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Is It Time for a Federal Corporation Law

Roberta S. Karmel

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IS IT TIME FOR A FEDERAL CORPORATION LAW?

*Roberta S. Karmel**

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INTRODUCTION

Large public corporations are business enterprises operated for private gain, but they also are social institutions imbued with a public interest.¹ Debates in American legal circles about how corporate managers should be held accountable and whether corporations should be operated solely for the benefit of share-

* Professor of Law and Co-Director of the Center for the Study of International Business Law, Brooklyn Law School. B.A. Radcliffe 1959; LL.B. New York University 1962. Professor Karmel is also a partner of Kelley Drye and Warren and was a Commissioner of the Securities and Exchange Commission from 1977-80. The research assistance of Brooklyn Law Student Jane Drummey is gratefully acknowledged.

¹ "Notwithstanding the pervasive intrusion of external government, corporation boards and executives still make most of the decisions which affect the welfare of consumers, employees and the national economy." A.F. CONARD, *CORPORATIONS IN PERSPECTIVE* 318 (1976).

holders, or also with a view to the interests of society, including employees and the community, are of long standing.²

Today's corporate governance debates focus on the role that should be played by institutional investors, including public pension funds. Professor Richard Buxbaum, in his Pomerantz Lecture,³ has suggested that such investors may be pushing United States corporations to the two-tier board model of German corporations. This Article will explore the current ferment over corporate governance, describe various reform proposals and suggest that institutional investors may be having a negative influence on corporate governance. Their demand for a possibly unreasonable return on their investments, in the form of takeover premiums or other dividends, has generated a wave of state antitakeover litigation curtailing shareholder rights.

The Securities and Exchange Commission (SEC or Commission) has been unable to counter this trend, for both political and legal reasons. Whether recent initiatives by the California Public Employees' Retirement System (CalPERS) and other investor activists will change the SEC's course remains to be seen. It is noteworthy that during the same period that shareholder rights have eroded in the United States, the European Communities (EC) have been improving shareholders' rights through federal legislation.

Accordingly, it may be appropriate to revive the debate about whether a federal corporation law is needed.⁴ Any such law should impose obligations for appropriate capital structures on institutional investors in addition to better protecting their rights.

² The debate between Professors Berle and Dodd in 1931 and 1932 formed the backdrop for sweeping New Deal reform legislation, including the first federal securities laws. See Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Dodd, *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI. L. REV. 194 (1935).

³ Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOKLYN L. REV. 1 (1991).

⁴ See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

I. DEBATES ABOUT CORPORATE GOVERNANCE

A. *The Past as Prologue*

In the early years of the Great Depression, Berle and Means reached the insightful and influential conclusion that there had been a divorce between ownership and management in large public corporations.⁵ The political implications of this conclusion were then hotly debated by Berle and Dodd, both of whom argued by analogy, comparing corporations to governmental agencies.⁶ Dodd argued that the state should regulate the absolute control of corporate property exercised by corporate managers not only for the benefit of shareholders but also for society at large. He viewed corporations as autocratic merchant states that derived their power from the government and therefore had to be brought under government control for the benefit of society at large.⁷ Berle, by contrast, viewed corporate officers as representatives and was concerned about making corporate managers more responsive to the economic interests of shareholders. He hypothesized that shareholders had surrendered control of the corporation to management and that such control needed to be returned to shareholders through the enforcement of fiduciary duties owed to them by officers and directors.⁸

The Dodd perspective was revived in the 1970s by consumer advocate Ralph Nader, who expressed the view that corporations are state agencies which enjoy special privileges in order to achieve social or national ends. According to Nader, the consensual economic cornerstone for corporate privilege had crumbled because of the breakdown of controls that historically legitimized corporate power. These controls were state chartering, competition, remedial law, federal regulation, labor unions, shareholders and the board of directors. In Nader's view, each had failed to control or prevent irresponsible and unlawful conduct by corporate executives, individually and collectively. As a

⁵ A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933).

⁶ Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1368 (1932); Dodd, *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?*, 2 U. CHI. L. REV. 194, 203-04 (1935).

⁷ Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1156 (1932).

⁸ Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); Berle, *supra* note 6, at 1367-68.

result, giant, multinational corporations became private governments, exercising an influence on the quality of life for which they were not held accountable. Nader's prescription was federal chartering of corporations, which would restructure the board of directors, redefine its relationships with management, employees and shareholders, and regulate corporate disclosure and conduct in certain significant areas of social concern.⁹

In response to the same political movement to reform large corporations, a federal minimum standards corporation law was advocated by Professor William Cary, former Chairman of the SEC.¹⁰ Cary, like Berle, was more concerned about making corporate officers and directors accountable to shareholders than he was concerned about making corporations accountable to society generally. The SEC then seized the flag of corporate governance in what became a political battle to curtail the power of private corporations and their management. This development was not so much in response to the collapse of business power, as had been the case in the early 1930s, but was due to a perception that business had become too powerful, and also too corrupt.

Coincident with Harold Williams becoming Chairman of the SEC, in April 1977, the Commission announced that it would hold "public hearings concerning shareholder communications, shareholder participation in the corporate electoral process, and, more generally, corporate governance."¹¹ The background cited for the need to focus public attention on the subject of corporate accountability was the SEC's own enforcement program which had resulted in the public exposure of a "wide variety of questionable and illegal corporate practices including bribes, kick-backs, illegal political contributions, and improper accounting practices."¹² The Commission's political predilections for reform legislation were clearly set forth. The Commission stated that:

a number of proposals designed to achieve a new "corporate governance" have been suggested, including placing greater emphasis on the role of outside directors and audit committees, increasing federal con-

⁹ R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976).

¹⁰ Cary, *supra* note 4. See also Schwartz, *A Case For Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976).

¹¹ Reexamination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 13,482 (Apr. 28, 1977), 42 Fed. Reg. 23,901, 23,902 (1977).

¹² *Id.* at 23,902 n.1.

trol over corporate conduct through legislation which requires federal chartering or setting of minimum standards of corporate conduct, and providing mechanisms to assure a higher level of management accountability to shareholders through revisions of the Commission's proxy rules.¹³

The SEC's threat to reform corporate governance by mandating boards of independent directors was given teeth by the views concerning independent directors expressed by Chairman Williams. In one of his first speeches as SEC Chairman, he stated that:

the large corporation has ceased to be private property—even though theoretically-owned by its shareholders. It is now a quasi-public institution. If it is such a quasi-public institution, then the self-perpetuating oligarchy that constitutes management does not have the same rights it once had.¹⁴

In Williams's opinion, the only way for the private sector to stem the tide of increasing government regulation of business and to fill the gap left by shareholder passivity was to make corporate power more accountable to the general public. The mechanisms by which Williams believed such accountability should be achieved included a board composed entirely of persons not in any way affiliated with the corporation except for the chief executive officer. Further, the CEO should not be chairman of the board because the substance and process of board deliberations should not be management's prerogatives.¹⁵ At the very least, a board's nominating, compensation and audit committees should be composed of independent directors, because these committees are key elements in corporate accountability.¹⁶

The SEC's Corporate Governance Hearings, held in four cities around the United States, lasted many months. Following the hearings, the Commission engaged in a number of rulemaking proceedings concerning the proxy rules. Although these rules required increased public disclosure of board composition and

¹³ *Id.* at 23,902 (citations omitted).

¹⁴ Address on Corporate Ethics, by Harold M. Williams, Chairman, SEC, American Assembly, Columbia University 16 (Apr. 16, 1977).

¹⁵ Address on Corporate Accountability, by Harold M. Williams, Chairman, SEC, Fifth Annual Securities Regulation Institute, San Diego, Calif. (Jan. 18, 1978).

¹⁶ Address on Corporate Accountability—One Year Later, by Harold M. Williams, Chairman, SEC, Sixth Annual Securities Regulation Institute, San Diego, Calif. (Jan. 18, 1979).

board committees, none of the SEC's rulemaking proceedings endeavored to regulate the substantive composition of the board.¹⁷ The staff report on the hearings concluded: "The board of directors has come to be viewed by many as the center of efforts to enhance corporate accountability. With an increased number of truly independent directors and an effectively functioning committee system, an institutionalized process for holding management accountable will be created."¹⁸ Nevertheless, the report did not include any legal recommendations as to whether or how to create a board composed of independent directors controlling the nominating process.

The Business Roundtable basically agreed with the SEC that the boards of large public corporations should be composed of a significant number of outside or independent directors.¹⁹ However, business leaders found the SEC's proposed rulemaking highly objectionable because it threatened to eliminate the separation of political and economic power on which the United States private enterprise system had long depended.²⁰ As one commentator expressed the matter:

The SEC then is not crusading only for reform of corporate governance. Whether or not the SEC knows precisely what it is doing, in fact it is entering into a social, economic and political controversy over whether corporations should remain essentially private property dedicated to economic purpose or should become essentially public property dedicated to social ends.²¹

There was one area of agreement between business leaders and Chairman Williams. Both suspected that shareholders were exacerbating corporate misconduct. Williams asserted that it

¹⁷ The SEC proposed the labeling of directors as "management," "affiliated non-management," or "independent." Exchange Act Release No. 14,970 (July 18, 1978), 43 Fed. Reg. 31,945, 31,947 (1978). Because this raised a howl of protest from commentators, the final rules required only a brief description of "significant economic and personal relationships . . . between the director and the issuer." Exchange Act Release No. 15,384 (Dec. 6, 1978), 43 Fed. Reg. 58,522, 58,523 (1978) (codified at 17 C.F.R. § 240.14a-1 (1990)).

¹⁸ SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY, PRINTED FOR USE OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 96th Cong., 2d Sess. 579 (Sept. 4, 1980).

¹⁹ The Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2105-08 (1978).

²⁰ *Id.* at 2089-91.

²¹ Kohlmeier, *SEC Seeks Governance Goals Far Beyond Its Mandate*, FINANCIER, Aug. 1978, at 8.

was not in the long-term interests of corporations to pander to short-term speculators in a corporate income stream.

The "shareholder" to which management should regard itself as accountable is not simply those individuals who happen to be shareholders today—or at any arbitrary point in time—but to "ownership" as an institution over time. When the "shareholder" is viewed as a continuing, long-term group—even though its membership is changing daily—there is far greater congruence between corporate activity in the interests of its shareholders and the interests of the larger society.²²

Further, Williams suggested that if investors do not change their attitudes to take a longer term view of corporate activity, we should "unlink the income stream speculator from ownership in American business," perhaps by increasing "the role of debt so that equity financing is less important."²³

During the 1980s, controversy about corporate governance focused on The American Law Institute's Corporate Governance Project (the Project).²⁴ This ongoing "prestatement" of the law covers numerous areas of corporate law, only two of which will be mentioned here. As to board structure and composition, the Project advocates a monitoring model of corporate governance with at least a majority of independent directors.²⁵ Section 2.01, which speaks to corporate purpose, provides that "[a] business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."²⁶ Nevertheless, a corporation "may devote a reasonable amount of [its] resources to public welfare, humanitarian, educational, and philanthropic purposes," without regard to immediate economic gain.²⁷

The most acrimonious objections to the Project's formulations concerning board structure, composition and objectives

²² Address by Harold M. Williams, Chairman, SEC, Corporate Accountability and Corporate Power, Fairless Lecture Series, Carnegie-Mellon University 13 (Oct. 24, 1979).

²³ Address by Harold M. Williams, Chairman, SEC, The Economy and the Future—The Tyranny of the Short-Run, the Commonwealth Club, San Francisco, Cal. 17-18 (Nov. 21, 1980).

²⁴ See generally Perkins, *The ALI Corporate Governance Project in Midstream*, 41 BUS. LAW. 1195 (1986).

