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David Michael Israel

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NOTES AND COMMENTS

THE BUSINESS JUDGMENT RULE AND THE DECLARATION OF CORPORATE DIVIDENDS: A REAPPRAISAL

The application of the business judgment rule to the declaration of corporate dividends is one of the oldest and most widely accepted principles of corporation law. This seemingly universal acceptance, however, has failed to quell criticism by commentators who maintain that the rule's application to dividends is no longer viable since the advent of the modern corporation with its separation of ownership and control.

At the heart of this debate are two fundamental issues. First, is dividend policy an independent variable in the process of share valuation? An answer to this question depends upon “whether corporate dividend policy is an active variable which... affects share prices or simply a means of distributing funds for which management can find no profitable employment.” Second, while there is little doubt that the interests of “ownership” and “control” do not always coincide, to what extent is there a significant conflict of interest? For, although recognized as a fiduciary to both the corporation and its shareholders, management “is ordi-


5. Berwald v. Mission Dev. Co., 40 Del. Ch. 599, 185 A.2d 480, 482 (Sup. Ct. 1962) (“It is quite true that in some cases the interests of a controlling stockholder and of minority stockholders may conflict...”)

For a discussion of the potential for a conflict of interest between management and stockholders see Donaldson, Financial Goals: Management vs. Stockholders, 41 HARV. BUS. REV. 116 (May-June 1963); Marsh, Are Directors Trustees: Conflict of Interest and Corporate Morality, 22 BUS. LAWYER 35, 63 (1966).
narily immune from challenge except in the case of clear abuse.”

Thus, should their interests conflict, potential for oppression is inherent in the present state of the law governing dividend policy. The resulting harm, however, must be balanced against the disadvantages of “subjecting action by the board of directors [of publicly held corporations] to close and constant judicial scrutiny, perhaps at the behest of troublesome minorities.” Indeed, the cure for this potential fiduciary malady might prove to be more harmful than the disease.

I. THE BUSINESS JUDGMENT RULE

A board of directors, ordinarily and in the absence of any statute to the contrary, is vested with the exclusive authority to declare dividends.\(^8\) Coupled with this power, the directors are clothed with a strong presumption of sound business judgment and good faith.\(^9\) Furthermore, “courts have been traditionally reluctant to interfere with the discretion of the directors to whom the disposition of corporate earnings is otherwise entrusted.”\(^10\) Thus, absent a clear showing of fraud,\(^11\) bad faith,\(^12\) or other serious misconduct,\(^13\) a court will decline to override the collective business judgment of the board of directors and compel the declaration of a dividend, regardless of the apparent wisdom or fairness.

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7. Note, Minority Shareholder Suits To Compel Declaration of Dividends, 64 HARV. L. REV. 299 (1950) [hereinafter cited as Shareholder].


10. Shareholder, supra note 7, at 299.


of the dividend policy. As one court stated the business judgment rule:

[T]he directors of a corporation are charged with the duty of managing its affairs and only in cases of the greatest emergency are courts warranted in interfering with the internal operation of its affairs. . . . [A]nd no principle of law is more firmly fixed in our jurisprudence than the one which declares that courts will not interfere in matters involving merely the judgment of the majority in exercising control over corporate affairs.

The unwillingness of the courts to be drawn into what are regarded as internal corporate affairs is, however, somewhat less strictly adhered to in cases involving closely held corporations than in those involving publicly held ones. This apparent double standard is based on the probabilities of abuse. Close corporations generally lack an available market for their securities. Consequently, minority shareholders are more prone to oppression and "squeeze-outs" by a majority who, while not declaring dividends, may nonetheless employ themselves with substantial remuneration.

There are three alternative rationales for the application of the business judgment rule to corporate dividends (and obversely, to investment policy). First, investors in equity securities are commonly regarded as risk-takers, cooperating in a collective venture for the purpose of earning profits. Part of the risk they are deemed to have assumed is that the directors whom they have "selected" will make errors of judgment with the most serious consequences befalling those who supplied the risk capital.

17. Baker & Cary, supra note 15, at 1041 ("As a practical matter dividend policy seldom, if ever, arises as a question of law in the case of a widely-held public issue corporation.")
Courts have reasoned that shareholders of all classes have given their implied consent (at the very least) to submit to the business judgment of the board of directors with respect to dividends so long as their judgment is exercised honestly and in good faith.19

Justice Oliver Wendell Holmes, writing for the majority in the landmark case of Wabash Railway v. Barclay,20 noted that even if available remedies were inadequate to protect preferred stockholders from an oppressive dividend policy fostered by directors more closely identified with the interests of common stockholders, "the law... has long advised them that their rights depend upon the judgment of men subject to just that possible bias."21 Yet, to say that the investor has given his implied consent to virtually unbridled managerial discretion, and has thereby assumed the risk of a conflict of interest, is to make only a conclusory statement providing no aid to analysis.

