corporations.[91] Corporate statutes refer to committees, but the use of committees, in practice, has overtaken what the statute writers contemplated. Monitoring has replaced management as a board function,[92] but state law has rarely recognized that fact nor attempted to deal with the implications of the change.

Third, the election process is almost totally under the control of management. The shareholder role is a formal one only, except when a proxy contest is under way. The uncontested election of directors is almost completely a function of the nominating process, which, under prevailing law, is within the control of management.[93]

Fourth, many problems beset the remedies and enforcement provisions. The derivative suit is subject to abuse on all sides. A temptation remains to bring strike suits resulting in lucrative and quick settlements. At the same time, management has developed the wherewithal to terminate derivative suits on the strength of internal decisions, which are barely policed under the laws of many jurisdictions.[94] A number of state statutes impose procedural obstacles to bringing a derivative suit, which may give management undue protection.[95] Finally, even when suits may proceed, the prospect of redressing a wrong with draconian relief may lead courts to relax the standards of care and loyalty rather than to impose financial ruin on the defendants.[96]

The prospects for changing the state legal structures are slim. State corporation

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90. COMMITTEE FOR ECONOMIC DEVELOPMENT, SOCIAL RESPONSIBILITIES OF BUSINESS CORPORATIONS (1971).

91. M. MACE, DIRECTORS: MYTH AND REALITY (1971).

92. Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375 (1975); Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799 (1976).

93. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1494–1502 (1970).

94. Interestingly, Delaware provides a tougher standard than New York. *Compare* Zapata v. Maldonado, 430 A.2d 779 (Del. 1981) (an independent committee of directors may obtain dismissal only where the court determines that the committee was independent and acted in good faith upon reasonable investigation, and that in the court's independent business judgment, dismissal is in the corporation's best interest) *with* Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979) (the business judgment rule limits judicial scrutiny of the recommendations of an independent committee of directors only to their good faith, thoroughness and independence). *See* Joy v. North, 692 F.2d 880 (2d Cir. 1982) (comparing *Zapata* with *Auerbach* and adopting Delaware law). *See generally*, A.L.I. PROJECT, *supra* note 33, at § 7.03 (setting forth circumstances in which corporate law should provide for the termination of derivative action on the basis of Board or shareholder action).

95. Standing may be conditioned upon owning stock at the time of the wrong in some jurisdictions. *See, e.g.*, DEL. CODE ANN. tit. 8, § 327 (Supp. 1982); N.Y. BUS. CORP. LAW § 626(b) (McKinney 1980); MODEL BUSINESS CORP. ACT § 49 (1979). Some statutes require that the shareholder post security to cover expenses of the suit. *See e.g.*, CAL. CORP. CODE § 800(c),(d),(e) (West Supp. 1984); N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1982).

96. An example of such an application of the business judgment rule may be the dismissal of the action against the directors of Marshall Field and Co. for thwarting a favorable tender offer. Damages would have exceeded $200 million if plaintiffs were successful. Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

laws compete with the laws of other states because a corporation may incorporate in one state and do business everywhere. State statutes must be attractive to those who decide where the corporation will be incorporated. This decision is mainly made by managers or promoters in consultation with their counsel. A state legislature that attempts to restrict in any significant way the power of managers or to use state corporation law as a regulatory device soon finds that corporations will escape the jurisdiction of that statute and "flee" to another state, all of which may be accomplished effortlessly by the stroke of a word processor without moving a single brick or soul.[97] If the reforms in corporate governance do not appeal to corporate managers, and presumptively the reforms do not appeal to the managers, or else they would have adopted these reforms voluntarily, then the ability of any one state to impose the changes is practically nil.[98]

In fact, the process of writing and amending most corporate statutes is largely controlled by the corporate bar.[99] The legislature's role in enacting corporate statutes is passive, and the usual cross currents of the political process are not significant in determining the substance of corporate statutes. Corporate statutes are much more a result of the market process than the political process, but those who possess the currency in this market are not the only ones affected by the results.

In some areas of law, states have resolved competing interests through the adoption of uniform laws. The Uniform Commercial Code is perhaps the best illustration of that process. However, one has no reason to expect the uniform law process to create a uniform corporation statute that achieves balance among competing interests.

States have no incentive to adopt a uniform corporation law. Those states that have more permissive statutes have an incentive to maintain their status, and a uniform law would provide no trade-off benefit for them. State corporation statutes are unlike the Uniform Commercial Code because corporate managers can painlessly select the state of incorporation without in any way inconveniencing their method of doing business. In the absence of uniform commercial laws, commercial transactions cannot be arranged easily to maximize advantage from different rules of law. The selection of a state of incorporation can be arbitrary, but the selection of a place of a commercial transaction is more often based on commercial necessity. In addition, a state has little incentive not to go along with uniformity in commercial transactions because the adoption of a more relaxed statute does not hold out the promise of

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97. Historian Charles A. Beard once testified before a Senate subcommittee about a local attempt to achieve a restriction of the power of managers on a state level:

> Under the leadership of Woodrow Wilson, after he was challenged by Theodore Roosevelt to reform his own State, the Legislature of New Jersey passed a series of laws doing away with corporate abuses and applying high standards to corporations. What was the result? The revenues of the State from taxes on corporations fell. Malefactors moved over into other States. In time the New Jersey Legislature repealed its strict and prudent legislation, and went back, not quite, but almost to old ways. . . . It is folly to expect all the States and Territories to apply strict and uniform principles to corporate legislation; the business of controlling corporations engaged in interstate commerce belongs to the Government of the United States. That seems to me to be the lesson we learn from history.

Hearings on S.10 Before a Subcommittee of the Senate Committee on the Judiciary, 75th Cong., 1st Sess. 74 (1937).

98. This is the thrust of what Professor William Cary described as the "race for the bottom," Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974), and what Justice Brandeis observed was a race "not one of diligence but of laxity." Liggett Co. v. Lee, 288 U.S. 517, 558-59 (1933) (Brandeis, J., dissenting).

99. Folk, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. BAR J. 409 (1968).

increased state revenue. Finally, a state's adoption of a lax body of commercial law could work to the disadvantage of the citizens within that state, resulting in a high political price. The adoption of a lax corporation statute, which imposes no regulatory burdens, is not likely to work to the disadvantage of a small state, few of whose citizens are likely to be shareholders.

However, the corporate governance system cannot be understood by reference to state law alone. Federal law plays a role, as shall be examined in the next section. Even this role does not round out the picture. As is true in many areas of corporate affairs corporate practice explains as much of the governance system as does corporate law. Changes have taken place in the prevailing governance scheme of large corporations as a whole. Most large corporations have boards composed predominantly of outside directors; most have audit committees, and many have nominating committees. Directors receive more pay than ever before, and they spend their time monitoring management. These changes are not universal, however, and actual standards of practice of independent directors, audit committees, and nominating committees probably vary considerably. The importance and prevalence of these voluntary changes cannot be ignored, even if we cannot yet assess their effectiveness when not converted into a legal standard with sanctions. The perceived need to provide an enforceable accountability standard leads us to examine how federal law has supplemented the basic state law governance system.

III. The Federal Overlay On the Governance Scheme

The limited power of states to remedy the governance problems has convinced critics and reformers that federalism and reform are linked. Those who seek reform think in terms of federal legislation. In fact, a substantial federal overlay on the prevailing state law system already exists. While no single federal statute deals with the governance of corporations generally, numerous statutes affect corporate governance. In some cases, the statutes deal with particular industries, and in other cases, the statutes are more generic.

The national banking system contains a number of provisions that relate to the election of directors and the composition of the board of directors. National banks are governed primarily by the National Bank Act,[100] but national banks that are members of the Federal Reserve System and the Federal Deposit Insurance Corporation are subject to other sections of Title 12 and Title 15 as well. These provisions contain several requirements relating to the governance of national banks.

The National Bank Act requires that the board of directors consist of at least five members.[101] Also, directors are prohibited from participating in the management of another local financial institution or from being connected with a firm engaged primarily in securities transactions.[102] Directors are elected by shareholders, initially at the shareholders' meeting prior to the opening of business, and subsequently at

100. 12 U.S.C § 21–216d
101. *Id.* § 71(a).
102. *Id.* § 78.

annual meetings.[103] Cumulative voting is required,[104] and directors are chosen for one year terms.

Shareholder approval is required not only for those transactions for which comparable requirements exist under state corporation law, but also for changes in capital structure or reduction of capital[105] and the decision to levy an assessment on shareholders if the Comptroller determines that capital stock is impaired. In addition, transactions affecting capitalization, structure, and mergers also must be approved by the Comptroller of the Currency. Acquisition by a person or persons acting in concert who have the power to vote twenty-five percent or more of a class of voting securities requires prior notice to the Comptroller, subject to certain exemptions relating primarily to prior control.[106] Under certain conditions, a transfer of voting stock through which a person will acquire ten percent or more of a class of voting stock is rebuttably presumed to be an acquisition of control.[107]

Both the Investment Company Act of 1940[108] and the Public Utility Holding Company Act of 1935,[109] unlike the other federal securities laws, are avowedly regulatory. Each subjects the governance scheme of the industries it affects to federal requirements. The Investment Company Act was enacted following the Investment Trust Study during the 1930s[110] of abuses in the structure of interest companies. The external management that prevailed in the industry was preserved; that is, the key management decisions are made not by the board of directors but by another company, which usually is owned by the promoters of the investment company and that has contracted to render such services. However, these investment advisory contracts must be approved by the shareholders for a term of not more than two years and must be renewed annually by a vote of the board of directors or the shareholders.[111] Shareholders also must have the power to elect directors,[112] to select independent auditors,[113] to change the investment policy of the company,[114] and to approve distributions of shares by a mutual fund.[115] The independence of directors also is addressed by the statute, which prohibits more than sixty percent of the board to be "interested persons."[116] The importance of independent directors and the need to tighten the definition was emphasized by the SEC in a special report in 1966,[117] which ultimately produced amendments to the statute in 1970.[118]

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103. *Id.* § 71.
104. *Id.* § 61.
105. *Id.* §§ 57, 59.
106. *Id.* § 5.50(e).
107. *Id.*
108. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (1982).
109. Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1982).
110. *See* 1 L. Loss, SECURITIES REGULATION 147 n.52 (2d ed. 1961).
111. Investment Company Act of 1940, 15 U.S.C. § 80a-15 (1982).
112. *Id.* § 80a-16(a).
113. *Id.* § 80a-31(a).
114. *Id.* § 80a-13(a).
115. 17 C.F.R. § 270.12b-1(b)(1) (1983).
116. *Id.* §§ 10(a), 2(a) (19).
117. REPORT OF THE SEC ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 130-32, 332-35 (1966).
118. More recently, the SEC outlined options for the elimination of shareholder voting or both shareholder voting and the board of directors in the management of investment companies, since conditions and problems have changed

Beyond these structural requirements, investment companies are restricted in self-dealing transactions.[119] Rather than completely prohibiting conflict of interest transactions, however, Congress granted the SEC exemptive power, which extends to the full range of the Act, if the exemption "is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter."[120]

The Public Utility Holding Company Act also followed a massive federal study of the problems of the industry, some of which related to the manner of governance.[121] This Act was the most controversial of the securities laws, and its purpose was to transform an industry and administer a death sentence to the massive holding company structures as then existed.[122] However, not all holding companies were abolished, and the SEC remained in the business of regulating those that survived.

The regulation is extensive and directly involves the Commission in approving specific types of business decisions. These include decisions relating to capital structure,[123] proxy solicitation,[124] accounting practices,[125] and intracompany transactions.[126] One commentator notes that the statute grants the SEC power to condition acquisitions of another company's securities upon the making of a "fair offer to buy other securitites of that company,"[127] a federal solution to the sale of control problem presented in *Perlman v. Feldmann.*[128]

The Internal Revenue Code contains countless provisions that have implications beyond the raising of revenues. One provision intended to affect corporate governance is Section 4975(e)(7),[129] which created employee stock ownership plans (ESOPs). ESOPs assist corporations in obtaining financing, and, at the same time,

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considerably over the past several years. The SEC announced that its goal was reducing the expense of fund operations without sacrificing investor protections.