²⁵ PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 3.02-.04 (Tent. Draft 1984).

²⁶ *Id.* § 2.01.

²⁷ *Id.*

came from the Business Roundtable.²⁸ In the Roundtable's view, the Project proposed significant changes in current law, while using the form of a traditional Restatement. According to the Roundtable, the Project recommended new law and formulated black-letter rules in spite of conflicting case law and imposed duties not required under current law.²⁹ The Roundtable also attacked the Project's choice of one model of corporate governance, the monitoring model, to the exclusion of all others.³⁰ Regarding the merits of the Project's theories on board composition, the Roundtable's statement criticized the Project for imposing "new rules and regulations on United States corporations which will serve only to decrease the risk-taking and flexibility critical for corporate survival."³¹

The Roundtable also objected to the emphasis on shareholder gain as a corporate objective, suggesting that corporations have multiple bottom lines.³² As one astute observer remarked, this criticism of the goal of shareholder wealth enhancement was perhaps a mask for an argument to allow leeway to management to oppose tender offers.³³

B. *The Takeover Mania*

The long-term effects of the takeover mania of the 1980s will not be known for some time. Persistent arguments that the leveraging involved in many buyouts posed a danger to the United States economy³⁴ fell on deaf ears until the collapse of

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

²⁹ *Id.* at 2.

³⁰ *Id.* at 20-27.

³¹ *Id.* at 35.

³² See Schwartz, *Objective and Conduct of the Corporation*, 52 GEO. WASH. L. REV. 511, 520 (1984) (quoting Comments of The Business Roundtable Concerning the American Law Institute's Corporate Governance Project 14-15 (unpublished memorandum, May 4, 1984)).

³³ *Id.* at 520.

³⁴ See, e.g., Clark & Malabre, *Borrowing Binge: Takeover Helps Push Corporate Debt and Defaults Upward*, Wall St. J., Mar. 15, 1988, at 1, col. 6; Forstmann, *Leveraged to the Hilt, Violating Our Rules of Prudence*, Wall St. J., Oct. 25, 1988, at 26, col. 5; Grant, *Will History Repeat Itself?*, Wall St. J., Oct. 25, 1988, at 26, col. 3; Rohatyn, *Junk Bonds and Other Securities Swill*, Wall St. J., Apr. 18, 1985, at 30, col. 3; Shad, *The Leveraging of America*, Wall St. J., June 8, 1984, at 28, col. 4; *Junk Bond Defaults Are Expected to Increase*, S & P Official Warns, 20 Sec. Reg. & L. Rep. (BNA) 334

Drexel Burnham Lambert, which in turn led to the collapse of the junk bond market.³⁵

Scholarly opinion along a broad political spectrum during the 1980s favored takeovers as a corporate accountability mechanism.³⁶ Even the high levels of debt that resulted from many buyouts were defended as a mechanism that compelled managers to work harder and eliminate inefficiency.³⁷ The few strong voices that decried the takeover boom³⁸ tended to speak for corporate managers³⁹ or bondholders.⁴⁰ Even the SEC justified takeovers as an appropriate corporate governance device.⁴¹

Corporate managers saw events differently. Decrying takeovers as a threat to corporate values and structures, they resisted takeovers through a variety of corporate governance defenses.⁴² Business leaders, joined by labor groups, also persuaded state legislatures to enact antitakeover laws.⁴³ Such legislation included "other constituencies" statutes, which permit directors to take nonshareholder constituencies into account in making corporate decisions.⁴⁴ Such statutes go much further than a

(Mar. 4, 1988); Kaufman *Voices Concern About Growing Debt, Volatility of Markets*, 46 Wash. Fin. Rep. (BNA) 160 (Jan. 27, 1986).

³⁵ See Siconolfi, Powe, Cohe & Guenther, *Rise and Fall: Wall Street Era Ends as Drexel Burnham Decides to Liquidate*, Wall St. J., Feb. 14, 1990, at A1, col. 6.

³⁶ See Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169-73 (1981); Epstein, *Who Owns The Corporation?*, A Twentieth Century Fund Paper (1986). See also Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-18 (1965).

³⁷ See, e.g., Epstein, *supra* note 36, at 37-38; Jensen, *The Takeover Controversy: Analysis and Evidence*, 4 MIDLAND CORP. FIN. J. 6, 13-14 (1986); Sobel, *Junk: Issues of the Past and Future*, Wall St. J., Feb. 28, 1990, at A14, col. 3. See also *They Will Return*, ECONOMIST, Feb. 9, 1991, at 19.

³⁸ E.g., L. LOWENSTEIN, *WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER* (1988).

³⁹ See Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 8-9 (1987).

⁴⁰ See Bratton, *Corporate Debt Relationships: Legal Theory In a Time of Restructuring*, 1989 DUKE L.J. 92, 95; McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 206-07 (1988).

⁴¹ See *Special Report: The Battle Over Tender Offer Reform: From the States and the Courts to Congress*, 20 SEC. REG. & L. REP. (BNA) 60, 69 (Jan. 15, 1989) [hereinafter *Battle Over Reform*].

⁴² See Gilson, *Just Say No to Whom?*, 25 WAKE FOREST L. REV. 121 (1990).

⁴³ Lieberman & Bartell, *The Rise in State Anti-Takeover Laws*, 23 SEC. & COMMODITIES REG. 149 (Sept. 5, 1990).

⁴⁴ Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990).

grant of wide discretion to directors involved in a contest for corporate control and could change the traditional corporate law standard covering corporate objectives and purposes.⁴⁵ While only one statute mandates the subordination of shareholder gain to the interests of other corporate groups such as employees, customers and communities, all permit such societal preferences.⁴⁶ Although Delaware has not passed an "other constituencies" statute, its courts have accorded directors wide latitude in responding to takeovers, including some consideration of matters other than the benefit to shareholders of the takeover premium.⁴⁷

An even more drastic change in laws and regulations pertaining to corporate governance that resulted from efforts to stifle takeovers was the erosion of shareholder voting rights, which will be more fully described below.⁴⁸ It is ironic that by the end of the 1980s business was appealing to state government to suppress takeovers by adopting the Dodd-Nader arguments that employee and societal concerns were more important than shareholder profit.

C. *Current Proposals*

Most current corporate governance proposals are aimed at giving institutional shareholders greater voice. Generally, the predicate behind these proposals is that management needs to be disciplined and made more accountable to shareholders. However, a few writers have predicated reform proposals on the need for the modern public corporation to become more responsible to society. While all of these proposals recognize that the institutionalization of the securities markets has created the need for rethinking corporate governance, in the author's view none of the current academic proposals comes to terms with the movement to curb institutional investor power expressed by state antitakeover and "other constituencies" legislation.

Professor Alfred Conard has urged the activation of institu-

⁴⁵ *Id.* at 2268-69.

⁴⁶ *Id.* at 2262-67.

⁴⁷ See *Paramount Communications v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989), *aff'd* 571 A.2d 1140 (Del. 1990).

⁴⁸ See text accompanying notes 104-121 *infra*.

tional investors in order to curb managerial abuses.⁴⁹ He has argued that current mechanisms for holding management accountable—derivative suits, shareholder proposals and independent directors—have failed.⁵⁰ Although Conard recognizes that the substitution of “investor capitalism” for “managerial capitalism” could mean the sacrifice of long-term goals for short-term goals, an exacerbation of insider trading and even the entrenchment of managers who ally with institutional investors, he nevertheless believes these risks are worth the potential benefits of institutional control of corporate enterprise. These benefits might be an enhancement of profitability, a cooling of the takeover wars and rationalization of managerial compensation.⁵¹ In Conard’s view, pension fund socialism is no less likely to be socially responsible than managerial capitalism.⁵² He therefore advocates the liberation of institutional investors from control by their sponsors and urges reform to give them access to management’s proxy statement.⁵³

Other academic writers of a more free market orientation have likewise advocated the activation of institutional investors and reforms that would free them to combine forces and act more like the “proprietor-capitalists” of Germany and Japan than the “punter-capitalists” of the United Kingdom and the United States.⁵⁴ Professor Bernard Black has argued that shareholders are passive in part because of legal constraints imposed upon them by the SEC, bank regulators, and the Department of Labor under the Employee Retirement Income Security Act (ERISA), as well as by antitrust laws and state corporation law.⁵⁵ In his view, these constraints should be removed so institutional investors can find their voice.⁵⁶ Similarly, Professor George Dent has urged that institutional investors combine to assert control over business enterprises.⁵⁷ These views would jus-

⁴⁹ Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988).

⁵⁰ *Id.* at 126-30.

⁵¹ *Id.* at 163-72.

⁵² *Id.* at 172-74.

⁵³ *Id.* at 177-78.

⁵⁴ See *Capitalism Survey: Punters or Proprietors*, *ECONOMIST*, May 5, 1990, at 5.

⁵⁵ Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

⁵⁶ *Id.*

⁵⁷ Dent, *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 908.

tify the proposals for reform of the proxy rules made to the SEC by the California Public Employees' Retirement System (CalPERS) and United Shareholders of America (USA), which will be discussed below.⁵⁸

The independent director solution to the problem of corporate accountability remains popular. Professor Jay Lorsch has revived some of the ideas of Harold Williams, including the notion that the chairman of the board should be an independent director.⁵⁹ Professors Gilson and Kraakman have recommended the creation of a cadre of paid professional directors who would represent institutional investors.⁶⁰ However, for all of the reasons cited by Lorsch as to why directors are not more effective—time constraints, information constraints and board room social norms⁶¹—it is unlikely that this professor-director version of the philosopher king will make corporations more profitable or more socially responsible.

Professor Richard Buxbaum has examined the two-tier model of large German corporations⁶² and concluded that representatives of institutional investors could function like the supervising board or board of overseers of the German Aktiengesellschaft, while other directors could function like the managing or executive directors.⁶³ Buxbaum advocates such an evolution in corporate structure to encourage corporations to better deal with environmental and other societal problems as well as economic challenges.⁶⁴ While this model is interesting, there is no reason to presume that tomorrow's institutional investors will be any more or less public-spirited or endowed with business sense than today's directors.⁶⁵

The most creative and controversial pending reform proposals have come from Martin Lipton, who is not an academic but a

⁵⁸ See text accompanying notes 161-172 *infra*.

⁵⁹ J. LORSCH & E. MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 184-87 (1989).

⁶⁰ Gilson & Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

⁶¹ J. LORSCH & E. MACIVER, *supra* note 59, at 83-91.

⁶² See E.W. ERCKLENTZ, I MODERN GERMAN CORPORATION LAW 89-100, 115-19 (1979).

⁶³ Buxbaum, *supra* note 3.

⁶⁴ *Id.*

⁶⁵ But see Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REF. 19, 75-79 (1988).

corporate lawyer who invented the poison pill⁶⁶ and has generally defended incumbent managements against hostile takeovers.⁶⁷ Lipton and his partner, Steven Rosenblum, have proposed that directors be elected for five-year terms, removable only for cause, and that such quinquennial election be based on a five-year report and plan by the corporation.⁶⁸ A majority of the board would be required to be composed of independent directors.⁶⁹ Under this plan any stockholder or group with 5 percent or \$5 million of outstanding shares would have free access to the proxy machinery.⁷⁰ Quinquennial elections would be the only means for a nonconsensual change of control, so all antitakeover devices and statutes would be repealed.⁷¹

One serious question raised by Lipton's proposal, as well as most of the other current reforms advocated, is how such changes in corporate governance will be accomplished. Absent a federal law mandating change in board structure and composition, it is unlikely that any radical corporate governance reform will be accomplished. While particular states could impose such change on their corporations, any legislation that threatens managerial autonomy is unlikely to be enacted because corporations can easily migrate to a more manager-friendly jurisdiction.⁷² Similarly, absent federal preemption, it is unlikely that state antitakeover legislation will be repealed.⁷³

⁶⁶ Poison pill plans involve the issuance to shareholders, as a dividend, of rights to buy stock which, when exercised, unacceptably dilute the capital stock of a hostile bidder. Originally triggered only by mergers or similar business combinations, such plans evolved to cover any sort of self-dealing transaction by a large stockholder. BRANCATO, *LEVERAGED BUYOUTS AND THE POT OF GOLD: 1989 UPDATE, REPORT FOR SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS, HOUSE COMM. ON ENERGY AND COMMERCE, 101st Cong., 1st Sess. 90 n.82 (Comm. Print 101-K 1989)* [hereinafter BRANCATO REPORT].