A better basis for sustaining the application of the business judgment rule to the declaration of corporate dividends is the recognition by courts that as an institution, the judiciary is fundamentally ill-equipped to make business decisions or to evaluate the wisdom of such decisions made by others.22 Add to this the element of subjectivity inherent in corporate policy making and it is not surprising that courts have cautiously avoided involvement in this potential quagmire:23

Personal relationships, organizational patterns, traditional operating methods, and many equally subtle factors may be involved in making "correct" business decisions. Uncertainty in the decision-making process is probably the critical factor in the general acceptance of the business judgment rule.

There is one additional, though infrequently articulated reason for the continued application of the business judgment rule to the declaration of dividends. A substantial lessening of the aggrieved shareholder's burden of proof would almost certainly result in a significant increase in litigation. While avoidance of

20. 280 U.S. 197 (1930).
21. Id. at 203.
23. Manne, supra note 18, at 422.
meritorious suits is not a positive social policy, there is a danger that complete abandonment of the rule would facilitate costly "strike suits" against large, publicly held corporations.  

II. Dividend Policy and Share Valuation

At this juncture, the relationship between dividend policy and share valuation will be explored. Specifically, it must be determined whether the pursuit of a dividend policy resulting in an optimal mix of dividends and reinvested earnings maximizes the market value of equity securities. To satisfactorily deal with this issue it is necessary to ascertain whether the familiar practice of retaining perhaps the greater share of corporate earnings actually serves the best interests of stockholders.  

Would the stockholder maximize the return on his investment if he received a proportionately larger dividend at the expense of the corporation's ability to internally generate most of its capital requirements? Or does the stockholder in fact maximize his return when the corporation pursues a policy of low pay-out with correspondingly higher internal reinvestment? While this issue is now being debated in financial circles, a consensus has not yet been reached.

A. Valuation of Preferred Stock

In discussing the relationship of dividend policy to share valuation it is essential to differentiate between preferred stock, whose value depends solely upon dividends, and its junior counterpart—common stock. Preferred stock is classified as equity, but its characteristics more closely resemble those of a debt security. Generally, preferred stockholders may not participate in the management of the company and are usually not entitled to vote. Consequently, management retains closer ties to the common stockholders and a greater sense of accountability for their economic interests, while tending to treat preferred stock as debt. Unlike preferred stockholders, discontented common stockholders may subject the corporation to a battle for control waged through the tender offer or the proxy contest. While such occur-

24. Shareholder, supra note 7, at 305.
25. For a discussion of the profitability of reinvested earnings by large, publicly held corporations, see Baumol, Earnings Retention, New Capital And The Growth of the Firm, 52 REV. ECON. & STAT. 345 (1970).
26. See BRUDNEY & CHIRELSTEIN, supra note 4, at 406.
rences are not commonplace, management cannot ignore the threat they pose.\textsuperscript{28}

Preferred stock enjoys a limited preference on dividends up to an amount fixed in the investment contract or appearing on the face of the stock certificate. Notwithstanding its complete dependence upon regular dividends for its marketability, however, the process by which a preferred dividend is declared is identical to that for a dividend on the common stock. Management has unfettered discretion in each case, and the same presumption of good faith applies in both instances. Thus, if a preferred dividend is not declared, the shareholder must overcome the heavy burden of proof in a suit to compel its declaration, or witness a marked decline in the market value of his shares.

If the preferred stock is non-cumulative and the board of directors fails to declare a dividend, the stockholders lose forever that amount which they would have otherwise received.\textsuperscript{29} If the preferred stock is cumulative, however, and a dividend is passed, there then arises a dividend arrearage. Although not a debt, the arrears must be completely paid to the holders of the preferred stock before the common stockholders are entitled to receive any dividends whatsoever.\textsuperscript{30} In reality, what frequently occurs is that a substantial accumulation of arrears precipitates a dramatic decline in the market value of the preferred stock, often followed by a recapitalization at less than fair terms.\textsuperscript{31}