The Commission stated it is considering exempting mutual funds from shareholder voting requirements. The arguments for the exemption are the high cost and apparent apathy of shareholders with respect to shareholder voting. The arguments opposing the change are the creation of self-perpetuating boards and the loss of the deterrent effect and means of communication of shareholders connected with the proxy statement.

The Commission also is considering a new type of investment fund with neither voting shareholders nor a board of directors. The fund would be managed by its sponsor, who would be required to register under the Investment Advisors Act. Management fee, fund objectives, and other investment features would be set out in the manager's contract. The law would declare that an investment manager has no fiduciary duty with respect to compensation.

The Unitary Investment Fund (UIF) concept raises the following important issues:

a. whether the SEC should continue its trend of increasing the discretion of independent directors, or resort to increased regulation;
b. whether 15 U.S.C. § 80a–35b (shareholders' private right of action) should apply to UIF's, or whether shareholders should rely on the market mechanism for protection; and
c. whether changes should be made by rules or legislation.

119. Investment Company Act of 1940, 15 U.S.C. § 80a–17 (1982).

120. *Id.* § 80a–6(c).

121. *See* 1 L. Loss, *supra* note 110, at 132.

122. Public Utility Holding Company Act of 1935, 15 U.S.C. § 79k (1982); *see* J. SELIGMAN, THE TRANSFORMATION OF WALL STREET 122 (1982).

123. Public Utility Holding Act, 15 U.S.C. § 79; (1982).

124. *Id.* § 79k(9), l(e).

125. *Id.* § 79o.

126. *Id.* § 79l(a)-(d), (g).

127. Hawes, *Public Utility Holding Company Act of 1935—Fossil or Foil?*, 30 VAND. L. REV. 605, 622 (1977).

128. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

129. I.R.C. § 4975 (d)(3), (e)(7) (1983).

provide a stock ownership interest for employees. Stock is owned by a trust, and voting rights are exercised solely by the trustee, but eventually, stock ownership is vested in the employee. ESOPs have not been widely adopted.[130] However, the Tax Reform Act of 1976 extended the idea and created Tax Credit Employee Stock Ownership Plans (TRASOPs),[131] which give broader voting participation to employees.

The Employee Retirement Income Security Act of 1974 (ERISA),[132] enacted to protect the rights of employees who participate in private pension plans, has also had an impact on corporate governance, in a limited way. Pension plans have become major stockholders of the companies that created them. When a tender offer is made for the shares of that company, the pension plan may hold the key votes that will decide the outcome. In deciding how to react to a tender offer, the trustees must consider the restrictions imposed by ERISA.

An example of the operation of the law occurred in the LTV tender offer for shares of Grumman. The trustees of the plan were Grumman officers, who hastily decided not to tender the trust's shares. Instead, the plan purchased additional shares at a price that was momentarily inflated by the LTV bid and which declined immediately after a preliminary injunction against the offer was issued. In *Donovan v. Bierwirth*[133] the Second Circuit found that the trustees had violated their duties under Sections 404(a)(1)(A) and (B) of ERISA, which require that trustees' decisions "must be made with an eye single to the interests of the participants."[134] This standard of care prescribed by the statute is that of the prudent person.[135]

In addition, Sections 406 and 407 of ERISA prohibit trustees from engaging in certain types of transactions that present inherent conflicts of interest.[136] Although in *Bierworth* the court found no violation of these sections by the purchase of additional Grumman shares, at least one analyst argues that when the trustees of the plan are officers of the corporation, purchase of employer shares after the announcement of a tender offer should result in a per se violation.[137]

The resolution of this particular technical issue is not the point. The impact of federal law, even beyond the statute specifically designed to deal with tender offers, on a profoundly significant structural transaction is the point to observe. Few corporate transactions affect the governance of the corporation as much as tender offers, and federal law, from various angles, provides the rules for tender offers.

Many industries are regulated under various statutes and by different regulatory agencies, and the law that governs those companies often has implications for corpo-

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130. The idea originated with Louis Kelso, a lawyer-economist, who sought to create a second source of income and a capital base for workers. *See* L. KELSO & P. HETTER, TWO FACTOR THEORY: THE ECONOMICS OF REALITY (1970); *see also* STAFF OF THE JOINT ECONOMIC COMM. BROADENING THE OWNERSHIP OF NEW CAPITAL: ESOPS AND OTHER ALTERNATIVES, 94th Cong., 2d Sess. (1976).

131. I.R.C. § 409A (1983).

132. 29 U.S.C. §§ 1001–1381 (1982).

133. 680 F.2d 263 (2d Cir.) *cert. denied,* 459 U.S. 1069 (1982).

134. *Id.* at 271.

135. ERISA § 404, 29 U.S.C. § 1104(a)(1) (1982).

136. ERISA §§ 406, 407, 29 U.S.C. §§ 1106, 1107 (1982).

137. Note, *The Duties of Employment Benefit Plan Trustees Under ERISA in Hostile Tender Offers,* 82 COLUM. L. REV. 1692 (1982).

rate governance. The federal communications law, for example, prohibits foreign ownership of a television station, and the effect of this prohibition on control transactions, including tender offers, is significant.[138] A number of other industries are similarly regulated, and this provides a degree of protection for existing management.

While the antitrust laws are not customarily involved with corporate governance, a significant exception is the Hart-Scott-Rodino Anti-Trust Improvements Act of 1976.[139] Acquisition transactions above a threshold amount must be filed with the Department of Justice or the Federal Trade Commission fifteen or thirty days prior to their consummation.[140] This time period may be extended by request of the government, possibly delaying the closing. In tender offers, the delay may be decisive. Mobil Corporation, on two occasions, was prevented from successfully purchasing shares of Conoco and Marathon Oil Corporation tendered to it in contested tender offers. Since the bidders with whom Mobil was competing were not subjected to the additional delay and therefore could conclude their purchases, Mobil's higher bid was thwarted by the effect of the law.

From a planning standpoint, Hart-Scott-Rodino Anti-Trust Improvements Act plays an important role.[141] The delay that may be occasioned by the law provides targets with an additional defense and room to maneuver. At the same time, white knights who come to the rescue of beleaguered targets must structure their bids to induce shareholders to wait out the prescribed statutory period, which might be prolonged past that provided in the securities laws.

The most fundamental impact of federal law on corporate governance is through the basic federal securities laws, the Securities Act of 1933 and the Securities Exchange Act of 1934. It is clear that the purpose of these statutes was not to replace state corporation law. Federal chartering of corporations was an idea floating around at the time of the adoption of these statutes, but these Acts were the result of a conscious decision to enact more limited legislation.[142] While the 1934 Act impacted upon a number of areas of basic corporate-shareholder relations, such as the periodic furnishing of information to shareholders, restricting insider trading, and most important, regulating the solicitation of proxies, the legislative history indicates that Congress did not intend to supplant state law and did not intend the 1934 Act to be used as a mechanism for regulating the relationship between management and shareholders.[143] Nonetheless, these statutes have had a profound effect on the corporate governance scheme. SEC interest in corporate governance crested in 1980 with the publication of the Staff Report on Corporate Accountability, containing a wide range

138. 47 U.S.C. §§ 301–311 (1982).

139. 15 U.S.C. § 18a (1982).

140. *Id.* § 18a(b)(1).

141. Volk, *The Practical Effects of Hart-Scott-Rodino Premerger Notifications on Tactics in Tender Offers and Related Transactions*, 48 A.B.A. ANTITRUST L.J. 1459 (1979).

142. J. SELIGMAN, *supra* note 122, at 87.

143. THE CONFERENCE REPORT TO THE SECURITIES EXCHANGE ACT OF 1934, H.R. REP. No. 1838, 73rd Cong., 2d Sess. 35 (1934), contains the following passage:

> The House bill does not contain a provision corresponding to that contained in subsection (d) of section 13 of the Senate amendment providing that "nothing in this title shall be construed as authorizing the Commission to interfere with the management of the affairs of an issuer." This provision is omitted from the substitute as unnecessary, since it is not believed that the bill is open to misconstruction in this respect.

of proposals including such matters as board functions and composition, shareholder communications, and institutional investor voting practices.

For the most part, however, the securities laws have addressed specific problems rather than corporate governance as a whole. Since shareholder voting power had been rendered largely impotent by 1934, one purpose of the 1934 Act was to strengthen the shareholder position and provide for "fair corporate suffrage."[144] The legislative history shows that Congress was concerned about management domination of the shareholders' meeting process, whereby proxies were solicited for the automatic reelection of management-selected directors.[145] Rather than enacting detailed regulation to control this area, Congress authorized the SEC to adopt rules, which were initially promulgated in 1935 and which have been amended with regularity since that time.[146]

In effect, the proxy solicitation acts as a surrogate for the shareholder meeting, since it is physically impossible to convene any more than a small percentage of the shareholders.[147] As a result, practically all of the important regulations affecting shareholder meetings and communications with shareholders have occurred under the proxy rules rather than under state law.[148].

The proxy rules contain specific requirements for the content of shareholder communications.[149] An equally important regulator is rule 14a–9, which prohibits false or misleading statements in a proxy communication, a prohibition that may be privately enforced, either in a direct action or a derivative action, by shareholders who can show that the misleading solicitation caused injury.[150]

In connection with a proxy contest for corporate control, federal rules are of paramount importance. The time periods that are key to the strategy of a contest are dictated by the federal proxy rules and not by state law.[151] Moreover, contestants seek at least tacit approval from the staff of the SEC that their documents are free from false and misleading statements before documents are disseminated. Thus, the legal battleground in a proxy contest is either the Securities and Exchange Commission or a federal court that interprets the proxy rules.

Tender offers became a frequently employed alternative to proxy contests in the mid–1960s. While proxy contests were governed by specific federal rules, no rules

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144. H.R. REP. No. 1383, 73rd Cong., 2d Sess. 13 (1934).

145. S. REP. No. 792, 73rd Cong., 2d Sess. 12 (1934).

146. Regulation 14A under the Securities Exchange Act of 1934 contains the existing regulations, 17 C.F.R. § 240.14a-1 to -102 (1983).

147. A then-SEC commissioner once explained, "I know that the old-fashioned meeting cannot be revived. Admittedly that is impossible. It is not impossible, however, to utilize the proxy machinery to approximate the conditions of the old-fashioned meeting." Address of Comm. Robert H. O'Brien before The Conference Board in New York City, at 3 (January 21, 1943), *quoted in* Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419, 438 n.88 (1971).

148. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 211, 212 (1982).

149. Regulation 14A, 17 C.F.R. § 240.14a–1 to –102 (1983).

150. Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); J.I. Case Co. v. Borak, 377 U.S. 426 (1964). However, courts will not allow plaintiffs to allege a violation of the federal proxy rules by pleading an omission to characterize a transaction as unfair. Golub v. PPD Corp., 576 F.2d 759 (8th Cir. 1978).

151. *See* Rule 14a–11, Schedule 14B, under Regulation 14A of the Securities Exchange Act of 1934, 17 C.F.R. § 240.14(a)–11, .14(a)–102 (1983).

covered tender offers, creating a gap in the regulatory scheme.[152] The SEC did not immediately urge that the gap be filled, but target company managers, under threat of attack in a tender offer, persuaded Senator Harrison A. Williams, chairman of the Securities Subcommittee of the Banking and Currency Committee, to initiate action. Senator Wiliams' first proposed legislation dealing with tender offers in 1965, judging from the tone of his bill, was clearly antagonistic to the hostile tender offers. Bidders were described as "raiders" and "pirates."[153] At this point, the Commission decided to study the bill and to achieve more balance. A revised version of the bill was enacted in 1968. This statute made federal law and the SEC the principal arenas in which these contests for control were conducted.

The statute purports to be neutral with respect to tender offers, trying neither to discourage them, nor to tip the balance in favor of one side or the other.[154] Substantial paper work is required of both contestants,[155] and the documents that are produced frequently spawn litigation, practically all of which is fruitless and expensive. The tender offer rules, however, go far beyond requiring disclosure, which is the customary scope of the federal securities laws. Instead, these rules govern virtually all of the significant conduct in a tender offer. Federal law dictates the minimum period of the length of a tender offer[156] and requires that offers for less than all the shares be accepted on a pro rata basis,[157] that there be withdrawal rights,[158] that price increases be retroactive,[159] and that the management of the corporation be obligated to make recommendations to the shareholders whether to accept the bid.[160] Federal law is so pervasive that a number of federal courts have concluded that the state statutes are preempted by the Williams Act,[161] a position that the Supreme Court came close to supporting.[162] The Court did hold that state law has virtually no place in the regulation of tender offers because of the commerce clause.[163]

The combined effect of a neutral federal position concerning tender offers and the virtual exclusion of state law from a role in the tender offer transaction for large

152. "Once something has been identified as a 'gap' there of course remains only one thing to do—'fill' it!" R. JENNINGS & H. MARSH, SECURITIES REGULATION 627 n.9 (5th ed. 1982).