⁶⁷ Lipton has defended management resistance to hostile takeovers in *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987).

⁶⁸ Lipton & Rosenblum, *A Proposal for a New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991) [hereinafter *Quinquennial Proposal*].

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² See Schwartz, *Federal Chartering Revisited*, 22 U. MICH. J.L. REF. 7 (1989).

⁷³ See text accompanying notes 131-132 *infra*.

II. INSTITUTIONAL POWER

A. *The Separation of Savings from Investment*

The Berle and Means insight that ownership of large public corporations had become divorced from management sparked the corporate governance debates of the 1930s and continues to motivate reform proposals. However, the insight of Dean Robert Clark that the institutionalization of the securities market has wrought an additional divorce of savings from professional investment is more relevant to current debates.⁷⁴ Institutional money managers do not invest their own funds, but the funds of others. The providers of capital in our economy are no longer involved in the process of choosing investments, but decide only whether to relinquish funds to a particular intermediary.⁷⁵

In 1980, institutions held 33 percent of all publicly quoted American shares. Today, they are believed to own 45 percent.⁷⁶ Pensions fund holdings are particularly large. By the end of 1989, pension funds owned an estimated 25-40 percent of publicly traded equities and they could own 50 percent by the year 2000.⁷⁷ The percentage of ownership in the top 250 public companies, ranked by stock market value, is even greater. In 1989, institutions held 50 percent of the stock in the top fifty public corporations, 56.5 percent in the top 51-100 and 54.2 percent in the top 101-250.⁷⁸ Moreover, institutional assets are heavily concentrated. At the end of 1988, the top thirty public and private pension funds held approximately 27.3 percent of the asset value of all such funds and 39.6 percent of the assets of the thousand largest funds.⁷⁹

The percentage of institutional participation in stock mar-

⁷⁴ Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561, 565-66 (1981).

⁷⁵ *Id.* at 571.

⁷⁶ *A Word With Your Owners*, ECONOMIST, Jan. 12, 1991, at 17.

⁷⁷ Letter from Richard H. Koppes, General Counsel, CalPERS, to Linda C. Quinn, Director, Division of Corporation Finance, SEC 3 (Nov. 3, 1989) [hereinafter CalPERS Letter].

⁷⁸ Brancato, *The Pivotal Role of Institutional Investors in Capital Markets: A Summary of Economic Research at the Columbia Institutional Investor Project*, Table 7 (June 14, 1990) [hereinafter Brancato].

⁷⁹ BRANCATO REPORT, *supra* note 66, at 129. See also White, *Giant Pension Funds' Explosive Growth Concentrates on Economic Assets and Power*, WALL ST. J., June 28, 1990, at C1, col. 3.

ket activity is equally startling. Large block (10,000 or more shares) transactions are a gauge of institutional trading. In 1977, block trades represented 22.4 percent of reported volume on the New York Stock Exchange (NYSE). By 1987, large block transactions represented 45.9 percent of NYSE volume.⁸⁰

The institutionalization of the stock market has been accompanied by the growth of passive investment strategies, such as indexing, and the use of derivative products.⁸¹ Program trading, commonly blamed for an assortment of stock market ills, is one technique used in passive investment.⁸² Such trading strategies leave institutions open to the charge that they are short-term investors or speculators in the income stream of large public corporations.⁸³ Even if institutions hold equity investments for a long period of time,⁸⁴ the very size and diversity of their holdings distinguishes them from traditional individual investors. They do not choose to invest in individual stocks based on an analysis of fundamental values, but rather to invest in portfolios. Institutional trading habits have earned investors a variety of epithets, ranging from "punter capitalists"⁸⁵ to "takeover entrepreneurs."⁸⁶ Pleas for "patient capital" investment strategies⁸⁷ have alternated with ideas for government regulation of stock market turnover.⁸⁸

Institutional investors are by no means monolithic. They include private and public pension funds, investment companies,

⁸⁰ Report by the Division of Market Regulation, U.S. Securities and Exchange Commission, *The October 1987 Market Break III-2* (Feb. 1988).

⁸¹ *Id.* at III-3.

⁸² See Katzenbach, *An Overview of Program Trading and Its Impact on Current Market Practices* 4-5, 13, 21-22 (Dec. 21, 1987) (a study commissioned by the NYSE).

⁸³ See O'Connell, *Institutional Shareholders: New Gadflies*, *DIRECTORSHIP*, Jan. 1988, at 5; Rohatyn, *Institutional "Investor" or "Speculator"?*, *Wall St. J.*, June 24, 1988, at 18, col. 4; Stout & Wessel, *Brady Blasts Pension Funds for Taking Short-Term View, Suggests Alternatives*, *Wall St. J.*, Feb. 23, 1990, at A2, col. 2; Williams, *supra* note 23.

⁸⁴ CalPERS holds stock positions on average from 6 to 10 years. CalPERS Letter, *supra* note 77, at 2.

⁸⁵ See *Capitalism Survey*, *supra* note 54, at 5.

⁸⁶ Lipton, *supra* note 67, at 14.

⁸⁷ *Quinquennial Proposal*, *supra* note 68; Report of the Governor's Task Force on Pension Fund Investment, *Our Money's Worth*, New York State Industrial Cooperation Council, June 1989, at 27-33 [hereinafter Governor's Task Force].

⁸⁸ Recommendations have included a tax on short-term trading profits and various proposals to reduce leverage in the trading of equities. See Rohatyn, *supra* note 83.

insurance companies, bank trusts and foundations.⁸⁹ It can therefore fairly be said that "virtually all of us are stockholders in one way or another, whether through direct holdings, through mutual funds or as beneficiaries of plans which invest in stock."⁹⁰ It has been argued, however, that limited stockholder liability and the ease and rapidity of ownership transfer in liquid public securities markets give stockholders benefits not enjoyed by owners of most other forms of property, with an absence of corresponding social responsibility.⁹¹ This responsibility gap, coupled with the power of institutions to make changes in corporate control,⁹² has made business leaders quick to take umbrage at real or perceived threats by institutional investors to managerial prerogatives.

B. *The Negative Impact of Institutional Investment*

During the 1980s the pressure for high overall return by institutional investors in United States corporations resulted in an unhealthy leveraging of United States corporations to meet that demand. Net equity issues by United States nonfinancial institutions have been negative every year since 1984.⁹³ In other words, funds were borrowed to pay dividends to shareholders, in the form of ordinary cash distributions, share repurchases or takeover premiums. The net effect was the opposite of capital formation: it was a liquidation of industry. Furthermore, the transaction costs from this restructuring were huge and siphoned money from our industrial base into investment banking and attorney fees.⁹⁴

To look at this phenomenon from another perspective, the ratio of nonfinancial corporate debt to nonfinancial corporate

⁸⁹ See Brancato, *supra* note 78, at Table 1.

⁹⁰ Letter from Richard H. Troy, Chairman, Ad Hoc Committee on the Proxy System, American Society of Corporate Secretaries, Inc., to Linda C. Quinn, Director, Division of Corporation Finance, SEC 24 (July 30, 1990) [hereinafter Corporate Secretaries Letter].

⁹¹ *Id.* at 24-25.

⁹² See E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 63 (1981).

⁹³ Auerbach, *Tax Policy and Corporate Borrowing*, in PROCEEDINGS OF A CONFERENCE: ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING? 136 (R. Kopcke & E. Rosengren eds. 1989) [hereinafter DEBT/EQUITY PROCEEDINGS].

⁹⁴ See B. BURROUGH & J. HELYAR, BARBARIANS AT THE GATE 108, 187, 208, 220-21, 243, 254, 298-99, 317, 336-37, 390, 510 (1990); Brill, *The Morning After*, AM. LAW., Apr. 1990, at 5.

gross domestic product rose from 52 percent in 1982 to over 67 percent by the end of 1988.⁹⁵ This shift of capital by United States corporations from equity into debt was not for the purpose of financing real corporate growth. Rather, borrowers used a major proportion of the proceeds of new debt to purchase either their own equity shares or the shares of other corporations.⁹⁶

Frequently the low level of capital formation in the United States, in comparison to Germany and Japan, is attributed to a lower savings rate.⁹⁷ Further, the higher cost of capital in the United States can be blamed on higher interest rates linked to the federal budget deficit.⁹⁸ However, dividends are also higher in the United States.⁹⁹ Moreover, such dividends have frequently been paid out of capital.¹⁰⁰

The result of this decapitalization of industry has been declining productivity of United States business and a declining standard of living for most Americans. Productivity rose an av-

⁹⁵ Bernstein, *Discussion*, in *DEBT/EQUITY PROCEEDINGS*, *supra* note 93, at 129.

⁹⁶ *Id.* It should be noted that during the 1980s corporate pension funds were reducing their equity holdings in favor of debt holdings, whereas public pension funds were doing the reverse. White, *Giant Pension Funds' Explosive Growth Concentrates on Economic Assets and Power*, Wall St. J., June 28, 1990, at C1, col. 3.

⁹⁷ Altany, *The Savings Pinch*, Industry Week, Apr. 2, 1990, at 86; Holberton, *The Differing Cost of Capital*, Fin. Times, June 1, 1990, § I, at 16.

⁹⁸ See A.L. MALABRE, *WITHIN OUR MEANS* 51-52, 126 (1991); Plender, *Malaise in Need of Long-term Remedy*, Fin. Times, July 20, 1990, § I, at 16, col. 3. In a global capital market, however, the cost of capital can change because of transnational capital flows. In the summer of 1990, the nominal bond yield in Japan was 7.5% and the inflation rate was 2.5%, whereas in the United States, the nominal bond yield was 8.4% and the inflation rate was 5%. Japan therefore had higher long-term real interest rates, despite its higher savings rate. This occurred because Japanese investors found foreign investments more attractive. *Task Force on International Competitiveness of U.S. Financial Institutions, How Should the U.S. Respond to the Japanese Challenge in Financial Services?*, in *Hearing before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance, House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 46 (Aug. 2, 1990). While such transnational capital flows have serious implications for corporate governance, their discussion is beyond the scope of this Article.

⁹⁹ Keppler, *The Importance of Dividend Yields in Country Selection*, J. PORTFOLIO MGMT. 24 (Winter 1991); Rudnick, *Safe Trading Without Tricks*, The Times, Dec. 11, 1990. The national interest may require investors to forego such dividends. See Regan, *Pension Funds: New Power, New Responsibility*, Wall St. J., Nov. 2, 1987, at 28, col. 3.

¹⁰⁰ See *Dividends in Recession*, ECONOMIST, Jan. 19, 1991, at 16; *GM's Payout, Spending Cuts, Layoffs Spark Mixed Reaction by Analysts; Bears Have Edge*, Wall St. J., Feb. 6, 1991, at C2, col. 3. See also Lombo, *Annual Report on American Industry*, FORBES, Jan. 8, 1990, at 238.

erage of about one percent a year during the 1980s, slightly less than the poor performance of the 1970s and the worst productivity showing for any decade of the century.¹⁰¹ Similarly, although investment bankers and attorneys may have made spectacular earnings during the 1980s, other workers saw their wages steadily deteriorate.¹⁰²

Institutional investors hardly deserve all of the blame for this dire state of economic affairs. Plenty of blame can also be leveled at government officials, corporate managers and even academics spouting free market ideologies.¹⁰³ Nevertheless, investors deserve to be held accountable for the highly questionable capital distributions that were made to them during the last half of the 1980s. Further, large institutions dominate the markets to such an extent that they now threaten to become a capital cartel.

III. THE EROSION OF SHAREHOLDER RIGHTS

A. *Developments at the State Level*

During the 1980s institutional investors threatened the autonomy of corporate managers and directors, who then exploited fears and suspicions of the takeover mania by labor and the public to insulate themselves from accountability. This insulation was accomplished through antitakeover legislation, the destruction of shareholder voting power, Delaware court decisions approving actions to thwart takeovers and new state laws eliminating liability for breach of the duty of care.

The basic duties of care and loyalty that directors of United States corporations owe to their corporation and its shareholders are governed by state corporation law.¹⁰⁴ The burdens imposed upon directors by these twin duties are threshold requirements

¹⁰¹ *Raising Productivity Will be Tough in the '90's*, Wall St. J., Dec. 10, 1990, at A1, col. 5.

¹⁰² Uchitelle, *Not Getting Ahead? Better Get Used to It*, N.Y. Times, Dec. 16, 1990, § 4, at 1, col. 4.

¹⁰³ The author previously made this case in Karmel, *A Decade of Greed*, N.Y.L.J., Mar. 1, 1990, at 3, col. 1.

¹⁰⁴ The duty of care is that degree of skill, diligence and care that an ordinary prudent person would exercise in similar circumstances. REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984). The duty of loyalty requires directors who have a conflict of interest to demonstrate the fairness of a transaction in which they are interested. 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 931 (perm. ed. 1986).

that must be met before a court will apply the business judgment rule, which shields directors from liability for disinterested business decisions made with due care, in good faith and without an abuse of discretion.¹⁰⁵ Classic corporation law principles concerning the duties of care and loyalty and the business judgment rule have been severely strained by the takeover battles of the past decade.

In reaction to the highly publicized *Smith v. Van Gorkom* case,¹⁰⁶ which imposed liability on directors for failure to exercise due care in a change of control situation, Delaware and numerous other states passed legislation permitting corporations to limit or eliminate the personal liability of directors for breach of the duty of care.¹⁰⁷ However, in cases involving target company defenses against hostile takeovers, the line between the duty of care and the duty of loyalty sometimes became blurred because courts recognized that directors often are interested in remaining in office.¹⁰⁸

In the context of a takeover, the business judgment rule grants the same protection to directors as in any other context. However, in *Unocal Corp. v. Mesa Petroleum Co.*,¹⁰⁹ the Delaware Supreme Court developed two prerequisites for the application of the business judgment rule to antitakeover measures. First, the board must demonstrate good faith and a reasonable investigation to prove that protection of the corporate enterprise

¹⁰⁵ D. BLOCK, N. BARTON & S. RADIN, *THE BUSINESS JUDGMENT RULE* 1-4 (3d ed. 1989).

¹⁰⁶ 488 A.2d 858 (Del. 1985). This case and its aftermath are discussed in A. FLEISCHER, G. HAZARD & M. KLIPPER, *BOARD GAMES* (1988).

¹⁰⁷ In Delaware shareholders can adopt a charter provision limiting or even eliminating the personal liability of a director except for breach of the duty of loyalty or intentional misconduct. DEL. CODE ANN. tit. 8, § 102(b)(7) (1974 & Supp. 1983). Many other states have followed this approach. See, e.g., N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1988). Other states have simply lowered the duty of care. See Hazen, *Corporate Directors' Accountability: The Race to the Bottom—The Second Lap*, 66 N.C.L. REV. 171, 174-77 (1987). Some have even suggested that directors be permitted to opt out of duty of loyalty obligations. See generally Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 376 (1988).

¹⁰⁸ When a board fights a takeover, there is the danger that it is "acting primarily in its own interests, rather than those of the corporation and its shareholders." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985), later proceeding, *Silverzweig v. Unocal Corp.*, No. 90-78 (Del. Ch. Jan. 19, 1989) (LEXIS, Genfed library, Dist file).

¹⁰⁹ *Id.*

and shareholders is necessary. Second, defensive measures must be reasonable in the face of the threat posed.

This notion of the Delaware Supreme Court that a takeover is a "threat" is curious, but significant. It presumes that a corporation is an entity of economic and societal importance with an appropriate will to survive.¹¹⁰ Therefore, directors can use their business judgment to keep a corporation independent. This conclusion put the blessing of the highest court in the state where about half of the country's major corporations are incorporated¹¹¹ on a wide variety of poison pills and other mechanisms designed to ward off unwelcome takeovers.¹¹²

On a certain level, the Delaware Supreme Court was forced to recognize the legitimacy of management resistance to hostile takeovers because other state legislatures were passing antitakeover legislation. Such statutes include "other constituencies" laws,¹¹³ business combination laws,¹¹⁴ control share laws¹¹⁵ and fair price laws.¹¹⁶ All of these statutes have the effect of depriving a shareholder who obtains a controlling interest in a corporation from effecting a change of control without the consent of the corporation's board of directors or other shareholders. Directly or indirectly, this is accomplished by sterilizing the shareholder's vote. In the most extreme antitakeover statute yet passed, in Pennsylvania, which includes "other constituencies" and control share provisions, shareholders also are required to

¹¹⁰ See Gilson, *supra* note 42, at 127.

¹¹¹ Lipton & Rosenblum, *Quinquennial Proposal*, *supra* note 68, at 198 n.27.

¹¹² *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985). An analysis of the various mechanisms used to frustrate takeovers is beyond the scope of this Article. Shareholder activists argue all such devices should be put to a shareholder vote before they are activated. See Machold, *The American Corporation and the Institutional Investor: Are There Lessons From Abroad?*, 1988 COLUM. BUS. L. REV. 751, 752, 760. The Delaware Supreme Court has rejected this plea. See also text accompanying note 119 *infra*.

¹¹³ See Committee on Corporate Laws, *supra* note 44.

¹¹⁴ See, e.g., N.Y. BUS. CORP. LAW § 912 (Consol. Supp. 1989) which prohibits most New York corporations from entering into a "business combination" with a 20% stockholder for 5 years after the stockholder has acquired such 20% block, unless the board of directors approves prior to such acquisition. Any business combination after the 5-year period must be approved by a majority of the disinterested shareholders or satisfy a fair-price test.

¹¹⁵ See, e.g., IND. CODE ANN. §§ 23-1-42-1 to 23-1-42-11 (West 1989). Shares acquired in a "control share acquisition" (purchase of 20% or other higher threshold block) automatically lose their voting rights unless a majority of disinterested shareholders approve.

¹¹⁶ See, e.g., OHIO REV. CODE ANN. § 1707.04.1 (Baldwin 1991).

disgorge any trading profits made within eighteen months of a failed attempt to change control through a buyout or proxy contest.¹¹⁷

The general attitude of the states toward this diminution in shareholder voting power was perhaps best summarized by Chancellor Allen in *Lennane v. ASK Computer Systems, Inc.*,¹¹⁸ which involved the issuance of stock in violation of a shareholder participation listing requirement—such a violation could trigger a delisting. According to the Chancellor, the relationship between the directors' duty of loyalty and the shareholders' voting franchise is complex.

Directors are bound to accord great deference and respect to the shareholder vote as provided in the corporation's constitutional documents. A right to vote that arises only from director action is not constitutional in this sense, and with respect to such right, directors are bound simply to exercise their business judgment in an effort to promote the welfare of the corporation and the shareholders derivatively. Therefore, a vote of that type where it reasonably may be seen as endangering the accomplishment of a transaction that directors in good faith believe is in the corporation's best interest, may present a threat against which directors may act without breaching a faith with shareholders. Directors are not required in all instances to follow shareholder views of advantageous corporate action.¹¹⁹

The rapid success enjoyed by business leaders in persuading state legislatures and courts to shift so much power from shareholders to managers and directors could not have occurred without the support of labor and the public. This support was particularly strong in states with mature industrial companies confronting a long-term United States decline in manufacturing employment.¹²⁰ Furthermore, when jobs are at stake, pension

¹¹⁷ 15 PA. CONS. STAT. ANN. § 2571 (Purdon Supp. 1991).

See Shargel & Mitchell, *Pennsylvania's New Anti-Takeover Legislation*, 24 Rev. Sec. & Commodities Reg. (S & P) 7 (Jan. 9, 1991). Institutional investor opposition to this bill was fierce, and as a result the statute includes an ability to opt-out, which numerous public companies have done. Klein & Greenbaum, *Many Pa. Companies Opt Out*, Nat'l Law J., Sept. 10, 1990, at 15.

¹¹⁸ [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,674 (Oct. 11, 1990). Similarly, in *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1990), the continuation of the corporation as an independent entity was given a higher value by the court than shareholder choice or a takeover premium to shareholders.

¹¹⁹ [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) at ¶ 93,155.

¹²⁰ See Johnson & Millon, *Missing the Point About State Takeover Statutes*, 87

funds are in a poor position to fight for managerial accountability to shareholders.¹²¹

B. *The Limited Federal Interest*

Corporate governance is primarily a matter of state corporation law. This was expressed by the United States Supreme Court in a non-securities law case as follows:

Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.¹²²

Thereafter, in *Santa Fe Industries, Inc. v. Green*,¹²³ the Court applied this principle in a case arising under the federal securities laws involving a short form merger. Under Delaware law owners of at least ninety percent of a subsidiary's stock may merge with that subsidiary without requesting the consent of minority shareholders—who, in turn, must receive fair value for their shares. In their complaint, the minority shareholders in *Santa Fe* did not allege any material misrepresentation or omission. Rather, they argued that the antifraud provisions of the federal securities laws were applicable to a breach of corporate fiduciary duty, in that the majority shareholders were not pursuing a legitimate corporate purpose. The Court, however, refused to apply Rule 10b-5 to allegations of internal corporate mismanagement. It stated:

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

MICH. L. REV. 846, 852-53 (1989); Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 120-22 (1987).

¹²¹ Despite declining overall U.S. productivity, see text accompanying note 101 *supra*, productivity per U.S. worker increased 3.6% between 1979 and 1990. *They Will Return*, ECONOMIST, Feb. 9, 1991, at 19. Further, manufacturing grew as a proportion of GNP from 20% in 1982 to over 23% in 1990. *Id.* This suggests that the corporate restructurings of the 1980s assisted in the downsizing of the U.S. workforce engaged in manufacturing. See Ryan, *Corporate Directors and the "Social Costs" of Takeovers—Reflections on the Tin Parachute*, 64 TUL. L. REV. 3, 5-14 (1989).

¹²² Cort v. Ash, 422 U.S. 66, 84 (1975).