153. J. SELIGMAN, *supra* note 122, at 431; *see* S. 2731, 89th Cong., 1st Sess., 111 CONG. REC. 28,257–60 (1965).

154. *See* Piper v. Chris-Craft Indus. Inc., 430 U.S. 1 (1977).

155. *See* Schedule 13D, 14 C.F.R. § 240.13d-101 (1983).

156. 17 C.F.R. § 240.14e-1(a) (1983).

157. 15 U.S.C. § 78n(d)(6) (1982); 17 C.F.R. § 240.14d-8 (1983).

158. 15 U.S.C. § 78n(d)(5) (1982); 17 C.F.R. § 240.14d-7 (1983).

159. 15 U.S.C. § 78n(d)(7) (1982).

160. 17 C.F.R. § 240.14e-2; 240.14d-9 (1983).

161. MITE Corp. v. Dixon, 633 F.2d 486, (7th Cir. 1980) *aff'd on other grounds*, 457 U.S. 624 (1982) (Illinois Business Takeover Act held pre-empted); Great West. United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978) (Idaho Takeover Statute held preempted by the 1934 Act as amended by the Williams Act); Dart Indus., Inc. v. Conrad, 462 F. Supp. 1 (S.D. Ind. 1978) (Delaware takeover statute held unconstitutional).

162. Edgar v. MITE Corp., 457 U.S. 624 (1982). The Court was splintered in at least four directions in *MITE*. There were three major issues: whether the case was moot, and hence should be dismissed; assuming the case was not moot whether the Illinois statute was preempted and void under the supremacy clause; and, assuming the case was not moot, whether the Illinois statute was unconstitutional under the commerce clause. Four justices (Marshall, Brennan, Rehnquist and Powell) thought the case was moot. Five (White, Burger, Powell, Stevens and O'Connor) believed that the statute was unconstitutional under the commerce clause. Three (White, Blackmun and Burger) believed the statute was preempted. Stevens and Powell had doubts as to preemption. O'Connor, Marshall, Brennan and Rehnquist did not address the preemption issue.

163. *Id.*

multistate corporations significantly affects corporate control transactions in a way that was probably not foreseen by the SEC or Congress. Corporate acquisition transactions require approval by the board of directors under state law.[164] The board can negotiate transactions in a way that shareholders functionally cannot. Furthermore, the board can reject totally certain transactions or impose conditions on their acceptance with a view to the best interests of the enterprise. This pattern reflects a conscious corporate governance decision:[165] to give shareholders a direct role that totally ignores the board's power would alter the dynamics of the transaction in a fundamental respect.[166] Shareholders are approached to accept a transaction entirely on the basis of their individual welfare. The decision they make is not collegial but completely solitary. Indeed, it is largely a coerced decision.[167] A would-be merger partner whose offer is spurned by the board thus is able to render that rejection irrelevant by appealing directly to the shareholders. Ownership and control—long separated as Berle and Means[168] and Herman[169] have observed—are rejoined. The wisdom of that alteration of power, recognized by all state statutes and by the common law, is a big subject—one left for another day.[170]

Beginning in 1938, and formalized in 1942, the SEC recognized that shareholders could initiate their own proposals for action at a shareholder meeting and make use of the proxy statement prepared and circulated by management to solicit support.[171] The result has made the SEC and federal courts arbiters of what conceptually are state law decisions—of what matters are properly within the scope of shareholder action.[172] While state law theoretically governs the proper scope of shareholder actions, or even shareholder recommendations for actions,[173] few state law decisions have decided these matters.[174] Consequently, the SEC must decide what state law would provide when management seeks to exclude a proposal from the proxy statement. In the process, the SEC has created a type of free floating state law that describes the limits of shareholder participation. This intrusion by the SEC into the state process is unavoidable and is required by the necessity of interpreting the

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164. *E.g.*, DEL. CODE ANN. tit. 8, § 251 (1983).

165. Corporate control transactions often present conflicts of interest to management contemplating their possible loss of employment. For outside directors the loss of control presents little or no pecuniary loss, and hence a lesser degree of conflict, but their objectivity may still be questioned. Courts have not found it easy to move through this minefield. *See* Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981); Treadway Co., Inc. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964).

166. *Automatic Self-cleaning Filter Syndicate Co. Ltd. v. Cunninghame* [1906] 2 Ch. 34.

167. Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 307–09 (1983).

168. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

169. E. HERMAN, CORPORATE CONTROL, CORPORATE POWER (1981).

170. The strongest support for this view comes from Easterbrook & Fischel, *The Proper Role of A Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). Many economists also are supportive. *See* Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

171. Schwartz & Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 635, 654–56 (1977).

172. An example of the application of this principle is the Commission's decision in *Crown Cork & Seal*, reported in a minute of a meeting of the Securities & Exchange Commission, Feb. 28, 1964, *reprinted in* W. CARY, CORPORATIONS 1576 (unabridged 4th ed. 1969).

173. C.F.R. § 240.14a-8(c)(1) (1983); *see* SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947).

174. Schulman, *Shareholder Cause Proposals: A Technique to Catch the Conscience of the Corporation*, 40 GEO. WASH. L. REV. 1, 55 (1971).

SEC's rule allowing shareholder proposals. Moreover, this intrusion may be further justified since the proxy process has become, in substance, the real meeting. Once Congress decided that this surrogate process was a federal concern, the important question of what matters could be considered at the shareholder meeting inevitably was decided as a matter of federal law.[175]

Except for the Public Utility Holding Company Act and the Investment Company Act,[176] the federal securities laws were conceived as disclosure laws and not as regulatory statutes, but disclosure may have a therapeutic effect and thus, substantive impact.[177] The Securities and Exchange Commission contemplated an extensive use of therapeutic disclosure in 1978 when the Commission proposed new rules requiring the furnishing of detailed information about the composition and function of boards of directors.[178] Although the Commission's power to intrude so deeply into corporate governance received strenuous opposition,[179] a modified version of the proposal was adopted,[180] which calls for disclosure of governance information, and probably encourages the types of boardroom changes that the Commission had theretofore urged.[181]

The combination of disclosure requirements, the antifraud provisions of the securities laws,[182] and the implication of private rights of action[183] worked to extend the influence of federal securities law into matters of corporate governance. Management, advised by counsel of the need to disclose all material facts, was forced to structure transactions, particularly self-dealing transactions, so that disclosure of the material facts would not reveal any unfairness. What were material facts, of course, was to be decided under federal law. Consequently, planning corporate transactions became largely an interpretation of the federal disclosure standards.

All this is in keeping with a traditional application of the federal securities laws with an inevitable side effect on internal corporate affairs. However, some courts

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175. There is at least some evidence that state law, as locally interpreted, narrowly views the shareholder right to initiate matters. In Carter v. Portland General Electric Co., 227 Or. 401, 362 P.2d 766 (1961), the court opposed a management proposal for a major construction project, noting a probable difference of result if Rule 14a-8 applied. A more permissive view was taken in Auer v. Dressel, 306 N.Y. 427, 118 N.E.2d 590 (1954).

176. *See supra* text accompanying notes 110-28.

177. Two contemporary scholars, Professors Frankfurter and Douglas, both expected the disclosure requirements to have an important effect on corporate conduct. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1323-24 (1934); Frankfurter, *The Federal Securities Act II*, FORTUNE, Aug. 1933, at 53, 55. The intellectual father of the federal securities laws, Louis Brandeis, had earlier written an oft quoted passage: "Sunlight is the best disinfectant; electric light the most efficient policeman." L. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1913).

178. SEC Release No. 34-14970 (July 18, 1978), 43 Fed. Reg. 31,945 (1978).

179. Weiss & Schwartz, *Using Disclosure to Activate the Board of Directors*, in CORPORATIONS AT THE CROSSROADS: GOVERNANCE AND REFORM 136 (D. DeMott, ed. 1980).

180. SEC Release No. 34-15384 (Dec. 6, 1978), 16 SEC Docket No. 6 at 348 (Dec. 12, 1978).

181. Chairman Williams expressed his notions of an ideal board on many occasions. See his address at the University of California Securities Regulation Institute, January 1980 in 1978 SEC. REG. & L. REP. (BNA) No. 437, at A-22 (Jan. 25, 1978). The Commission also voiced its concern about lax performance by outside directors in its *Report of Investigation in the Matter of Stirling Homex Corporation Relating to the Activities of the Board of Directors of Stirling Homex Corporation*, SEC Release No. 34-11516, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80, 219; *Report of Investigation of Outside Directors of National Telephone*, SEC Release No. 34-14380 (Jan. 16, 1978), 135 SEC Docket No. 20 at 1393 (Jan. 31, 1978).

182. *See generally* Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78 (1982).

183. J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

went a great deal further and decided that a transaction that was unfair, as a matter of judicial interpretation, violated the anti-fraud provisions of federal securities law regardless of disclosure. In *Schoenbaum v. Firstbrook,*[184] a parent corporation sold property to its partially owned subsidiary without disclosing all the facts of the transaction to the minority shareholders. State law did not require such disclosure of course, since the directors of the corporation—all of whom were fully informed—had full power to authorize the transaction. Nonetheless, the Second Circuit found a violation of the antifraud provisions because of the nature of the transaction, which was allegedly unfair to the minority shareholders of the subsidiary.[185]

Unfairness as the basis of a federal violation of the antifraud rules catapulted federal law into primacy in the control of corporate transactions. What constituted "unfairness" in violation of the federal securities laws was a matter of federal law, and state law became insignificant in the control of corporate transactions. The apogee of this movement was *Green v. Santa Fe Industries, Inc.,*[186] a going private transaction involving a Delaware corporation. The transaction was authorized by a fully informed board of directors in accordance with section 253 of the General Corporation Law of Delaware, which allowed a parent to merge with its ninety percent or more owned subsidiary without approval by the shareholders, requiring only after-the-fact disclosure.[187] Delaware law, at that time (and currently)[188] provided no injunctive remedy against the transaction in favor of the minority shareholders; their only redress was to exercise their appraisal rights. The Second Circuit found a violation of federal law because the transaction was allegedly unfair, and Judge Medina emphasized the point by stressing: "But, lest there be any lingering doubt on this point, we now hold that in such cases [involving breach of fiduciary duty], including the one now before us, no allegation or proof of misrepresentation or nondisclosure is necessary."[189]

The Supreme Court reversed in *Santa Fe Industries, Inc. v. Green,*[190] with a strong opinion that also left little doubt that the Court insisted that deception was a necessary element of an action under rule 10b–5. Regulation of breaches of fiduciary duty belonged to state law.

The Court was less than fully successful in removing the governance of fiduciary duties from federal securities law. In the Second, Third, Fifth, Seventh, and Ninth, Circuits, the courts of appeals have permitted a federal claim under rule 10b–5, notwithstanding full disclosure to a board of directors entrusted with plenary authority under state law to authorize the transaction because of inadequate or no disclosure to shareholders.[191] In all of these cases, the claims of deception arose when

184. 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied,* 395 U.S. 906 (1969).

185. *Id.* at 218; *see* Note, *The Controlling Influence Standard in Rule 10b–5 Corporate Mismanagement Cases,* 86 HARV. L. REV. 1007 (1973).

186. 533 F.2d 1283 (2d Cir. 1976), *rev'd,* 430 U.S. 462 (1977).

187. *Id.* at 1288.

188. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

189. 533 F.2d 1283, 1287 (2d Cir. 1976).

190. 430 U.S. 462 (1977).

191. Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641 (3d Cir. 1980); Alabama Farm Bureau Casualty Co. v. American Fidelity Life Ins. Co., 606 F.2d 602 (5th Cir. 1979), *cert. denied,* 446 U.S. 933 (1980); Kidwell *ex rel* Penfold

shareholders were dissuaded or lulled into inactivity by voluntary statements or by complete silence in circumstances in which if the facts had been known, the shareholders would have sought to enjoin the transaction under state law. This is either constructive deception or constructive causation, both of which are necessary elements of a rule 10b–5 claim. This logic appears to dovetail federal and state roles, each in their respective places, but it actually federalizes the issue of the fairness of the transaction. The arena for judging management conduct shifts from the state courts to the federal courts, a result the Supreme Court in *Santa Fe*[192] doubtless wished to avoid and probably thought it had checked.

In addition to the general antifraud provision, the SEC has paid special attention to particular transactions that the SEC thought presented problems. Going private transactions offer the best example. The Commission had looked suspiciously on these purchases,[193] and finally proposed a rule that required the transaction to be fair.[194] Rule 13e–3[195] as finally adopted, however, requires the proponent of the transaction to disclose whether in the proponent's opinion the transaction is fair and then state reasons for believing so.[196] There may be little more than a gnat's worth of difference between the two versions in a practical sense. The underlying issue remains one of fairness, and a federal forum is provided to deal with that question. Rules 13e–1 and 13e–4, which govern repurchases of stock by the target company in a tender offer once the tender offer has commenced and tender offers by issuers for their own stock, contain similar patterns of disclosure and substance.

It should be clear that all these transactions—self-dealing transactions involving securities, going private transactions, issuer tender offers, and target company repurchases of stock—have become governed largely by federal law standards under the guise of a statute that is concerned with disclosure and deception. Plaintiffs must show that deception was a cause of the injury, so courts have inquired into whether shareholders could have taken any action to prevent the transaction had they been fully informed. Some courts have gone further and required that plaintiffs show they would have actually succeeded in state court on their claim.[197] This has the ironic effect of trying the state law issue in federal court. Under the circumstances, the courts could demur and require the plaintiff to go directly to the state court, since the controlling issue in the case is one of state law, but nonetheless, federal courts have tried the case.

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v. Meikle, 597 F.2d 1273 (9th Cir. 1979); Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

The idea of "constructive deception" was discussed in Note, *Suits for Breach of Fiduciary Duty Under Rule 10b–5 After* Santa Fe Industries, Inc. v. Green, 91 HARV. L. REV. 1874 (1978). *See also* Ferrara & Steinberg, *A Reappraisal of* Santa Fe: *Rule 10b–5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980).

192. 430 U.S. 462 (1977).

193. SEC Commissioner Sommer had expressed serious misgivings about the fairness of the transactions. Address by A. Sommer, Jr., Comr. SEC Law Advisory Lecture, Notre Dame Law School, South Bend, Ind., *"Going Private": A Lesson in Corporate Responsibility*, [1974–1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,010.

194. SEC Release No. 33–5884, FED. SEC. L. REP. (CCH) ¶ 81, 366 (Nov. 17, 1977).

195. 17 C.F.R. § 240.13e–3 (1983).

196. 17 C.F.R. § 240.13e–1, –4 (1983).

197. Madison Consultants v. FDIC, 710 F.2d 57 (2d Cir. 1983); Wright v. Heizer Corp., 560 F.2d (7th Cir. 1977).

However, the courts have declined to find violations of the proxy rules predicated on the unfairness of a transaction that was fully disclosed to shareholders in a proxy statement on the theory that the shareholders made an informed decision.[198] Courts have also declined to find deception when the omission in the proxy statement was characterizing the transaction as unfair, obviously an unrealistic expectation, but rather an effort by plaintiffs to have the court, as a matter of federal law, decide the substantive issue. That is precisely what the Supreme Court in *Santa Fe*[199] intended to check.

Probably the most celebrated example of SEC involvement in corporate governance occurred during the post Watergate revelations of illegal corporate political contributions and other illegal or questionable payments abroad. Most of the payments involved sums of money or affected areas of company business that were not material relative to the size of the corporation. Self-dealing was rare. The SEC's jurisdiction over this subject was predicated upon a determination that the corporation made materially false or misleading statements in its filings with the Commission. Since the payments did not require shareholder approval, it was not easy to show a causal connection between the omitted disclosure and the transaction. By and large, private suits foundered on these obstacles.[200] The Commission, seeking injunctions and ancillary relief, alleged that there were material omissions either in proxy statements or in other reports filed by the issuer.

The Commission harkened back to its 1964 decision in *Matter of Franchard Corp.*,[201] to justify the materiality of these omissions. In *Franchard*, the chief executive officer, founder, and guiding force behind the company, had engaged in certain financial transactions with the company which were not quantitatively significant. But the Commission found that by omitting disclosure of those transactions, the company failed to reveal important information about the integrity of management.[202] From this decision, the latter-day Commission could conclude that illegal or unethical conduct, even in the pursuit of corporate goals, provided evidence about the character of management that investors needed.[203] Obviously, this rationale requires limitations. An objective standard is needed to avoid overloading the amount of information that bears on the integrity of management.[204] Not every violation of the law is germane to the issue of character any more than strict compliance with the law bespeaks integrity.[205]

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198. Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972).

199. 430 U.S. 462 (1977).

200. Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981). However, if the objection was to the election of directors without adequate disclosure, even of improper practices, a different result obtains. Weisberg v. Coastal States Gas Corp., 609 F.2d 650 (2d Cir. 1979).

201. 42 S.E.C. 163 (1964).

202. *Id.* at 169.

203. SECURITIES AND EXCHANGE COMMISSION, REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, SUBMITTED TO THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94th Cong., 2d Sess., 68 (Comm. Print May 19, 1976).

204. Recently, the Commission has narrowed the scope of disclosure to require more of the standard criteria of materiality. Longstreth, *SEC Disclosure Policy Regarding Management Integrity*, 38 BUS. LAW. 1413 (1983); Speech by John M. Fedders before Fed. Reg. of Sec. Comm. of ABA, Nov. 17, 1982, *reprinted in* 1982 SEC. REG. & L. REP. (BNA) 2057 (Nov. 26, 1982).

205. For instance, when the Commission adopted some proposed rules requiring only disclosure of material finan-

The Commission used the various payments scandals as the basis for numerous actions, which, for the most part, were not tested in court. In practically every case, the Commission entered into a settlement with the corporation and obtained relief through a consent order.[206] Of considerable importance for our inquiry, the relief granted in many of the cases specifically altered the corporate governance structure. The SEC wanted assurances that the conduct would not be repeated. The consent decrees provided for the designation of new directors, the creation of audit and special litigation committees, and the description of specific functions for those committees. These settlements gave the Commission an influence in the boardroom far beyond that allowed under any specific provision in the statutes or rules, or under any court decisions.

In *Franchard,* the Commission rejected a staff argument that the board of directors of the corporation acted improperly in violation of its duty of due care. Chairman Cary's opinion noted that the question was one of state law and not of federal securities law.[207] However, the activities of the Commission in responding to the payments cases tended to ignore this limitation, since the complaints and reports often drew conclusions about the propriety of conduct of outside directors.

The power issues largely may have been put to rest by the adoption of the Foreign Corrupt Practices Act (FCPA) in 1977.[208] The Act also dealt with a related issue—the proper maintenance of company books and records that had often concealed improper payments— and thereby gave the Commission another powerful tool to affect corporate governance.[209] The failure of internal controls was seen as a major reason for corporate misconduct. Section 13(b)(2) was added to the 1934 Act to require accurate accounting and internal control provisions, embellished by rules adopted by the Commission.[210] As seen by Daniel L. Goelzer, then executive assistant to the chairman and now the general counsel of the SEC, "the consequence of adding substantive requirements governing accounting control to the federal securities laws may significantly augment the degree of federal involvement in the internal management of public corporations."[211]

Goelzer notes that the efficiency of an internal control system cannot be evaluated without considering organizational structure, the caliber of employees, the strength of an audit committee, and the effectiveness of internal audit operations.[212]

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cial effects of corporate compliance with environmental laws in SEC Release No. 33-5386 (April 20, 1973), 38 Fed. Reg. 12,100 (1973), within their rulemaking authority, they were criticized for not requiring more burdensome reporting for the benefit of investors and the general public. *See* Natural Resources Defense Council, Inc. v. SEC, 389 F. Supp. 689 (1974). Following remand, the Commission held 19 days of public hearings between April 14, 1975 and May 14, 1975, before announcing its proposals for further rulemaking in SEC Release No. 5627, 40 Fed. Reg. 51,656 (1975). Although the Commission's ultimate conclusion not to adopt its October 14, 1975, rulemaking proposal in SEC Release No. 5704, 41 Fed. Reg. 21,632 (1976) was held to be "arbitrary and capricious" and again remanded by the district court, *see* Natural Resources Defense Council, Inc. v. SEC, 432 F. Supp. 1190 (D.D.C. 1977) (stayed pending outcome on appeal) the court of appeals reversed and the initial "materiality" standard was upheld.

206. *E.g.,* SEC v. Jos. Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978).

207. 42 S.E.C. 163, 176-77 (1964).

208. 15 U.S.C. § 78dd (1982).

209. Foreign Corrupt Practices Act of 1977, § 30A, 15 U.S.C. § 78dd-1 (1983).

210. 15 U.S.C. § 78m-(b)(7) (1982).

211. Goelzer, *The Accounting Provisions of the Foreign Corrupt Practices Act—The Federalization of Corporate Recordkeeping and Internal Control,* 5 J. CORP. L. 1, 5 (1979).

212. *Id.* at 28; *see also* SEC v. World-Wide Coin Investments, Ltd., 567 F. Supp. 724 (N.D. Ga. 1983).

The Commission agreed with this assessment in adopting rule 13b2–2 when the Commission stressed that the purpose of the FCPA was to promote integrity in the management process.[213] Unlike the antifraud statutes, these provisions can be enforced without a showing of scienter on the part of management.[214] Given the broad scope of the accounting provisions of the FCPA, the Commission can range far and deep into the internal affairs of corporations.

The creation of audit committees was central to the SEC objective to influence the control system. Rather than adopt a controversial requirement, the Commission exerted its influence on the New York Stock Exchange to have it adopt such a rule for companies listed on the Exchange. This may be seen as regulation by raised eyebrow. The SEC has the power to compel stock exchanges to adopt rule changes under section 19(c) of the 1934 Act.[215] Whether the SEC had the power to require the exchanges to adopt rules regarding corporate governance is an open question, but in any event, the Commission, through a speech by its then chairman, Roderick Hills, suggested that this was a good idea for the Exchange, and the New York Stock Exchange responded by adopting such a rule.[216] As a result, all New York Stock Exchange listed companies now have audit committees that are essentially independent.

IV. THE FEDERALISM ISSUES IN REGULATING CORPORATE GOVERNANCE

Federal influence on corporate governance could be enhanced either through action by Congress, the regulatory agencies, or the courts. The power to act of each of these instrumentalities of the federal government needs to be examined in order to assess both whether the existing federal action is valid and whether authority exists to go further.

No specific constitutional provisions authorize Congress to enact corporate legislation, but proposals for a general federal corporation law have been advanced from time to time.[217] Such legislation probably would be sustained under the commerce clause.[218] If such a law did not attempt to supplant existing state corporation laws but only impose additional federal requirements on corporations engaged in interstate commerce to structure their boards of directors in a particular manner, to have audit and nominating committees, or to follow certain prescribed procedures, there would appear to be no tenth amendment limitations.[219] In other words, the proposals contained in the Metzenbaum Bill introduced in 1980[220] would seem to pass constitutional muster.

213. SEC Release No. 34–15570 (Feb. 15, 1979); 16 SEC Docket No. 17 at 1143 (Mar. 6, 1979).

214. SEC v. World-Wide Coin Invs., Ltd., 567 F. Supp, 724, 749 (N.D. Ga. 1983).

215. 15 U.S.C. § 78s–(c) (1982).

216. Letter from Chairman Roderick M. Hills to William M. Batten, Chairman, New York Stock Exchange, May 11, 1976, *reprinted in* SENATE COMM. BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 2D SESS., REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, Exhibit D (1976) [hereinafter cited as Letter from Chairman Hills].

217. *See* R. NADER, M. GREEN, & J. SELIGMAN, *supra* note 19, at 65–71.