¹²³ 430 U.S. 462 (1977).

policies of corporate regulation would be overridden.¹²⁴

In *Schreiber v. Burlington Northern, Inc.*,¹²⁵ the Supreme Court indicated that *Santa Fe* would not be confined to its facts, but rather was a general holding concerning fiduciary duty. *Schreiber* raised the issue of whether the withdrawal of a hostile tender offer bid and the substitution of a partial bid, following negotiations with the target company's management, constituted a manipulative act under the Williams Act.¹²⁶ The Court held that the term "manipulation" in sections 10(b) and 14(c) of the Securities Exchange Act of 1934 (Exchange Act)¹²⁷ should be similarly interpreted and that manipulative acts require misrepresentation or nondisclosure. These cases halted and even reversed the development of a federal corporation law through a line of decisions in the federal courts under section 10(b) of the Exchange Act.¹²⁸

Even with regard to securities law, federal regulatory coverage is limited. All of the states have state securities laws, commonly called blue sky laws, many of which preceded the federal securities laws. Some of these laws are merit regulation statutes, which give a blue sky commissioner the authority to prevent an issuer from selling its securities in the state when the offering or the issuer's capital structure is substantively unfair or presents excessive risks to the investor.¹²⁹ In a trio of cases decided sixteen years before the first federal securities law was passed, the United States Supreme Court upheld the constitutionality of state blue sky laws on the ground that they were only applicable to dispositions of securities within the state and thus did not burden interstate commerce.¹³⁰

¹²⁴ *Id.* at 479.

¹²⁵ 472 U.S. 1 (1985).

¹²⁶ The Williams Act, which regulates tender offers, is contained in §§ 13(d)-(e) and 14(d)-(f) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f) (1988) and the regulations thereunder, 17 C.F.R. §§ 240.13d-1 to 13e-101, 240.14a-1 to 14f-1 (1990).

¹²⁷ 15 U.S.C. §§ 78j(b), n(e) (1988).

¹²⁸ See Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146, 1148 (1965); Friendly, *In Praise of Erie—and of the New Federal Common Law*, 39 N.Y.U. L. REV. 383 (1964).

¹²⁹ *Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 787 (1986) [hereinafter ABA Report].

¹³⁰ *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock*

State antitakeover statutes raised more serious constitutional questions. However, in *CTS Corp. v. Dynamics Corp. of America*,¹³¹ the Supreme Court held that an Indiana control share act was neither preempted by the Williams Act nor made unconstitutional by reason of the commerce clause. Rather, the Court asserted that "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."¹³²

C. *The One Share, One Vote Controversy*

Although most state corporation statutes enunciate a one-share, one-vote standard, this standard is not mandatory. The articles of incorporation can provide otherwise.¹³³ As a general matter, there is no prohibition against the issuance of nonvoting common stock or any requirement that voting control be commensurate with economic investment. While some state blue sky laws have required fair shareholder voting rights, which are related to the relative economic investments of insiders and the public, these statutes have been watered down in recent years by permitting corporations to recapitalize and issue limited voting shares which receive a higher dividend.¹³⁴

Disenfranchisement of shareholders who already have voting rights or voting control is more problematic than original issue nonvoting stock, but such a taking of this incident of stock ownership is increasingly condoned. Changes in voting rights, or the dilution of a class of stockholders with voting rights, is accomplished by amending the certificate of incorporation. In New York and Delaware, this is accomplished first by a vote of the board, and then by the holders of a majority of all outstanding

Yards Co., 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

¹³¹ 481 U.S. 69 (1987).

¹³² *Id.* at 89. Although the SEC argued that the Indiana control share statute was an impermissible burden on commerce, it failed to argue that the law was preempted by the Williams Act, acceding to the states' rights policies of the Reagan Administration.

¹³³ See *Giuricich v. Emtrol Corp.*, 449 A.2d 232, 239 (Del. 1982); 2 MODEL BUSINESS CORP. ACT ANN. § 7.21 (3d ed. Supp. 1986).

¹³⁴ See NASAA Statement of Policy, Non-Voting Stock, NASAA Reports (CCH) ¶ 2401, at 1401 (adopted Sept. 17, 1980). Contractual protection of such a dividend right, similar to protections given to preferred stockholders, is not necessarily provided.

shares entitled to vote.¹³⁵ A dissenting shareholder can receive appraisal rights, but a majority can then disenfranchise or restrict the votes of common stockholders indefinitely.¹³⁶

For large public corporations, however, the New York Stock Exchange has provided a national one-share, one-vote standard for common stockholders for over sixty years. Although a one-share, one-vote standard had been common for corporate ownership after the Civil War,¹³⁷ a variety of pyramiding and other devices enabled managements with minor equity interests to maintain control of public corporations after the public began trading in listed equities in the 1920s. Then, in 1925, Dillon Read & Company financed its acquisition of control over Dodge Brothers, Inc. by paying only \$2.5 million for an enterprise worth \$130 million through the issuance of nonvoting common and preferred stock.¹³⁸

As a result of public and academic outrage over this event,¹³⁹ in 1926 the NYSE disapproved an issue of nonvoting common stock and stated that the Exchange, in considering applications for the listing of securities, would give careful thought to the matter of voting control. Thereafter, the NYSE refused to list any company with nonvoting common stock or any company with more than one class of common stock having disparate voting rights. Moreover, the NYSE delisted the stock of any company that created a class of nonvoting common stock.¹⁴⁰

In 1986, the NYSE filed with the SEC proposed amendments to its voting rights policies under which disparate voting rights stock, if created as part of a recapitalization by a public company, would have been allowed if approved by a majority of the company's independent directors and a majority of the votes eligible to be cast by its public directors.¹⁴¹ An initial distribu-

¹³⁵ DEL. CODE ANN. tit. 8, §§ 151(a), 242 (1990); N.Y. BUSINESS CORP. LAW, §§ 801-04 (McKinney 1990).

¹³⁶ See N.Y. BUSINESS CORP. LAW § 806 (McKinney 1990).

¹³⁷ Kerbel, *An Examination of Nonvoting and Limited Voting Common Shares—Their History, Legality and Validity*, 15 SEC. REG. J. 37, 48-50 (1937).

¹³⁸ Loomis & Rubman, *Corporate Governance in Historical Perspective*, 8 HOFSTRA L. REV. 141, 152-53 (1979).

¹³⁹ Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 694-98 (1986).

¹⁴⁰ NYSE Listed Company Manual § 313.00(A) & (C) (repealed).

¹⁴¹ Securities Exchange Act Release No. 34-23,724 (Oct. 17 1986), 51 Fed. Reg. 37,529 (Oct. 22, 1986).

tion of weighted voting stock could have been listed.¹⁴² After holding public hearings, the SEC refused to approve the proposed NYSE relaxation of its listing standards and instead promulgated Rule 19c-4 under the Exchange Act which prohibited all exchanges and other self-regulatory organizations (SROs) from listing the stock of any corporation that takes any action to nullify, restrict or disparately reduce the per share voting rights of common stockholders.¹⁴³

In *The Business Roundtable v. SEC*,¹⁴⁴ the United States Court of Appeals for the D.C. Circuit invalidated Rule 19c-4. The court determined that the NYSE amendment to its listing standard was a "rule" required to be filed with and approved or disapproved by the SEC. However, it found that the SEC's Rule 19c-4 substitution for the NYSE standard was invalid because it was not in furtherance of any purpose of the Exchange Act. Rather, the court found that the rule directly controlled the substantive allocation of powers among classes of shareholders and impinged severely on the tradition of state regulation of corporate law. It therefore invalidated the rule on the authority of *Santa Fe Industries, Inc. v. Green*, discussed above.¹⁴⁵ The logic of this case is problematic, both as a matter of statutory construction and public policy, but it surely casts a pall over SEC corporate governance rulemaking.¹⁴⁶ Although the NYSE has maintained Rule 19c-4 as a listing standard for the present, a further deterioration of shareholder voting rights is likely.¹⁴⁷

¹⁴² *Id.*

¹⁴³ Securities Exchange Act Release No. 16,888 (June 11, 1980), 45 Fed. Reg. 41,125 (June 18, 1980). Sections 19(b) and (c) of the Exchange Act give the SEC the power to approve, disapprove, abrogate, add to or delete from rules of SROs. 15 U.S.C. §§ 78s(b), (c) (1988).

¹⁴⁴ 905 F.2d 406 (D.C. Cir. 1990).

¹⁴⁵ See text accompanying notes 123-124 *supra*.

¹⁴⁶ To conclude that the SEC must review SRO rules but cannot judge their substantive merit makes a mockery of the administrative process. Elsewhere, the author has argued that the SEC had ample authority to adopt Rule 19c-4. Karmel, *Qualitative Standards For "Qualified Securities": SEC Regulation of Voting Rights*, 36 CATH. U.L. REV. 809, 828-30 (1987). A better reasoned decision of the Third Circuit upholds the exercise of power by the SEC to thwart certain frustrating action by management confronted with a hostile bid. *Polaroid Corp. v. Disney*, 862 F.2d 987 (3d Cir. 1988), *later proceeding*, *Shamrock Holdings, Inc. v. Polaroid Corp.*, 709 F. Supp. 1311 (D.C. Del. 1989). The SEC was weakened, in the author's view, by its failure to argue, no doubt for political reasons, that authority for Rule 19c-4 could be found under the Williams Act.

¹⁴⁷ See Hooper, *Panel Says Amex Should Ease Rule on 1 Share, 1 Vote*, Wall St. J., Feb. 15, 1991, at C9, col. 5.

In the view of some observers, commenting on *The Business Roundtable* case, "the outlook for shareholder rights is fairly dismal, and neither state legislatures nor courts can be counted on to help re-establish the relevance of shareholders in corporate governance."¹⁴⁸ Indeed, any such assistance will have to come either from the SEC, whose authority has been called into question by the cases discussed above, or Congress. Although bills to require that common stock traded on national exchanges have uniform voting rights were introduced prior to *The Business Roundtable* decision, they made no progress.¹⁴⁹ Whether such legislation will be better received in the future is an open question.

D. Tender Offer Reform

The failure of Congress to enact any tender offer reform legislation during the 1980s does not augur well for one-share, one-vote federal legislation at this time. In 1984, an advisory committee to the SEC recommended various reforms under the Williams Act that would have curbed tender offer abuses and, in addition, prevented certain management efforts to thwart hostile takeovers.¹⁵⁰ Among other things, the advisory committee recommended closing the so-called 13(d) window by more prompt reporting of large scale purchases of stock, a twenty percent cap on acquisitions of a company's stock in the open market, extensions of time for tender offers to remain open and shareholder advisory votes on certain defensive tactics, including shareholder disenfranchisement and change of control compensation (golden parachutes).¹⁵¹ The SEC translated only a few of these recommendations into proposed legislation and submitted them to Congress.¹⁵² Although Congress held extensive hearings and nu-

¹⁴⁸ McNew & Seglias, *Gerrymandering Comes to Corporate America*, *Legal Times*, Aug. 27, 1990, at 19.

¹⁴⁹ See, e.g., H.R. 2783, 99th Cong., 1st Sess. (June 18, 1985); S. 1314, 99th Cong., 1st Sess. (June 18, 1985); S. 1794, 101st Cong., 1st Sess., 135 CONG. REC. 14134 (Sept. 18, 1989).

¹⁵⁰ SEC Advisory Committee on Tender Offers, *Report of Recommendations* (Securities and Exchange Commission, July 8, 1983), reprinted in [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,511 (Mar. 28, 1984).

¹⁵¹ *Id.*

¹⁵² See MEMORANDUM OF THE SEC REGARDING 5693, AS AMENDED AND ORDERED REPORTED BY THE HOUSE COMMITTEE ON ENERGY AND COMMERCE, H.R. 1028, 98th Cong., 2d Sess. (1984), reprinted in [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,659

merous tender offer reform bills were introduced, no legislation was ever passed.¹⁵³ This occurred in part because of the political impasse between the SEC, the Administration and Congress concerning the basic question of whether tender offers were beneficial or detrimental and questions about the proper federal role in matters affecting corporate governance.