218. Note, *Federal Chartering of Corporations: Constitutional Challenges*, 61 GEO. L.J. 123, 134 (1972).

219. *Id.*

220. S. 2567, 96th Cong., 2d Sess. (1980).

Following another tack, legislation embodying the proposals advanced by the late Professor William L. Cary in a celebrated law review article in 1974, prescribing minimum federal fiduciary standards,[221] would appear unobjectionable from a constitutional standpoint. Congressional power would be pegged to particular types of transactions, such as securities transactions, tender offers, or other control transactions, all of which are presently regulated under the authority of the commerce clause and impose federal duties on top of existing state law applications. For example, Congress could elect to assert its authority over tender offer transactions by regulating the use of "golden parachute" contracts.[222]

Various forms of this kind of legislation, a limited federal intrusion into the law of corporation, already exist, as we have noted. Arguably, Congress could enact a federal corporation law that replaced existing state corporation statutes and totally federalized corporation law, provided a proper federal nexus existed.[223] Provisions would have to be made to preserve existing rights of persons that were created under valid state laws,[224] but nonetheless, the congressional power to act is probably plenary, at least with respect to all those corporations in which Congress is likely to have any interest.[225]

Moving from the broadest possible application of federal power to a more surgical approach, to what extent may federal agencies or courts affect the governing structure of corporations in narrower ways? Since the SEC is the agency that most affects corporations as a whole, that agency's rulemaking authority is most relevant. In particular, the SEC's interest in structural changes in the board of directors merits the most attention.

The SEC has favored the use of independent directors to resolve a number of problems.[226] As we observed earlier, that approach is built into the Investment Company Act.[227] The Commission also has championed special committees of the board, notably the audit comittee, as a means of assuring compliance with certain objectives of the federal securities laws.[228] The Commission's power to require these governance changes may be sustained if it is necessarily or properly related to the SEC's main missions, such as providing full and accurate disclosure, maintaining the integrity of the market, or exercising supervisory powers over self regulatory organizations.[229]

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221. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663 (1974).

222. The SEC Advisory Committee on tender offers recommended several changes in federal law to govern areas of tender offer resistance that are now covered by state law, principally by the business judgment rule. Thus, an "advisory vote" by shareholders would be required for "golden parachutes." *See* SEC ADVISORY COMMITTEE ON TENDER OFFERS, REPORT OF RECOMMENDATIONS 41 (July 8, 1983).

223. Note, *Federal Chartering of Corporations: Constitutional Challenges,* 61 GEO. L.J. 123, 144 (1972).

224. Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat) 518 (1819).

225. Wickard v. Filburn, 317 U.S. 111 (1942).

226. SEC v. Mattel, Inc., [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,754 (D.D.C. 1974); Note, *Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions,* 64 GEO. L.J. 737 (1976).

227. REPORT OF THE SEC ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 332-34 (1966).

228. Mathews, *Internal Corporate Investigations,* 45 OHIO STATE L.J. 655, 666-70 (1984).

229. Mourning v. Family Publications Serv., Inc., 411 U.S. 356, 369 (1973).

The Commission has never acted by rule to require all corporations subject to its jurisdiction to create an audit committee.[230] However, it has used its influence on the New York Stock Exchange to have that organization write such a rule, with the result that most major corporations now have audit committees. Other stock exchanges and the National Association of Securities Dealers do not compel companies who trade through their facilities to have such a committee. Moreover, it is not clear that the SEC's goals for such a committee can be achieved without direct action, requiring us to examine the Commission's independent power to mandate an audit committee.

The Commission has broad power regarding accounting principles, accounting books and records, and possibly, auditing standards.[231] In 1978, the Commission's then general counsel, Harvey Pitt, expressed the view that these powers enable the Commission to require the creation of an audit committee in the interest of greater reliability of financial statements by assuring the independence of auditors and the strengthening of internal controls.[232] Surely Mr. Pitt had some basis for his opinion because Congress relied heavily on the requirement for independent auditors rather than on any role of management as a means of providing integrity in financial statements. Requiring an audit committee to give added credence to the independence of auditors seems to be an afterthought. Nevertheless, a mandated audit committee to implement the accounting provisions of the Foreign Corrupt Practices Act is reasonably related to that statutory objective, even if no specific rulemaking by the Commission is mentioned in Section 13(b)(2).[233]

Instead of directly requiring an audit committee or any other committee, the Commission might use its power under Section 19(c) of the 1934 Act[234] to compel stock exchanges to adopt rule changes requiring such committees, designed along lines the SEC favors. This provision resulted from the 1975 amendments to the securities laws, dealing largely with market structure and the creation of a national market system. It has been suggested that the SEC could compel the stock exchanges to adopt rules relating to corporate governance and not necessarily limited to the audit committee.[235] That idea is disputed, and its suggestion has been greeted with great hostility[236] as well as with gentle but firm rejection.[237] The reform of corporate governance was not on Congress' mind when it enacted Section 19(c), and despite the New York Stock Exchange's long history of some governance involvement, the idea of *compelling* the Exchange to play a central role in governance reform is at least a big stretch.

230. Letter from Chairman Hills, *supra* note 216.

231. Securities Act of 1933, § 19(a), 15 U.S.C. § 77s-(a) (1982); Securities Act of 1934, § 3(b), 15 U.S.C. § 78c-(b) (1982); Securites Act of 1934 § 12(b)(1)(J)-(L), 15 U.S.C. § 78l-(b)(1)(J)-(L) (1982); Securities Act of 1934, § 13(b)(1)(2), 15 U.S.C. § 78m-(b)(1)(2) (1982).

232. Opinion of SEC General Counsel on the Commission's Authority to Require Public Companies to Establish Independent Audit Committees (March 2, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,535.

233. Goelzer, *supra* note 211, at 33-34.

234. 15 U.S.C. § 77s-(c) (1982).

235. Symposium, *An In-Depth Analysis of the Federal and State Roles in Regulating Corporate Management*, 31 BUS. LAW. 863, 1095-96 (comments by Lee Pickard) (1976).

236. *Id.* at 1096 (comment by Stephen Paradise).

237. *Id.* at 1111 (comment by William Cary).

Both the New York and American Stock Exchanges, on their own initiative, have adopted many rules relating to corporate governance through the listing agreement with listed companies. The Company Manual of both the New York and American Stock Exchanges is an important source of de facto law for affected companies in major respects. Both exchanges require stockholder votes when none are required under state law.[238] The New York Stock Exchange requires at least two independent directors to comprise a majority of the audit committee, clearly exceeding any requirement under state law.[239] Both exchanges require the solicitation of proxies, which is not required under either state law or the SEC's proxy rule.[240]

However, all these requirements are self-initiated by the stock exchanges. By demonstrating that their standards are higher than minimally required by law, the exchanges develop public confidence in their markets. These requirements, therefore, are in part a commercial effort to boost trading on their markets, but the adoption of rules by the exchanges is limited by competitive factors. Companies now may secure many of the advantages that were once exclusively available through listing without listing or complying with exchange standards. The National Association of Securities Dealers (NASD) national listing system (NASDAQ) offers many of the same trading benefits, and the NASD has not gone as far as the major stock exchanges in imposing governance requirements. The New York and American Stock Exchanges risk losing business to the NASD if their governance requirements become too onerous. Since the exchanges' standards are not the result of legal mandate, they are enforced by the exchanges and not by the SEC and probably do not give rise to a private enforcement action.[241] Rules that deter listing may be revised or repealed, subject to the SEC's power to approve rules changes.

The SEC is not necessarily interested in the same competitive considerations when it decides whether to impose a rule on the stock exchanges, a fact which may militate against recognizing any such power in the hands of the SEC. The power question and the implied private remedies question are worthy of major consideration by themselves and cannot be discussed in detail in this Article.

Judge Henry Friendly found the idea of *experimentation* by the stock exchange in corporate governance worthier than legislation or rulemaking and put forth the idea at an American Law Institute-American Bar Association symposium.[242] Of course, Judge Friendly's idea does not advance the proposition that the SEC possesses the power to compel experimentation but rather is only an invitation to the exchanges to try new ideas.[243] Voluntary experiments may be the best means to see which governance changes work well, or if at all, but they are unlikely to be tried without SEC prodding. Given the reasonable relationship of governance reform to overall SEC

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238. N.Y.S.E. LISTED COMPANY MANUAL § 312.00 (1983). AMEX COMPANY GUIDE § 712–13.

239. N.Y.S.E. LISTED COMPANY MANUAL § 303.00 (1983).

240. N.Y.S.E. LISTED COMPANY MANUAL § 402.04 (1983 ed.); AMEX COMPANY GUIDE § 705.

241. *See* Walck v. American Stock Exch., 687 F.2d 778 (3d Cir. 1982), *cert. denied*, 103 S. Ct. 2118, *reh'g denied*, 104 S. Ct. 29 (1983).

242. Friendly, *Make Haste Slowly*, in COMMENTARIES, *supra* note 12, at 525.

243. *Id.*; N.Y.S.E. LISTED COMPANY MANUAL § 303.00 (1983). The New York Stock Exchange soon thereafter executed a Legal Advisory Committee whose charter stated that its principal focus was to be on matters relating to corporate goverance.

objectives, it is likely that the SEC's power to use its authority over the self-regulatory organizations to compel internal corporate changes would be recognized. However, such an idea has merit only if the SEC is willing to allow the exchange to design the content of the rule and if no private enforcement is allowed under the securities laws for any rule. Otherwise, the exchanges are mere shills for the SEC and there is no difference, let alone advantage, in having the exchanges adopt rules. Consequently, all the SEC should do, if it acts through these means, is to direct the exchanges to adopt *some* mandate that addresses the subject matter.

Still another approach that the Commission could employ to influence corporate governance is to condition the use of simplified disclosure procedures upon the installation of certain governance requirements. Thus, the Commission might determine that the use of independent nominating committees or a certain percentage of unaffiliated directors might be the hallmark of companies that have proper accountability systems and therefore are eligible for simplified disclosure with less supervision by the Commission. The use of Forms S–3[244] or of rule 415[245] could be made to turn on the existence of a board structured in this manner. The SEC would have to demonstrate that these governance mechanisms are related to the goal of securities regulation. Although the Commission is empowered to adopt rules for disclosure that are in the public interest, the SEC may not pursue public policy goals other than those for which the Commission was created.[246] Despite this restriction, the SEC probably has broad latitude to adopt rules along these lines.[247] A convincing case probably can be made that good management in part depends upon proper governance structures, and well managed companies require less detailed mandated disclosure to serve the interest of investors. Even more to the point, companies that have independent directors, an audit committee, and a nominating committee are more likely to produce full and fair disclosure and to police the internal disclosure process.

The Commission's traditional power is disclosure, which generally is used to assist investors in making informed choices. Proxy disclosure is only partially related to investment choice; for the most part, disclosure serves shareholders in making voting decisions, which are more closely related to the governance of the corporation than to investment decisions. In this function, the Commission may have greater latitude to use disclosure requirements to encourage conduct, such as the adoption of particular governance programs, because of the close relationship of disclosure to promoting meaningful shareholder participation. This process is known as therapeutic disclosure and is arguably one of the original purposes of the Securities Act of 1933.[248] In 1978, the Commission proposed disclosure requirements[249] relating to

244. 17 C.F.R. § 239.13 (1983).

245. 17 C.F.R. § 230.415 (1983).

246. NAACP v. FPC, 425 U.S. 662 (1976).

247. Cary, *Corporate Standards and Legal Rules,* 50 CALIF. L. REV. 408 (1962).

248. Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review,* 25 HASTINGS L.Q. 311, 330 (1974).

249. SEC Release No. 34–14970, 43 Fed. Reg. 31,945 (1978).

board structure and board committees. These proposed requirements in part were designed to promote more independent directors and to establish certain types of committees. Finally, the Commission retreated in substantial part from the original proposal,[250] although not necessarily from the notion of therapeutic disclosure.[251]

More recently, SEC officials have suggested that disclosure requirements should be closely related to traditional investor interests.[252] Qualitative disclosure, which was at the heart of the Commission's questionable payments or management fraud program, has been criticized as departing from the traditional goals of securities regulation. Investors were not interested in the forced revelations.[253] Of course, no one would claim that an incidental therapeutic objective or effect would deny power to the Commission to adopt a disclosure rule so long as investment or voting information was promoted. In actual effect, this gives the SEC broad latitude to adopt rules that it believes serve the traditional purposes of the securities statutes.