The SEC and the Reagan Administration generally favored tender offers as a free market, corporate-control mechanism.¹⁵⁴ On the other hand, the Administration was committed to states' rights and generally was opposed to any federal corporate governance regulation, a view that the SEC then adopted.¹⁵⁵ This stance was a marked departure from the SEC's position in 1980 that the Exchange Act be amended to specifically preempt state takeover laws.¹⁵⁶ After the Supreme Court decided the *CTS* case encouraging the states to adopt takeover legislation,¹⁵⁷ SEC obeisance to states' rights dogma led to the rather incongruous result that the SEC opposed its own recommendations to reform the Williams Act.¹⁵⁸ In the meantime, key members of Congress began to develop a consensus that takeovers were having a detrimental effect on the economy and should be curbed.¹⁵⁹ Accordingly, Congress passed tax legislation to take the profit from two popular takeover defense tactics, greenmail and golden parachutes, but then permitted the states to give corporate managements the power to thwart takeovers.¹⁶⁰

(Sept. 7, 1984). H.R. 5693, 98th Cong., 2d Sess. (1984) went beyond the SEC's recommendations aimed at facilitating tender offers and protecting shareholders and would have: extended the minimum tender offer period from 20 business days to 40 calendar days; closed the 13(d) window; required bidders to disclose the community impact of an offer; prohibited self-tenders without a shareholder vote; prohibited the issuance of more than 5% voting securities without a shareholder vote; prohibited golden parachutes during a tender offer; and prohibited greenmail.

¹⁵³ See *Battle Over Reform*, *supra* note 41.

¹⁵⁴ *Id.*

¹⁵⁵ See *Administration Group Rejects Proposal to Enter Debate on Corporate Takeovers*, 19 Sec. Reg. & L. Rep. (BNA) 819 (June 5, 1987).

¹⁵⁶ Memorandum of the SEC to the Senate Comm. on Banking, Housing and Urban Affairs Proposing Amendments to the Williams Act, reprinted in [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,453 (Feb. 15, 1980).

¹⁵⁷ See text accompanying notes 113-117, 131-132 *supra*.

¹⁵⁸ Leefeldt, *A Sweet Way to Foil Takeover Bids*, Wall St. J., Sept. 4, 1985, at 24, col. 4; *Commission Will Not Reintroduce Takeover Legislation Package*, Shad Says, 17 Sec. Reg. & L. Rep. (BNA) 573 (Apr. 5, 1985).

¹⁵⁹ *Battle Over Reform*, *supra* note 41.

¹⁶⁰ I.R.C. §§ 162(k), 280G (1988). See Lustig, *The Emerging Role of the Federal*

Even if one assumes the evils of takeovers, the problem with the resolution of the public policy questions at issue is that the shareholder mechanism for holding management accountable was seriously damaged. Moreover, assigning the responsibility for regulating takeovers to the states may prove a poor strategy for United States corporations active in international securities markets.

E. *Response by Institutional Investors*

The growing evidence in the late 1980s that managements were insulating themselves from accountability as well as hostile takeovers sparked proposals to the SEC by shareholder activists. CalPERS submitted to the SEC a request for a rulemaking project which would involve a comprehensive review of the proxy system under section 14(a) of the Exchange Act.¹⁶¹ This request proposed forty-eight separate changes in the proxy rules, divided into four categories: (a) structure and procedure; (b) shareholder communications; (c) enhancement of disclosure; and (d) SEC filing and review of proxy materials.¹⁶² At the heart of these proposals is an argument that institutional investors should be permitted to communicate freely with one another and to combine to force corporate governance reforms on public companies. As a predicate for such change, CalPERS asserted that the proxy rules discourage responsible, long-term investors from playing a meaningful role in the governance of public corporations by restricting shareholder access to the corporate proxy statement. Particular grievances cited by CalPERS included resistance to the provision of shareholder lists, management methods for counting votes on shareholder proposals, and delays and inconsistencies in SEC staff reviews of proxy materials.¹⁶³

The CalPERS rulemaking petition was subsequently supported by the United Shareholders Association (USA) which submitted a similar request for comprehensive revisions to the federal proxy rules.¹⁶⁴ The USA petition was more general than

Tax Law in Regulating Hostile Corporate Takeover Defenses: The New Section 5831 Excise Tax on Greenmail, 40 U. FLA. L. REV. 789 (1988).

¹⁶¹ 15 U.S.C. § 78n (1988).

¹⁶² CalPERS Letter, *supra* note 77.

¹⁶³ *Id.* at 7-8.

¹⁶⁴ Letter from Ralph V. Whitworth, Director, USA, to Jonathan G. Katz, Secretary,

the CalPERS submission and argued that reform of the proxy process to allow shareholders a meaningful corporate governance role could forge a fundamental realignment of the now conflicting interests of management and shareholders. According to USA, such a realignment would maximize value on a constant basis, rather than through one-time restructuring transactions.¹⁶⁵

Specific reforms urged by USA included confidential proxy voting; independent third party tabulation of proxies; access to management's proxy by any shareholder or group beneficially owning 3 percent or \$1 million of a corporation's voting equity securities; greater accessibility of shareholders to the beneficial shareholders' list; the adoption of an SEC rule requiring a shareholder vote on the adoption of any management entrenchment devices such as greenmail, golden parachutes or poison pills; and significant liberalization or elimination of the preclearance provisions of the proxy rules.

Business groups soon organized to attack this effort to enlist the SEC in a corporate governance initiative on behalf of institutional shareholders. The American Society of Corporate Secretaries, Inc. (the Society) generally objected to the CalPERS and USA proposals, which it viewed as improper efforts to create special rights and privileges for large stockholders; to convert the annual proxy process into an unwieldy annual massive multiparty referendum; to mandate secrecy among business associates and cover up possible conflicts of interest through mandatory confidential voting; to stretch federal securities laws to change state corporate law; and to remove from proxy rule regulation the solicitation of large blocks of votes and the activities of self-appointed public interest groups.¹⁶⁶ Indeed, the Society urged the SEC to review "whether, in view of the growing concentration of ever larger amounts of stock in ever fewer hands, the proxy rules continue to achieve their statutory purpose."¹⁶⁷

In the Society's view, stockholders, although technically "owners," are really only "investors" since they have no respon-

SEC (Mar. 20, 1990).

¹⁶⁵ CalPERS Letter, *supra* note 77, at 9-10.

¹⁶⁶ Corporate Secretaries Letter, *supra* note 90, at 3.

¹⁶⁷ *Id.*

sibilities for corporate activity. Accordingly, they should not be given any role in directing corporate affairs. Shareholders own only stock; the corporation owns corporate property.¹⁶⁸ "Directors are retained to manage the affairs of the corporation and take the responsibility for doing so."¹⁶⁹

A comment by the Business Roundtable on the SEC's review of the proxy rules was even more pointed in questioning the claims by institutional investors to greater voice in the proxy process.¹⁷⁰ In the view of the Roundtable, the proxy system already provides shareholders with an effective voice in corporate governance and "the ability of many institutions to contribute meaningfully to corporate performance has been limited by their choice of investment strategy."¹⁷¹ After criticizing the short-term horizons of institutional investors as well as indexation, the Roundtable expressed the view that "[u]nless institutional investors develop the ability to analyze and understand the long-term competitive performance of the companies in which they've invested, it's hard to see how their involvement in corporate governance will have a positive effect on corporate performance or U.S. competitiveness."¹⁷²

IV. THE IMPACT OF INTERNATIONALIZATION

A. *A Changing SEC Philosophy*

The internationalization of the securities markets has not only changed the markets, but it has changed the work and philosophy of the SEC. Internationalization initiatives now have a high priority and have been proceeding at a rapid pace.¹⁷³ Especially important are the proposals for facilitating multijurisdictional offerings.¹⁷⁴ The long-term objective of international regu-

¹⁶⁸ *Id.* at 24-25.

¹⁶⁹ *Id.* at 23.

¹⁷⁰ Letter from H.B. Atwater, Jr., Chairman, Task Force on Corporate Governance, The Business Roundtable, to Linda C. Quinn, Director, Division of Corporation Finance, SEC (Dec. 17, 1990).

¹⁷¹ *Id.* at 4.

¹⁷² *Id.* at 4-5.

¹⁷³ The author has summarized the most important of these developments in Karmel, *New Rules For Trading Foreign Securities*, N.Y.L.J., June 28, 1990, at 3, col. 1.

¹⁷⁴ Exchange Act Release No. 6,841 (July 24, 1989), 54 Fed. Reg. 32,226 (Aug. 4, 1989) (the original proposal); Exchange Act Release No. 6,879 (Oct. 22, 1990), 55 Fed. Reg. 46,288 (Nov. 2, 1990) (amended proposal).

lators with regard to international offerings is the development of a common prospectus that would contain financial statements prepared according to international accounting standards.¹⁷⁵ Accomplishment of this goal has been complicated by the existence of state blue sky laws alongside of the federal securities laws. Because every securities offering must comply not only with the registration provisions of the Securities Act of 1933,¹⁷⁶ but also with the registration provisions of all of the states, only federal preemption of state blue sky law for international offerings could assure that an accord reached by the SEC with foreign securities regulators on disclosure requirements for multijurisdictional offerings would bind state securities regulators.¹⁷⁷

The EC has been developing such a system of federal preemption by the establishment of minimum disclosure standards for securities offerings. If the minimum standards set forth in the relevant EC directives are met, mutual recognition of the national disclosure standards of any member state is compelled.¹⁷⁸ This state of affairs is pushing the SEC toward a demand for federal preemption of blue sky laws. SEC Chairman Richard Breeden has complained that as of 1991 Great Britain will allow the use of a prospectus filed in Berlin, but it will not be legal to use automatically a prospectus filed with the SEC in California.¹⁷⁹

One problem with exempting state blue sky regulation, however, is that the states, rather than the SEC, have imposed merit regulation on corporate capital structures. Merit regulators can change the internal structure of a securities issuer, the relations among insiders and outsiders and the terms of an offering for the purpose of protecting investors.¹⁸⁰ Stock exchange listing re-

¹⁷⁵ See Karmel, *The IOSCO Venice Conference*, N.Y.L.J., Oct. 19, 1989, at 3, col. 1. See also Exchange Act Release No. 6,568 (Mar. 1, 1985), 50 Fed. Reg. 9,281 (Mar. 7, 1985).

¹⁷⁶ 15 U.S.C. § 77e (1988).

¹⁷⁷ The author has made this argument in greater detail in Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOKLYN L. REV. 105, 106-07 (1987). See ABA Report, *supra* note 129, at 787.

¹⁷⁸ See *Proposal for a Public Offer Prospectus Directive*, 32 O.J. EUR. COMM. (No. L 124) 8 (1989); *EC Mutual Recognition of Listing Particulars Directive*, 30 O.J. EUR. COMM. (No. L 185) 81 (1987); 32 O.J. EUR. COMM. (No. C 101) 13 (1989).

¹⁷⁹ Breeden Repeats Call For Permitting U.S. Firms to Invest in Domestic Banks, 23 Sec. Reg. & L. Rep. (BNA) 115, 116 (Jan. 25, 1991).

¹⁸⁰ ABA Report, *supra* note 129, at 823. Such regulation includes offering price re-

quirements also have imposed merit standards on issuers. For this reason, state blue sky laws customarily have a "blue chip" exemption from state registration for offerings by listed companies.¹⁸¹ The one-share, one-vote standard was an example of such regulation and its demise represents the vulnerability of SRO merit regulation.