Much of the expansion of the federal securities laws has occurred in the courts.[254] Largely through application and interpretation of the antifraud provisions, the substantive reach of the federal securities law was extended so that conduct had only to "touch" a securities transaction to involve rule 10b–5.[255] However, most of this judicial activity resulted in the development of federal fiduciary standards and not in new rules or standards of corporate governance. As noted earlier, the Commission itself rejected an opportunity in 1964 to set forth a standard of director conduct,[256] and again in 1974 decided not to proceed with a project to define duties of directors.[257] Nonetheless, the Commission has been instrumental in persuading courts to issue orders that restructured the governance arrangement of many corporations, mainly as an outgrowth of management fraud cases involving questionable payments.

Practically every case in which courts appointed new directors, created new committees of the board, designated special counsel, or employed similar governance techniques was settled, and the restructuring orders were part of a consent decree.[258] The assumption by most courts that they possessed the power to issue such orders has rarely been challenged by an opponent who argued and briefed against the relief granted or questioned by the court itself.[259]

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250. SEC Release No. 34–15,384 (Dec. 6, 1978), 16 SEC Docket No. 6 at 348 (Dec. 19, 1978).

251. Sommer, *The Impact of the SEC on Corporate Governance*, in CORPORATIONS AT THE CROSSROADS 177, 191 (D. DeMott ed. 1980).

252. *See supra* note 204.

253. Freeman, *The Legality of the SEC's Management Fraud Program*, 31 BUS. LAW. 1295 (1976); Mann, *Moral and Ethical Problems; Loans to Management and Compensation Problems*, 31 BUS. LAW. 1305 (1976).

254. *See* McClure v. Borne Chem. Co., 292 F.2d 824, 832 (3d Cir. 1961); Fleischer, *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965); Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 1000–1001 (1976).

255. *See* Superintendent of Ins. v. Bankers Life & Casualty, 404 U.S. 6 (1971).

256. Matter of Franchard Corp., 42 S.E.C. 163 (1964).

257. Corporate Directors and the Federal Securities Laws, Address before the Thirteenth Annual Corporate Counsel Institute, Northwestern University School of Law; *see* 1974 SEC. REG. & L. REP. (BNA) No. 272, at A–11 (Oct. 9, 1974).

258. Dent, *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 946 (1983).

259. *But see* SEC v. American Realty Trust, 429 F. Supp. 1148 (E.D. Va. 1977), *rev'd*, 586 F.2d 1001 (4th Cir. 1978).

The court's authority must rest on its power to grant ancillary relief to remedy a violation of law. In general, courts have liberally viewed their equitable power to administer relief that is appropriate in order to effectuate the policies of the regulatory statutes at issue.[260] Thus, Professor George Dent writes, "The most persuasive argument for ancillary relief in federal securities law is that the Supreme Court and many lower courts have approved such relief and that almost no judicial precedent has questioned it."[261]

Until the mid 1970s, the Supreme Court read the SEC's mission broadly and indicated few restrictions on ancillary relief. The narrowing of the substantive provisions of federal securities laws beginning with *Blue Chip Stamps v. Manor Drug Stores*[262] and continuing with *Piper v. Chris-Craft Industries, Inc.*,[263] *Santa Fe Industries, Inc. v. Green*[264] *Touche Ross & Co. v. Redington,*[265] and *Transamerica Mortgage Advisors Inc. v. Lewis,*[266] checked the development of federal corporation law. Professor Dent argues that this development portends a similar limitation on the power of the lower courts to use ancillary relief in ways that carry the impact of the federal securities law into areas Congress did not intend.[267]

The question, then, is whether the courts overreach the congressional intent when their orders extend into the corporate governance arrangement. When the SEC and federal courts assert some control over the membership of the board, a conflict, or at least a potential conflict, with state corporation law is created. Can shareholders exercise their rights under state law to remove such directors without cause, or with cause? Can the shareholders simply refuse to reelect them? Can they swamp the directors by creating many new directorships, or is the size of the board frozen? What is the effect on cumulative voting or on staggered boards? What happens in a proxy fight when an insurgent offers a whole new slate? Ancillary power, after all, is only incidental to some principal policy or objective that is served by the law to which it adheres.

The legislative history of the federal securities laws demonstrates that Congress was not interested in adopting a federal law of corporations.[268] The management and affairs of the corporation were matters for state law, not federal law, and the committee reports left little doubt that Congress was not seeking to rearrange the internal affairs of the corporation.[269] Some impact on the internal operations of the corporation was inevitable, through the effect of the disclosure and proxy soliciting

260. Porter v. Warner Holding Co., 328 U.S. 395 (1946); Farrard, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976).

261. Dent, *supra* note 258, at 869.

262. 421 U.S. 723 (1975).

263. 430 U.S. 1 (1977).

264. 430 U.S. 462 (1977).

265. 442 U.S. 560 (1979).

266. 444 U.S. 11 (1979).

267. Dent, *supra* note 258, at 869; *see* Wolfson, *Needed: Statutory Reform to Improve Consent Decree Process*, 57 HARV. BUS. REV. No. 2 at 18 (March, April 1978).

268. 1 L. LOSS, *supra* note 110, at 902; Dent, *supra* note 258, at 880, 882, 893; Loomis & Rubman, *Corporate Governance in Historical Perspective*, 8 HOFSTRA L. REV. 141, 161 (1979).

269. S. REP. No. 792, 73rd Cong., 2d Sess. 10 (1934); H.R. Rep. No. 1838, 73rd Cong., 2d Sess. 35 (1934) (Conference Report).

regulations,[270] but it was surely not Congress' intention to prescribe standards for the composition and operation of the board of directors.

Many courts broadly construed the antifraud provisions of the statutes to reach "equitable fraud" and to impose federal standards of fiduciary duties.[271] However, when the issue whether a violation of rule 10b–5 could occur without deception first was presented to the Supreme Court, the Court reversed the lower court and wrote in no uncertain terms that rule 10b–5 did not cover such conduct.[272] The Court observed that a private cause of action under the antifraud provisions should not be implied unless it was necessary to ensure the fulfillment of the legislative purposes of the statute. The Court said it was reluctant to imply a federal claim, which served "at best a subsidiary purpose" of the law.[273]

The Court added that another factor militating against recognizing a federal claim for breach of fiduciary duty was that such a claim dealt with an area "traditionally relegated to state law."[274] The Court foresaw that to deal with a wide variety of transactions affecting minority shareholders, it would have to bring rule 10b–5 into areas of corporate conduct that traditionally had been left to state regulation, to create the danger of vexatious litigation, and to cause overlaps and possible interferences with state corporate law. "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[275]

While all this adds up to a powerful argument against the judicial authority to grant the kind of relief that the SEC has requested in many cases, I think the case for restricting the courts in the matter of relief has not been made. The issue, after all, is the power of the court, not the SEC, to impose a remedy; the issue is not whether to find a violation. It is true that the SEC initiates the request and may play a role in implementing it, but nonetheless the issue is the power of an equity court after it has found a violation of the law. It is also too sweeping to generalize that because Congress did not intend to enact a federal corporation law, Congress renounced all interest in the functioning of the board as it affected the substantive requirements of the securities laws. In truth, Congress focused little on the board of directors as a body separate from management.[276] Governance reform is a relatively new approach to prevention of managerial misconduct. The scholarly contributions of social scientists and lawyers who study boards of directors and prescribe new functions and methods were not available to Congress in the 1930s.[277] Consequently, governance

270. Cary, *supra* note 98.

271. *See* Schoenbaum v. Firstbook 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied,* 395 U.S. 906 (1969); Patrick, *Rule 10b-5, Equitable Fraud and* Schoenbaum v. Firstbook: *Another Step in the Continuing Development of Federal Corporation Law,* 21 ALA. L. REV. 457 (1969).

272. Patrick, *supra* note 271, at 478.

273. Sante Fe Indus. v. Green, 430 U.S. 462 (1977).

274. *Id.*

275. *Id.* at 479.

276. Weiss & Schwartz, *supra* note 179.

277. A considerable library of literature dealing with organizational theory and relating it to board of directors has been amassed. A sampling includes: R. CYERT & J. MARCH, A BEHAVIORAL THEORY OF THE FIRM (1963); R. LIKERT, THE HUMAN ORGANIZATION (1967); J. MARCH & H. SIMON, ORGANIZATIONS (1958); O. WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR (1970); O. WILLIAMSON, MARKETS AND HIERARCHIES (1975). Some of the more

reform in those pathological situations in which a court has found a violation is not a subterfuge to enable the federal government to get a foot in the federal corporation law door but is a surgical approach to an identified problem.

Additionally, in a broad sense, it is reasonable to think of corporate governance reform as closely related to the disclosure and suffrage objectives of the federal securities laws. The responsibilities of those laws are met by persons within the company, and increasingly, boards and their committees play a role in providing disclosure, reacting to tender offers, and making decisions in a number of areas within the scope of the federal securities laws. Certainly corporate governance structure is related to the goals of assuring proper internal controls as mandated by the Foreign Corrupt Practices Act.

The great strength of equity courts has been their ability to react in creative ways to individual situations. The Supreme Court's cautions not to engage in judicial legislation or to invade state substantive corporation law should not be read so extremely to deny equity courts their traditional powers. Certainly it is far too sweeping to conclude that restrictions on implied private rights portend a limitation on relief available when a public action is brought by the enforcing agency. No such reading is fair from any decision by the Court.

In addition to issuing orders that directly affect corporate governance, courts make general rules that may indirectly but profoundly affect the governance structure or process. To use a recent landmark state court decision as an illustration, the Delaware Supreme Court in *Weinberger v. UOP*[278] noted that fairness was, in part, a function of process.[279] The court observed that the transaction between the parent corporation and its subsidiary might have been accomplished by the creation of a special committee designated by the parent to carry out the negotiations with the subsidiary's management.[280] The court stopped short of requiring that procedure. Conceivably, a federal court might determine that a transaction, to pass federal standards of fairness, might require such a procedure. A federal court also might determine that the dismissal of a stockholder's derivative suit upon motion of the board of directors may be accomplished only if the board of directors is composed of independent directors and has followed certain procedures.

The limits on the federal courts' power to make such rules is constrained by *Santa Fe*[281] and by *Burks v. Lasker*.[282] The inapplicability of federal law to alleged breaches of fiduciary duty in general has been discussed. Of course, in cases arising under section 36 of the Investment Company Act of 1940, courts may apply a federally enacted fiduciary standard.[283] Conceivably, going private and issuer tender

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important legal academic contributions include: Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977); Conard, *A Behavorial Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895; Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1981).

278. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

279. *Id.* at 711.

280. *Id.* at 709 n.7.

281. 430 U.S. 462, 480 (1977).

282. 441 U.S. 471 (1977).

283. 15 U.S.C. § 80a-35 (1982).

offer transactions, which are the subject of federal rules,[284] may be governed by federal standards, although serious doubt about the applicability of federal law in these areas is expressed in *Santa Fe*.[285] Thus, federal courts have a limited opportunity, interpreting federal law, to render the type of substantive decision that leads to new governance rules.

The federal courts follow the Federal Rules of Civil Procedure in many aspects of derivative suits,[286] but the Supreme Court in *Burks*[287] limited the federal role in deciding whether the board of directors could terminate the suit. Consequently, there is little opportunity to prescribe federal governance standards for the exercise of that power.

Burks was a derivative suit by shareholders of a mutual fund against several directors of the fund and its investment adviser.[288] Plaintiffs alleged violations of the Investment Company Act of 1940 as well as common law breach of the duty of due care, centering around the fund's substantial purchases of Penn Central commercial paper just prior to Penn Central's insolvency. The complaint did not allege any self-dealing on the part of the defendants but rather charged that defendants had failed to exercise due care in relying almost exclusively upon the advice of a third party brokerage firm.[289] Five members of the eleven-person board, who were not affiliated with the fund's investment adviser and were not defendants in the suit, convened as a quorum pursuant to the company's by-laws, retained a retired chief judge of the New York Court of Appeals as independent counsel, and on the basis of their investigation, decided that the litigation was adverse to the company's best interest and moved to dismiss. After permitting discovery on the question of the directors' independence, the district court granted the motion.[290] The Court of Appeals for the Second Circuit reversed.[291]

The Supreme Court reversed the Second Circuit.[292] First, the Supreme Court held that state law governed the question whether disinterested directors possessed the power to terminate a derivative suit if they concluded that the litigation was adverse to the corporation's best interest. Second, the Court acknowledged that even if state law permitted such a decision under some circumstances, such a state policy might be inconsistent with a federal policy underlying the cause of action. The Court declined to find any conflict between the federal statutes involved in the case and the board action.[293]

Since *Burks*, few federal courts have found federal policies to be a basis for denying an effort to terminate the derivative suit. In *Galef v. Alexander*,[294] the

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284. 17 C.F.R. §§ 240.13e-3, -4 (1983).
285. 430 U.S. 462, 480 (1977).
286. Fed. R. Civ. P. 23.1.
287. 441 U.S. 471 (1977).
288. *Id.* at 473.
289. *Id.*
290. Lasker v. Burks, 426 F. Supp. 844 (S.D.N.Y. 1977).
291. Lasker v. Burks, 567 F.2d 1208 (2d Cir. 1982).
292. 441 U.S. 471, 486 (1977).
293. *Id.*
294. 615 F.2d 51 (2d Cir. 1980).

Second Circuit found that a derivative suit would frustrate the policy underlying the proxy rules, but most federal courts have employed the internal affairs rule under state law.[295]

The Federal Rules of Civil Procedure, in rule 23.1, require that demand be made upon the board of directors prior to the institution of a derivative suit, unless such demand is futile, and that demand be made upon shareholders "if necessary."[296] Most state laws have similar requirements.[297] The issue of the futility of the demand on directors is a federal question,[298] even in diversity cases, while the necessity of the demand on shareholders in non-federal cases turns on state law.[299] The determination of when a demand is required of directors usually turns upon whether the court believes that the board of directors is composed of persons who are capable of making a judgment in the interest of the corporation.[300] Thus, it would seem open to federal courts to decide by whatever standard they regard as appropriate whether a board possesses the necessary independence to make demand necessary. Courts could look to the process by which directors are nominated and against whom the suit is brought to decide the question. The existence of such standards could have a significant impact on the composition and selection process of boards of directors of corporations that are large enough to contemplate derivative suits brought in federal court.[301]

Finally, a federalism question that examines not the power of the federal government but rather the limitations of state law, concerns the extent to which federal regulation in certain corporate regulatory areas preempts state regulation. This issue recently has been presented in the tender offer area. By 1982, approximately thirty-five state laws superimposed state regulation onto the federal regulation of tender offers,[302] but most of those laws probably were invalidated by the Supreme Court's decision in *Edgar v. MITE Corp.*[303] The state laws failed by virtue of the commerce clause, and the Supreme Court did not rule upon the preemption issue.[304] However, new enactments by some states, which may satisfy the commerce clause test, once again compel consideration of the preemption issue, and the Court may have to decide whether the Williams Act preempts state tender offer statutes of the type

295. *E.g.*, Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

296. FED. R. CIV. P. 23.1.

297. *E.g.*, DEL. CH. CT. R. 23.1 (Michie Supp. 1983).

298. Hanna v. Plumer, 380 U.S. 460 (1965) (holding that the Federal Rules of Civil Procedure are not controlled by Erie R.R. v. Tomkins, 304 U.S. 64 (1938)).

299. Brooks v. Land Drilling Co., 564 F.Supp 1518, 1522 (D. Colo. 1983). *Compare* Rosengarten v. Buckley, 565 F.Supp. 193 (D. Md. 1982) *with* Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964).

300. Lewis v. Curtis, 671 F.2d 779 (3rd Cir. 1982).

301. Thus, § 7.03(b) of the ALI Project requires action of members of a board who qualify as independent directors in order to terminate a derivative action brought against corporate fiduciaries. Tent. Draft No. 2 is expected to make numerous changes when it appears in 1984 but the substance of the earlier draft remains the same. A more restrictive view on the board's power to terminate derivative litigation was stated in Coffee and Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981). Professor Coffee is the reporter for Part VII of the ALI Project, and Professor Schwartz is a consultant.

302. SEC Release No. 33-6158, n.14 (Nov. 29, 1979); 18 SEC Docket No. 17 at 1053 (Dec. 11, 1979).

303. 457 U.S. 624 (1982). Subsequent decisions by lower courts struck down state tender offer statutes on the same reasoning as *MITE*. Mesa Petroleum Co. v. Cities Serv. Co., 715 F.2d 1425 (10th Cir. 1983); Telvest, Inc. v. Bradshaw, 697 F.2d 576 (4th Cir. 1983); Martin-Marietta Corp. v. Bendix Corp., 690 F.2d 558 (6th Cir. 1982); National City Lines v. LLC Corp., 687 F.2d 1122 (8th Cir. 1982) .

304. *See supra* note 162.

adopted by Ohio[305] and Maryland.[306] I think a strong case can be made for federal preemption of the entire field on tender offer regulation. The federal design is not intended to thwart or encourage tender offers, unlike the state statutes, which are structured to impede tender offers, but this area is primarily one of corporate law rather than governance and beyond our present scope.

V. The ALI Project And Federalism

In the previous section, we discussed the federalism-corporate governance issue in terms of powers and limitations. The American Law Institute (ALI) is in the midst of a project that studies corporate governance from the standpoint of public policy.[307] That project and its relationship to federalism requires comment at this point.

The corporate governance project marks the first foray by the American Law Institute into traditional corporate law.[308] The ALI embarked upon it shortly after adopting the Federal Securities Code, which was a proposal for a statutory overhaul of all of the federal securities laws.[309] Neither corporate governance nor corporate law was a main focus of the Federal Securities Code.

Earlier efforts by the American Law Institute to deal with corporate law were never launched partly because of the ALI's difficulty in dealing with a subject matter that was so largely statutory.[310] However, in 1977 and 1978, the American Law Institute and the Corporation, Banking and Business Law Section of the American Bar Association conducted an exploration of corporate governance.[311] A series of regional invitational meetings were held at a time when the SEC[312] and Congress[313] were studying the subject and reform proposals were being floated.[314] Among other things, the meetings questioned whether any new federal legislation was appropriate.

A consensus developed from the regional meetings that the American Law Institute should undertake a project to deal with corporate governance.[315] The form of this project was unclear since little in the way of typical restating was contemplated and perhaps was best stated by Professor Loss who described the undertaking as "a new art form."[316] The project finally was approved by the Council and was funded

305. Ohio H.B. No. 822 (Nov. 18, 1982), codified at Ohio Rev. Code Ann. §§ 1701.01(2)(1), 1701.48, 1701.831, 1707.42 (Page Supp. 1983).

306. Md. Corps. & Ass'ns Code Ann. §§ 3-601 to 603, 8-301(14) (Supp. 1983).

307. Wechsler, *Foreword* of A.L.I. Project, *supra* note 33, at vii.

308. Wechsler, *Welcome on Behalf of the American Law Institute*, in Commentaries, *supra* note 12, at 17.

309. ALI Federal Securities Code (1980).

310. Wechsler, *supra* note 308.

311. Commentaries, *supra* note 12.

312. SEC Division of Corporation Finance, 96th Cong., 2d. Sess., Staff Report on Corporate Accountability 29 (Comm. Print Sept. 4, 1980).

313. *Corporate Rights and Responsibilities, Hearings before the Senate Comm. on Commerce*, 94th Cong., 2d Sess. (1976); *Protection of Shareholders Act of 1980, Hearings before the Subcommittee on Securities of Senate Comm. on Banking, Housing and Urban Affairs on S. 2567*, 96th Cong., 2d Sess. (1980).

314. R. Nader, M. Green, & J. Seligman, *supra* note 19; American Bar Association, Section of Corporation, Banking and Business Law, Committee on Corporate Laws, *Corporate Directors Guidebook*, 33 Bus. Law. 1591 (1978); Statement of the Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly-owned Corporation, 33 Bus. Law. 2083 (1978).

315. Commentaries, *supra* note 12, at 7.

316. Commentaries, *supra* note 12, at 280.

and staffed under the direction of Stanley A. Kaplan, a former law professor from the University of Chicago, and Harvey Goldschmid, a professor at Columbia Law School, as Deputy Chief Reporter. The other reporters initially appointed were Professor Melvin Aron Eisenberg of the University of California Law School, Professor John C. Coffee, at that time a professor of law at Georgetown and later a professor of law at Columbia, and Professor Ernest L. Folk, III of the University of Virginia Law School. Professor Folk later withdrew and Marshall Small, a San Francisco attorney, was designated as a reporter.

The "art form" still is emerging,[317] but the project now is organized into five main parts. One part attempts to prescribe a governance structure for corporations. As set forth in the first published draft,[318] the largest publicly held companies were required to have a board composed mainly of independent directors, one of whose main functions was to monitor senior management. Both audit and nominating committees were mandated. As more recently modified by the Council, only an audit committee remains mandated. All of these proposals are recommended, however, for publicly-issued companies.

The second part of the project deals with the duty of due care and the Business Judgment Rule.[319] The third part spells out the duties of loyalty of directors, officers, and controlling shareholders of corporations, the area historically labelled as fiduciary duties.[320] Following that, the fourth part will deal with areas of corporate control.[321] Finally, the project describes enforcement and remedies.[322]

Some portions of the project constitute traditional ALI restatement because they codify and systematize existing judge-made law. This is done mainly in the area of duties of due care and loyalty. The portions dealing with enforcement are partly traditional restatement but also contain proposals for change, which may be achieved either by courts choosing to follow them or by legislatures choosing to enact them. The corporate governance structure material, insofar as it mandates changes, is dependent on legislation, although not necessarily federal legislation. Moreover, those portions of the project that identify proper or preferable corporate practice might be picked up by courts as a standard to be applied in particular cases, while at the same time permitting necessary flexibility.[323]

While action by the American Law Institute is not official action and certainly is not action by any federal body, the American Law Institute is a national body. Its actions and recommendations, representing a broad consensus of distinguished law-

317. The ALI project does not fit within the customary ALI restatement mode; in fact, Tent. Draft No. 2 will be called "Analysis and Recommendations" instead of "Restatement and Recommendations." Many sections begin either with the words "Corporate Law should provide" which is sometimes a statement of present law and other times a recommendation for change. This appears as black letter. Some sections begin with the phrase "It is recommended as a matter of corporate practice that. . . ." These sections will not appear in black letter, to emphasize their non-mandatory character.

318. A.L.I. PROJECT, *supra* note 33, Part III.

319. *Id.*, Part IV.

320. *Id.*, forthcoming as Part V in Tent. Draft No. 3.

321. *Id.*, forthcoming in a future tentative draft as Part VI. This will not appear before 1985.

322. *Id.*, Part VII.

323. *See* The T. J. Hooper, 60 F.2d 737 (2d Cir. 1932); Mundheim, *A Time to Learn*, in COMMENTARIES, *supra* note 12, at 181.

yers, scholars, and judges from the entire country, have an effect on courts and legislatures throughout the country. Action by the ALI then may be a prelude for official governmental action.

The implementation by states of proposals adopted by the American Law Institute would be a form of functional federalism in that the proposals represent generally adopted solutions to national problems.

The opponents of the ALI project apparently perceive the significance just described, judging from the vigor of their efforts. Business groups and interested ABA committees have complained about a lack of communication and participation. The change in the political climate since 1978 may explain why some former supporters of the project now wish to trim it back or extinguish it entirely. Clearly this is not merely another academic undertaking. The collective experience and reputation of the ALI and the reporters probably will give the final project instant credibility.

Moreover, few efforts of the ALI have touched the nerves of the established bar and its clients as deeply as this project. It has the potential to cause a major impact on the manner in which large corporations conduct their business and affairs. Many business managers view the project as an unwarranted intrusion by lawyers and law professors into an area about which they know little. Worse, their efforts are seen as increasing the threats of litigation with uncertain results. Thus, even the seemingly benign recommendations of "good corporate practice" are viewed as unsettling because of the possibility that the recommendation is a modified mandate. Consequently, an intense, political-like struggle has surrounded the ALI project in its formative period, and compromises on most important provisions are likely.[324]

VI. What Is The Appropriate Federal Role?

Determining the proper role for federal law in corporate governance is not simply, or primarily, an analysis of the power of the Congress, federal agencies, and federal courts, but rather is mainly a consideration of whether and how those bodies should act. Policy, not power, is the main federalism issue in corporate governance, and this may not be an issue of federalism at all.