Foreign stock exchanges also frequently have merit standards.¹⁸² On the other hand, most foreign issuers that have securities which trade in the United States are not listed, and therefore they are not eligible for the blue chip exemption.¹⁸³ Furthermore, even those foreign issuers that are listed are exempt from the corporate governance listing standards applicable to United States issuers.¹⁸⁴

If the SEC were seriously to promote the concept of preemption of state blue sky laws, Congress would have to address the policy question of what, if any, merit standards should be injected into the federal securities laws. This question has be-

strictions and restrictions against excessive dilution. See H. SOWARDS & N. HIRSCH, *BUSINESS ORGANIZATIONS—BLUE SKY REGULATION* § 7A.02 [2] (Cum. Supp. 1990); Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. L. 689, 697-98 (1985).

¹⁸¹ See ABA Report, *supra* note 129, at 833-35; see also *NASD Proposes Corporate Governance Requirements to Aid Blue Sky Exemptions*, 17 Sec. Reg. & L. Rep. (BNA) 589 (Apr. 5, 1985).

¹⁸² On the London International Stock Exchange ("ISE"), for example, traditional merit standards require that shares to be listed must have a value of at least £700,000 and there must be an adequate spread of holders of not less than 30 shareholders for each £1,000,000 of the offering, with a minimum of 100. THE COUNCIL OF THE STOCK EXCHANGE, *ADMISSION OF SECURITIES TO LISTING*, Sec. 1, Ch. 2, ¶ 3; Ch. 3, ¶ 2.5(c) (1984 ed.). In addition, where a company has a relationship with a substantial shareholder that could result in a conflict between that shareholder and the general body of shareholders, the conflict can render the company unsuitable for listing. *Id.* at Sec. 1, Ch. 2, ¶ 6. At least 25% of the shares have to be in public hands. *Id.* at Sec. 1, Ch. 2, ¶ 8. Even if all such formal requirements are met, the Exchange retains a discretion to accept or reject listing applications as unsuitable. *Id.* at Sec. 1, Ch. 1, ¶ 14. The extent to which the ISE will be able to maintain such standards in the face of EC mutual recognition requirements is open to question. Such merit standards are threatened by EC harmonization. See FitzSimons, *EC Directives Change Securities Markets*, *Fin. Times*, Feb. 15, 1990, at 37, col. 1; Waller, *A Babble of Dialects Confuses Global Decisions*, *Fin. Times*, Apr. 19, 1990, at 15, col. 3.

¹⁸³ Foreign issuers that elect the exemption from Exchange Act reporting available under Rule 12g3-2(b), 17 C.F.R. § 240.12g3-2(b) (1990), may not list. See Exchange Act Release No. 5493 (Oct. 6, 1983), 48 Fed. Reg. 46,736 (Oct. 14, 1983).

¹⁸⁴ See and compare NYSE LISTING AGREEMENTS FOR DOMESTIC AND NON-U.S. COMPANIES, NYSE LISTED COMPANY MANUAL §§ 901.01 and 901.02. See also Exchange Act Release No. 24,634 (June 23, 1987), 52 Fed. Reg. 24,230 (June 29, 1987).

come timely in any event as a result of *The Business Roundtable* decision discussed above.¹⁸⁵

B. *Developments in the EC*

Over the past decade, at the same time that corporate and securities regulation in the United States has been undergoing decentralization, such regulation in Europe has been undergoing centralization by the EC. In addition to adopting directives on securities offerings, the EC has been formulating and adopting directives on company law and takeovers.¹⁸⁶ These directives have the potential to change the corporate governance structures and practices of large public European corporations.

In Europe, shareholder voting rights have long been chimerical except in the United Kingdom, and even the United Kingdom does not have a pure one-share, one-vote regime.¹⁸⁷ Voting limitations are common in many continental countries. For example, a single shareholder may not be permitted to vote more than some small percentage of total common stock holdings.¹⁸⁸ Friendly outsiders may be given preference shares and other outsiders may be given shares with no or low voting rights.¹⁸⁹ In addition, the procedures for voting by proxy limit shareholder power. In Germany, it is common for the banks to act as depositaries for shares and to then vote such shares pursuant to a general power of attorney.¹⁹⁰ Coupled with the large stock interests held by German banks in major German corporations, this depositary vote gives the banks, rather than stockholders, the

¹⁸⁵ See text and accompanying notes 144-49 *supra*.

¹⁸⁶ *Proposal for a Fifth Council Directive on Company Law*, 15 O.J. EUR. COMM. (No. C 131) 49 (1972); *Amended Proposal for a Fifth Council Directive on Company Law*, 26 O.J. EUR. COMM. (No. C 240) 2 (1983); *Proposal for a Thirteenth Council Directive on Company Law Concerning Takeovers, and Other General Bids*, 32 O.J. EUR. COMM. (No. C 64) 8 (1989), COM (90) 416 final (Sept. 10, 1990).

¹⁸⁷ See A.F. CONARD, *CORPORATIONS IN PERSPECTIVE* 320-21 n.4 (1976); Xuereb, *Voting Rights: A Comparative Review*, 8 *COMPANY LAW* 16, 19-20 (1987).

¹⁸⁸ See A.F. CONARD, *supra* note 187; Greenhouse, *Europe's Buyout Bulge*, N.Y. Times, § 3, at 1, col. 2.

¹⁸⁹ See A.F. CONARD, *supra* note 187; Raun, *Dutch Merger Defences May Be Self-Defeating*, Financial Times, Nov. 14, 1988, at 6; Maitland, *Fortifications Against Change*, Financial Times, Dec. 4, 1990, at 38.

¹⁹⁰ Kubler, *Juridification of Structures*, in *JURIDIFICATION OF SOCIAL SPHERES* 215-17 (G. Teubner ed. 1987); Price, *German Vote Curbs Under Fire*, Pension & Investment Age, Apr. 16, 1990, at 19.

power to effect changes in corporate control.¹⁹¹ Also, the directors of European corporations do not owe a fiduciary duty only to shareholders, but rather to the corporation as an entity and also to a broad range of constituencies.¹⁹² In addition, directors of continental corporations have considerable freedom to frustrate unwanted takeover bids.¹⁹³ For these and other reasons, until recently there has not been a public market for corporate control for continental companies.¹⁹⁴

In the United Kingdom, by contrast, there is an active market for corporate control, and shareholder rights in takeovers are protected more rigorously than in the United States. The conduct of directors in contests for corporate control in the United Kingdom is regulated not only by company law and judicial decisions, but also by the City Code on Take-overs and Mergers (the City Code), which is supervised by the Panel on Take-overs and Mergers (the Panel).¹⁹⁵ The City Code sets forth a limited number of general principles and detailed rules for the conduct of a takeover bid. Nevertheless, considerable latitude is left to the Panel to interpret the propriety of a board's conduct in the context of a particular bid. The two most important general

¹⁹¹ See Grossfeld, *Management and Control of Marketable Share Companies*, in XIII BUSINESS AND PRIVATE ORGANIZATIONS, INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 98-101; INTERNATIONAL CORPORATE GOVERNANCE 114-17 (J.C.F. Lufkin & D. Gallagher, eds. 1990).

¹⁹² See R.M. BUXBAUM & K.J. HOPT, LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE 177-81 (1988). The German model has been called employee-oriented capitalism. Eckhouse, *The Three Faces of Capitalism U.S., Japanese and German Systems Vie for Supremacy*, San Francisco Chron., Oct. 29, 1990, at C1. For the duty of directors to the corporation in the United Kingdom, see *Percival v. Wright*, [1902] 2 Ch. 421, [1902] 71 L.J. Ch. 846. The board of a U.K. corporation has a specific, statutory duty to employees. Companies Act, 1985, Ch. 6, s. 309.

¹⁹³ See Moerman, *Proposed EEC Takeover Legislation*, Insights, Aug. 1990, at 32; Maitland, *Fortifications Against Change*, Financial Times, Dec. 4, 1990, at 38.

¹⁹⁴ Kellaway, *Brussels Faces Uphill Struggle to Remove Takeover Barriers*, Financial Times, Nov. 27, 1989, § I, at 7.

¹⁹⁵ The City Code on Take-overs and Mergers (1988) [hereinafter "City Code"]. See Brayne, *Tender Offers Involving U.K. Companies*, 21 Rev. Sec. & Commodities Reg. (S & P) 67, 70 (Apr. 27, 1988). The Panel is a self-regulatory body and the City Code does not have the force of law. Nevertheless, because of the acceptance and support given to the City Code and Panel by securities and banking regulators, the Panel's decisions are obeyed. In addition, since the Panel is a semi-public body, its opinions are subject to judicial review. MacLachlan & Mackesy, *Acquisitions of Companies in Europe—Practicability, Disclosure, and Regulation: An Overview*, 23 INT'L LAW. 373, 386-87 (1989). See *Regina v. Panel on Take-Overs & Mergers, ex parte Datafin*, [1987] 1 All E.R. 564.

principles in the City Code are that the shareholders of an offeree company decide whether or not an offer should succeed, and all equity holders must be treated equally.¹⁹⁶ The board of a target company is obligated to seek independent outside financial advice when a bid is made, and then communicate the substance of such advice to the company's shareholders.¹⁹⁷

In addition, after an offer is communicated to the board, or even if a board has reason to believe an offer is imminent, the offeree board is prohibited from taking any action without the approval of shareholders in a general meeting "which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits."¹⁹⁸ Because of this anti-frustration provision, the law in the United Kingdom would appear to favor shareholders, or at least their freedom of choice when presented with a takeover, to a greater extent than the law in the United States.¹⁹⁹

Despite these historical differences in corporate governance practice in the United Kingdom and continental countries, the laws will soon become more congruent because of developments in the EC. The proposed Fifth Company Law Directive on the structure and management of large public corporations would limit the scope for weighted voting rights in such companies, prohibit the issuance of nonvoting shares except as preference shares and permit proxies to be given only for a specific meeting.²⁰⁰ Further, proposed amendments would prohibit limitations on voting rights by large shareholders, limit the value of nonvoting preference shares to 50 percent of total share capital, prohibit any provision in a company's charter giving certain

¹⁹⁶ MacLachlan & Mackesy, *supra* note 195, at 387-88.

¹⁹⁷ City Code, *supra* note 195, Rule 3.1.

¹⁹⁸ *Id.*, General Principle 7. Prohibitions against specific types of "poison pills" are enumerated in Rule 21. These include the issuance of new shares, the disposition of material assets and contracts not in the ordinary course of business.

¹⁹⁹ See *Takeovers—The Right Way to Regulate the Market*, ECONOMIST, Sept. 23, 1989, at 21-22; *A Tale of Two Takeovers*, WALL ST. J., July 17, 1989, at A10, col. 1. The latest draft of the ALI corporate governance project provides that directors of U.S. corporations "may take an action that has the foreseeable effect of blocking an unsolicited tender offer . . . unless the action would materially disfavor the long-term interests of the shareholders." AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 6.02 at 27 (Discussion Draft No. 2, Apr. 20, 1989).

²⁰⁰ See *Dutch Firms Warned on Takeover Exposure in a New EC Environment*, INT'L SEC. REG. REP., Dec. 17, 1990, at 3. See also *Amended Proposal for a Fifth Council Directive on Company Law*, 26 O.J. EUR. COMM. (No. C 240) arts. 28(1)(a), 33 (1983).

shareholders an exclusive right to propose the appointment of all directors and insure that a majority of shareholders can make changes to the board of the company.²⁰¹

The proposed Thirteenth Directive on Takeovers also would alter the regime for corporate accountability.²⁰² This directive would adopt the United Kingdom scheme of regulation, and it is designed to protect shareholders. Very importantly, all holders of an offeree company who are in the same position must be treated equally and the board of an offeree company is required to act in the interests of all the shareholders and not frustrate the bid.²⁰³ Any person acquiring one-third of a company's voting stock is required to make a bid for all shares.²⁰⁴

As a result of these developments, by the turn of the century, shareholders could be better protected in Europe than in the United States. Equity capital might then prefer European over United States corporations for investment.²⁰⁵ Such a situation would present an opportunity for the SEC to urge strengthening corporate governance shareholder protections at the federal level.

V. THE CASE FOR A FEDERAL CORPORATION LAW

In recent years, serious questions have been raised about the United States style of capitalism both by critics and defenders of business. Although the engine which moves the United States economy may not be broken, many believe that there are better machines moving the economies of Japan and Germany.²⁰⁶ Some blame corporate managers for the failure of

²⁰¹ See Cooke, *Lowering the Barriers to Euromergers*, INSTITUTIONAL INVESTORS, Apr. 1990, at 61; *Obstacles to Hostile Bids Are Target of New EC Strategy*, 22 Sec. Reg. & L. Rep. (BNA) 909 (June 15, 1990).

²⁰² 32 O.J. EUR. COMM. (No. C 64) 8 (1989), COM (90) 416 final (Sept. 10, 1990).

²⁰³ *Id.* at arts. 3, 4, p. 10.

²⁰⁴ *Id.* at art. 4(1), p. 10.

²⁰⁵ See Longstreth, *Changes in Managerial Control and Stock Ownership*, N.Y.L.J., Oct., 19, 1989, at 5, col. 1; *Obstacles to Hostile Bids Are Target of New EC Strategy*, 22 Sec. Reg. & L. Rep. (BNA) 909 (June 15, 1990). Investment in European and other foreign stock exchanges has offered superior returns to investment in U.S. stocks. See DuBois, *Five Bourses Beat U.S. in 1990*, BARRON'S, Jan. 7, 1991, at 56. Better corporate governance mechanisms could make these markets even more attractive. This argument was made regarding changes in Japanese law to promote shareholder democracy in Note, *Japan's Company Law and the Promotion of Corporate Democracy: A Futile Attempt?*, 27 COLUM. J. TRANSNAT'L L. 195, 197 (1988).

²⁰⁶ A.L. MALABRE, *WITHIN OUR MEANS* 18-23 (1991); D. VOGEL, *FLUCTUATING FOR-*

United States corporations to compete with foreign corporations; some blame institutional investors for their short-sighted view of corporate profitability.²⁰⁷ Many scholars and policy makers have been looking to Japan and Germany for models of corporate governance which might be more suitable to an international marketplace than the model of accountability by managers and directors to stockholders.²⁰⁸

Indeed, from a legal perspective, the model of stockholder accountability has long been faulty because the split between ownership and management, combined with managerial control of the proxy process, made shareholders relatively powerless. The allegiance of officers and directors to shareholders as corporate owners was a legal fiction which nevertheless gave corporate structures legitimacy because shareholder rights were enforced by courts and the SEC. Derivative and securities litigation and SEC regulation were the real monitoring devices of corporate managers and directors.

However, litigation and SEC prosecutions are crude corporate governance mechanisms. They may chastise the crooks, but they will not make corporations more efficient or more productive. A persuasive argument can be made that business is most effective in lobbying legislators to serve its interests when business is perceived as weak and beleaguered.²⁰⁹ In the 1980s institutional investors and the takeover mania appeared to menace corporate performance and capitalization. It is therefore not so surprising that state legislatures responded favorably to business requests for relief from shareholder accountability.

Nevertheless, state antitakeover laws have insulated management not merely from takeovers but also from accountability in conflict of interest situations. The absence of any shareholder check on management compensation could prove especially troublesome.²¹⁰ While the proxy review initiative by CalPERS

TUNES 10, 230 (1989).

²⁰⁷ *Capitalism*, ECONOMIST, May 5, 1990, at 5; *Short-Termism Reappraised*, Fin. Times, Nov. 7, 1990, at 24, col. 2.

²⁰⁸ See Buxbaum, *supra* note 3; Sykes, *Bigger Carrots and Sticks*, Fin. Times, Oct. 31, 1990, at 17, col. 2.

²⁰⁹ D. VOGEL, *supra* note 206, at 290-93.

²¹⁰ See Salwen, *Breeden Mulls "Bill of Rights" for Holders*, Wall St. J., Feb. 28, 1991, at C2, col. 3; Uchitelle, *No Recession For Executive Pay*, N.Y. Times, Mar. 18, 1991, at D1, col. 3.

and the USA could ameliorate these conflicts, if shareholder voting rights are not protected the proxy rules cannot be expected to function as an effective mechanism for shareholder-driven accountability. Moreover, it is questionable whether institutional investors have any inherently greater claim to control corporate assets than do corporate managers.

It appears that the SEC is beginning to understand the need to protect voting rights and reverse its hesitancy about federal preemption in matters impinging upon corporate control. Current SEC preemption proposals would cover not only takeover reform but also an expansion of the SEC's powers to regulate corporate governance structures for public corporations.²¹¹ In addition, the SEC has begun to believe that an effective regulatory policy with regard to internationalization of the market requires further preemption of state blue sky law.²¹²

Arguments for federal preemption made in a vacuum, however, are doomed to failure. Federal regulation of corporate governance of large public companies has always been strongly resisted, and the SEC has made inroads in such areas with difficulty and very slowly, and generally only in response to some particular market failure. Nevertheless, over the course of the past fifty years, the Commission has in incremental steps acquired greater power over public corporations.²¹³ *The Business Roundtable* case is the first significant step backwards. Moreover, coincidentally with the decision in that case, the SEC gained an enforcement tool for which it had long yearned—the power to bar or suspend directors of public companies who violate the securities laws from continuing to serve as directors.²¹⁴ It can be expected that in the settlement of such cases, the SEC will impose its corporate governance ideas on public companies.²¹⁵

Any preemption of state law, however, is likely to be limited

²¹¹ *Id.*

²¹² See *Lochner Calls On States to Eliminate Regulatory Burdens*, 22 Sec. Reg. & L. Rep. (BNA) 622 (Apr. 27, 1990); *Breeden Sees Ample Time to Complete Work on Jurisdictional Bill*, 22 Sec. Reg. & L. Rep. (BNA) 907 (June 15, 1990); *SEC To Repropose System to Promote Cross-Border Offerings By Canadians*, 22 Sec. Reg. & L. Rep. (BNA) 1440 (Oct. 12, 1990).

²¹³ The author made this argument in Karmel, *supra* note 146.

²¹⁴ Pub. L. No. 101-429, 104 Stat. 931 (1990).

²¹⁵ See R. KARMEL, REGULATION BY PROSECUTION 219-22 (1982).

and perhaps come in the form of imposing new obligations on managers and directors and perhaps even shareholders. For example, mechanisms for requiring a shareholder vote on executive compensation might challenge managerial autonomy in an area where business is vulnerable. This could lead to requirements for shareholder votes on entrenchment devices such as poison pills, greenmail payments or supermajority antitakeover provisions.²¹⁶ A statutory reversal of *The Business Roundtable* case can also be envisioned.

In the author's opinion, any amendments to the Williams Act or the proxy rules that give shareholders greater power to hold managers accountable should inject a new but appropriate concept of shareholder responsibility into federal law. At present, institutional investors are only held accountable to their beneficiaries.²¹⁷ A concept of shareholder responsibility to the business enterprise is entirely lacking from the law. This is a concept that deserves serious discussion. In particular, shareholders should become responsible for sound corporate capitalizations.

One reason merit regulation has been resisted at both the federal and state levels is that government bureaucrats have no particular expertise for passing upon corporate capitalizations. A structure that might be fair, just and equitable from the standpoint of an unsophisticated shareholder might nevertheless be unsound from the perspective of creditors or the needs of the business entity. Many institutional investors are both bondholders and stockholders. They, therefore, have the kind of short-term conflict of interest that could make them adequate long-term monitors. As Professor Buxbaum has pointed out, they could become surrogates for the universal German banks. Similarly, the New York Governor's Task Force on Pension Fund In-

²¹⁶ A shareholder bill of rights promulgated by the Council of Institutional Investors calls for shareholder votes to approve any corporate decision related to the finances of a company that will have a material effect upon the financial position of the company and the position of the company's shareholders. Shareholder approval is specifically required for actions such as greenmail, poison pills and golden parachutes. In addition, independent approval of executive compensation is required. Machold, *supra* note 112, at 752, 760.

²¹⁷ See Letter From Alan D. Lebowitz, Deputy Assistant Secretary for Program Operation, U.S. Dep't of Labor, to Robert A.G. Monks, Institutional Shareholder Services (Jan. 23, 1990) regarding responsibilities of plan fiduciaries under ERISA for voting proxies.

vestment took the view that institutions should be made to become providers of patient long-term capital.²¹⁸

Unfortunately, in our litigious and adversarial society, imposing new responsibilities on a sector of the economy is unlikely to be successful unless those responsibilities are legally enforceable in some way. In the past, the most flexible mechanism for imposing responsibilities on groups within the corporate community has been the enforcement of fiduciary duties by courts and SEC regulation. The concept of shareholder responsibility has little precedent in American law, except with regard to the fiduciary duty of controlling shareholders to minority shareholders.²¹⁹ Nevertheless, there is some basis in the law of other jurisdictions for the concept of shareholder responsibility to the corporation as a whole.

The common law tradition treats shareholder voting rights as a property interest, and therefore each shareholder is entitled to vote his or her shares in an entirely selfish way or, with few limitations, to contract with regard to encumbering or limiting that right.²²⁰ By way of contrast, under the laws of certain continental countries (France and Italy, for example), shareholder voting rights have a dual nature. Voting and related rights are granted not to the shareholder as an individual, but in the interests of the company and the general body of shareholders.²²¹ A correlative to shareholder rights is therefore shareholder duty. Such a theory of shareholder obligation would fit within the evolving concept of director duties to nonshareholder constituencies.

A further articulation of what content any federal corporation law should have requires another article. However, both the erosion of shareholder rights in the United States and developments in the EC require that the question of a federal corporation law at least be debated at this time. Further, in light of the institutionalization of the markets and the unhealthy corporate capitalizations which developed during the 1980s, at least partly in response to investor pressures, any new initiative toward a

²¹⁸ Governor's Task Force, *supra* note 87, at 27, 57-61.

²¹⁹ See, e.g., *Essex Universal Corp. v. Yates*, 305 F.2d 572, 576 (2d Cir. 1982); *Perlman v. Feldmann*, 219 F.2d 173, 176-77 (2d Cir. 1955), *cert. denied*, 349 U.S. 952 (1955); *Zahn v. Transamerica Corp.*, 162 F.2d 36, 42 (3d Cir. 1947).

²²⁰ See Xuereb, *supra* note 187, at 16.

²²¹ *Id.* at 22-27.

federal corporation law should include the consideration of merit standards and the responsibility of institutional investors for the establishment of such standards.

Corporate governance discussions are politically charged because they concern the power to control corporate assets and to enjoy the emoluments of corporate office. In large public corporations where managers own only a small percentage of the shares, and a majority of shareholders are institutions, neither corporate officials nor shareholders are truly owners of the corporation. Their competing claims to control and direct such assets are therefore both open to question. It can be anticipated that working out an accommodation between these forces will take some time. Further, the issue involved is no less than the legitimacy of United States business leadership.

The federal securities laws have long protected investors in order to inspire confidence in the securities markets and encourage capital formation. Whether or not the time is ripe for a federal corporation law, it is time to examine what responsibilities should be imposed upon investors in exchange for their rights.