This Article hopefully makes clear that the field of corporate governance and corporate law is presently a mixture of federal and state roles. The national government, acting through all of its instrumentalities, has chosen to act in numerous ways. It sometimes makes substantive rules affecting corporations; it sometimes makes detailed rules both as to substance and governance for specific industries that Congress has identified as meriting special attention, and in some respects, it has chosen to impose an overlay over state law rules. The main question is whether we should do more or less of what we are already doing and how we should do it.

Proponents of change argue that change will occur only through federal action. States are unlikely to act; voluntary action will be limited. In the late 1970s, a great deal of voluntary action occurred both in self-regulatory organizations, such as the

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324. Remarks of Roswell B. Perkins, president of the American Law Institute, at a Forum at the Association of the Bar of the City of New York (March 14, 1983).

New York Stock Exchange,[325] and in individual companies.[326] All of that action took place against the backdrop of a keen interest by the SEC in the subject, and the threat of possible federal legislation. With those external forces now quiet, a mood of relaxation has set in, soothing corporate managers and lulling them into the apparent belief that the present political climate will last forever. Recent opposition to the ALI project demonstrates the fickleness of support for voluntary change.

Before any larger federal role is established, it would be helpful to test, or at least to analyze, the effectiveness of existing federal efforts. National banks and investment companies have experienced the most pronounced federal experience; all companies have been affected by the impact of the federal securities laws. I am not aware of any conclusive empirical study that convincingly demonstrates that federal laws dealing with governance have improved shareholder or community welfare or that the costs involved have outweighed probable benefits. Personal and shared experiences, however, as well as a theoretical construct that appears reasonable persuade me that the federal law affecting corporate conduct provides numerous net benefits. Not *all* laws and regulations provide net benefits, of course, since we have come to cheerfully discard numerous rules that burden without benefit. With regard to much of the regulation, including tender offer regulation in the governance area, I believe the jury is still out and the evidence produced so far does not carry the day.

This Article accepts as a premise that corrective action in corporate governance is needed. The main problem to address is the inadequacy of the accountability systems, and while no remedy is without flaws, improved internal monitoring systems, accompanied by realistic enforcement tools, are the preferred reforms. Other corporate law changes, including the most fundamental one of defining the corporate purpose and its social relationships, also are desirable.

Some, mostly economists and some law professors, vigorously contend that the absence of empirical data to show the wisdom of the changes urged, together with evidence that the markets function well to produce the desired effect, destroys any argument in favor of governmentally imposed changes. Commentary by Professors James Mofsky and Nicholas Wolfson upon the oral presentation of this Article was strongly to that effect. In particular, they cite works by Stigler[327] and McAvoy,[328] to which they could add efforts by Jensen and Ruback,[329] Fama and Jensen,[330] Jarrell and Bradley,[331] Easterbrook and Fischel,[332] and others. At most, all these writings

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325. N.Y.S.E. LISTED COMPANY MANUAL § 3.03 (1983 ed.).

326. Heidrick & Struggles, Inc., *Director Data* (1982); Heidrick & Struggles, *The Changing Board—1983 Update;* Korn/Ferry International, *Board of Directors-Eighth Annual Study* (1981); New York Stock Exchange, *Survey of Corporate Boards, Structure and Composition* (1979).

327. Stigler & Friedland, *The Literature of Economics: The Case of Berle and Means,* 26 J.L. & ECON. 237 (1983).

328. McAvoy, Cantor, Dana, & Peck, *ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis,* in STATEMENT OF THE BUSINESS ROUNDTABLE ON AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPALS OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS." EX. C (1983).

329. Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence,* 11 J. FIN. ECON. 5 (1983).

330. Fama & Jensen, *Separation of Ownership and Control,* 26 J.L. & ECON. 301 (1983); Fama & Jensen, *Agency Problems and Residual Claims,* 26 J.L. & ECON. 327 (1983).

331. Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers,* 23 J.L. & ECON. 371 (1980).

332. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer,* 94 HARV. L. REV. 1161 (1981).

make a case that the market for corporate control, first identified by Henry Manne in 1965,[333] is important and the law should tread lightly lest it impair the market's effectiveness. The case is not made that the market for corporate control, or any other market function, addresses all the problems that have been identified for reform, much less addresses them all with total effectiveness. First, the market for control is a blunt instrument that does not permit moderate solutions for moderately excessive agency costs. Second, the tender offer, as the shining star in the market for control, has profound extra-corporate and extra-shareholder impacts that no one has yet studied nor devised a protocol for study. Third, and most important, the evidence does not demonstrate the scope of the market for control. That is, it may effectively constrain management where its light is focused, but the stock of numerous public companies is traded infrequently, not followed closely by analysts, and at best, come within the weak side application of the efficient market hypothesis. Constraints other than the market for corporate control are necessary when one dips much below the Fortune 200.

If federal action is necessary, what should it be? Federal chartering, as urged by a Nader task force[334] and by this author, in a different form,[335] would replace state law to a limited degree. That is, it would make federal law the exclusive law governing the affairs of the largest corporations. In many respects, this is an ideal solution because it wipes the slate clean of all the barnacles of outmoded notions of governance and the substantive content of corporation law. It ends the negative competition among states in their "race for the bottom."[336]

In other respects, however, it is a far from ideal solution. To begin with, it drains the energy of constructive thinking into a project that is almost certainly a political impossibility. Congress will not adopt a federal chartering statute at the present time nor in the foreseeable future.

Second, one cannot ignore the two hundred years of baggage that travel with our system of state corporation law. Sweeping aside state law that has been the standard since the beginning of the republic would jeopardize the benefits of a wealth of experience. Moreover, the uncertainties that would affect the counseling of corporations and their advisors with the state system cast aside might cause unnecessary confusion.[337].

However, the biggest objection that this erstwhile proponent of federal chartering perceives at this time is the weakness in the legislative process. Congress seems less capable of adopting major legislation at this time than at any time within memory. This is exemplified by the difficulties in having the Federal Securities Code even introduced as a bill and the inability to legislate a national energy policy, to reform the financial regulatory structure, and even to adopt an annual budget. Some attribute Congress' paralysis to the dominance of special interest electioneering that has frag-

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333. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).
334. R. NADER, M. GREEN, & J. SELIGMAN, *supra* note 19.
335. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976).
336. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).
337. Garrett, *The Limited Role of Corporation Statutes*, in COMMENTARIES, *supra* note 12, at 96.

mented Congress into many factions, each with a particular axe to grind and little interest in consensus politics. The growth of grass roots movements, the diminished importance of political machines, and the growing influence of television in politics probably all partially are responsible for this. While this author is not a political scientist and is not capable of analyzing the root causes of the change in our political functionings, the results are plain to see.

Therefore, I am drawn away from the idea of what I once believed to be the best approach to a search for a second best, and surely more modest approach, and one that is not wholly dependent on massive legislative action. Congress can probably only swallow bite-sized, predigested pieces, and if one attempts to conjure up a gourmet banquet, he is likely to walk away from the table hungry.

Although it is far from complete, I believe that the American Law Institute's project affords the best prospect for achievable reform. It retains our fundamental, long-standing arrangement that acknowledges state chartering of corporations and the primacy of state law, including existing choice of law standards. It creates national standards of corporate governance, some of which I believe should be enacted into federal law. The strong recommendations of the ALI, even if not enacted, provide guidance to managers, lawyers, and judges to promote voluntary, or in some cases, judicially imposed standards. At the same time, such recommendations and their responses blunt the need for further legislative changes, and permit diverse solutions to problems.

Federal agencies may also choose to adopt certain sections of the ALI Project through rulemaking, which is a flexible form of legislation. The SEC would be a particularly appropriate agency to enact portions of the ALI Project. In its regulation of tender offer transactions, going private transactions, and corporate repurchases of stock, fairness requirements may well include process and governance as an element of the test. If the ALI adopts governance and substantive standards, this would afford the SEC a sound basis for taking action embodying those standards in transactions subject to the SEC's jurisdiction.

Rule changes affecting remedies are more complicated. The ALI recommendations dealing with derivative suits are complex and legislative in nature because of the specificity of the rules. However, these rules may be taken as guidelines and safe harbors to be used by courts as a standard to apply and are not necessarily dependent upon implementation through legislation. It is appropriate to use a federal standard for at least some remedies provisions but not necessarily all of them. Whether derivative litigation may be terminated by boards of directors is a fundamental question that affects the future viability of the derivative suit. The temptation is great for corporate managers to attempt to enact into state legislation a rule which gives boards broad discretion to terminate such litigation. A federal response that limits their ability to do so in cases that are brought in federal court, whether they concern federal claims or common law claims, is necessary, or may be so, to counter this movement. The courts may require assistance in bringing about this result, either by legislation or by changes in the Federal Rules of Civil Procedure.

Recognizing an important place for a federal role in corporate governance still requires us to move with a degree of modesty and humility. That is to say, the

relevance of corporate governance to improving the standards of corporate law is a recently perceived wisdom. When the federal securities laws were first adopted, little distinction was drawn between inside directors and outside directors, or between management and the board of directors. Only recently have the business community, its critics, and regulators become convinced of the desirability of at least a critical mass of outside directors on boards of publicly-owned companies. The limitations of legitimate expectations are not yet fully understood;[338] we have not lived with the idea long enough.

What is proposed here as an appropriate federal role is not necessarily a package deal, nor must it all be enacted at one time. Many people remain to be convinced that governance reform has any importance at all. The cautions and thorough procedures of the American Law Institute afford an opportunity for an excellent beginning to think through the problem and the solutions which must follow to place reform of corporate governance on a sound footing.

Another approach to federal involvement is through the adoption of federal fiduciary standards as initially proposed by Professor Cary.[339] This would enable federal law to focus on isolated problems rather than to wrestle with cosmic schemes such as the structure of the board of directors. This is the traditional approach to reform. Presently, most fiduciary standards are embodied in judge-made rules, which have been criticized as being incapable of preventing fundamentally unfair transactions.[340] The enactment of definite standards, for parent-subsidiary mergers or tender offer responses, as examples, will permit predictability and relieve the courts from an unsupportable burden of attempting to fathom fairness in given situations.[341] This approach rejects the notion of attempting to solve particular problems by creating the right mechanism for dealing with the problem, but directly solves the problem.

The very firmness of the solution is at once its strength and its weakness. It uses the approach of Internal Revenue Code regulations in lieu of vague standards, but it acts in areas of traditional equity jurisdiction where chancellors have long employed experience and a sense of justice. The restatement approach of the ALI in part five, which lacks legislative rigor, seems preferable. Lawyers are still undecided as to whether directors' duties should be described as fiduciary duties or whether their obligations merit some other term, yet courts have loosely applied the fiduciary concept for centuries. A sudden fiat may cut the knot, all right, but may only create new and unanticipated problems.

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338. Despite the heavy emphasis that the American Law Institute, the American Bar Association and the SEC have placed on independent directors, there remains considerable skepticism that the development has much significance. Brudney, *The Independent Director—Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597 (1982); Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?*, 76 MICH. L. REV. 581 (1978); Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894 (1983).

339. Cary, *supra* note 247.

340. Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974).

341. Chirelstein, *Towards a Federal Fiduciary Standards Act*, 30 CLEV. ST. L. REV. 203 (1981).

Furthermore, state courts, in applying fiduciary standards, have not been the weakest link in the current system of corporate law and governance.[342] State courts have shown the ability to adapt to new problems and to advance the law that they have created.[343] State legislatures have been less responsive.[344] The area of state law that requires most attention has been that portion which is legislatively dominated, not judicially created. A legislative approach that did not draw bright lines but uses only rough contours to shape federal fiduciary standards would burden federal courts at a time when their overload has become a growing concern.[345] In terms of need, a federal solution should focus on that which is in greater need of repair.

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342. Schwartz, *supra* note 335, at 1136.

343. *E.g.*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977).

344. Folk, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. BAR J. 409 (1968).

345. *See* Patsy v. Board of Regents, 457 U.S. 496, 498 (1982).