\begin{footnotes}
\item[28] If the accustomed dividends are not covered, stockholders cannot wholly be counted on to remain quiescent; as we have seen, struggles for control in large corporations occur all but exclusively in those that are suffering losses or which have meager or irregular earnings.
\item[29] Wabash Ry. v. Barclay, 280 U.S. 197, 203 (1930). But see N.J. STAT. ANN. § 14A:7-1 (1969) (dividend credit rule); Cintas v. American Car & Foundry Co., 131 N.J. Eq. 419, 25 A.2d 418, 422 (Ch. 1942) ("where non-cumulative preferred stock has not been allotted the full dividend to which it is entitled in any one year and the corporation for that year has earned more than the dividend paid to the preferred stockholders, the preferred stock is entitled to have allotted to it such withheld earnings to the extent of its priority before dividends are paid to common stockholders."). See also Buckley v. Cuban Am. Sugar Co., 129 N.J. Eq. 322, 19 A.2d 820 (Ch. 1940); Longdale Securities Corp. v. International Mercantile Marine Co., 101 N.J. Eq. 554, 559, 139 A. 50 (Ch. 1927); Bassett v. United States Cast Iron Pipe & Foundry Co., 74 N.J. Eq. 698, 70 A. 929 (Ch. 1908), aff'd, 75 N.J. Eq. 539, 73 A. 514 (Ct. Err. & App. 1909).
\item[31] For a discussion of the fairness of recapitalizations, see Dodd, Fair and Equitable Recapitalizations, 55 HARV. L. REV. 780, 784 (1942); Gilson, How Fixed Are Shareholder Rights?, 23 LAW & CONTEMP. PROB. 283, 291-92 (1958); Halloran, Equitable Limitations
\end{footnotes}
There can be no doubt that in the lay mind incidents of favor, preference, and priority are ordinarily associated with preferred stocks generally. The history of preferred stock in the courts makes it clear . . . that such incidents are, for the most part, recognized with reluctance.\textsuperscript{32}

The preferred stockholders’ vulnerability to a recapitalization is typified by the following scenario:

 Corporation X has sustained a protracted decline in earnings for the past five years. In fact, in one of those years the corporation suffered substantial losses. As a result, preferred dividends have not been declared for the last three years and there is a sizable arrearage. Consequently, the preferred stock is selling on the market at 65 percent of par.

Fortunately, however, the future is looking brighter for Corporation X. Because of recently developed technological processes and the implementation of cost-saving techniques, a surplus has been earned and it is forecast that higher earnings will continue into the foreseeable future. But the common stockholders are aware that it will take quite a number of years before the accrued arrears are paid and dividends can be declared on the common. Therefore, an amendment to the certificate of incorporation has been proposed by management and an explanation of its terms and consequences has been sent to the shareholders of both classes.

In such cases the certificate of incorporation can be amended in a number of different ways. One form of amendment provides for the issuance of a prior preferred stock.\textsuperscript{33} Such a plan is known as an “indirect” or “voluntary” recapitalization. Under this method the arrears may be capitalized and a new class of preferred stock issued. Those who dissent will find their old shares to be junior in preference to the new issue. Another form of amendment merges the corporation with its already existing or newly created, wholly-owned subsidiary for the express purpose of eliminating arrears.\textsuperscript{34} The latter was a favored method during the 1930’s and 1940’s and its judicial acceptance heralded the

\textsuperscript{32} Keil, \textit{supra} note 3, at 168.
\textsuperscript{33} See, e.g., Johnson v. Fuller, 121 F.2d 618, 621 (3d Cir. 1941).
In a third variation, the preferred shareholders are subject to a direct charter amendment whereby they receive warrants, common shares, or a mix of securities as part of a recapitalization plan. Thus, common shareholders are able to choose from a variety of recapitalization techniques to assure that they will savor the fruits of the perhaps ephemeral surplus. Regardless of what type of recapitalization plan is employed, "[t]he face amount of what [the preferred investor] receives may or may not be equal to the amount of his dividend arrearages, and the immediately realizable value is invariably much less."³⁸

In addition to the above-mentioned recapitalization techniques, the corporation may actually purchase its own preferred shares and thus take advantage of the issue's decline in market price. This can serve as an alternative to traditional recapitalization plans. It provides the corporation with a way of retiring much of its preferred stock at a price well below its liquidation preference. Further, such a procedure removes the obstacle of a substantial accrued arrearage which stands between the common stock and a dividend, while avoiding the dilution of the common stock which may result from the issue of warrants or additional common stock.³⁷ While the corporation's purchase of its own preferred shares does have the additional effect of supporting the market for preferred sellers, it has been suggested that the earmarking of surplus funds to discharge arrearages would have a more positive effect on the market price of the security than the market acquisitions have.³⁴ Nevertheless, so long as the corporation publicly discloses its transactions, the repurchasing is legally acceptable.³⁹

³⁵ The substance of the "vested rights doctrine" was articulated in the then leading case of Keller v. Wilson & Co., 21 Del. Ch. 391, 411, 190 A. 115, 124 (Sup. Ct. 1936):

The right to have paid at some future time the accumulation of dividends on preferred stock, was as between the stockholders, a fixed and vested right, having the nature and character of a debt, postponable in enjoyment until the creation of a fund from which payment legally could be made.

For a discussion of the vested rights doctrine, see Brecht, The Power to Remove Accrued Dividends by Charter Amendment, 40 Colum. L. Rev. 653 (1940); Curran, Minority Stockholders and the Amendment of Corporate Charters, 32 Mich. L. Rev. 743 (1934).

³⁶ Meck, supra note 30, at 78.

³⁷ Note, Purchase By A Corporation of its Own Preferred Shares with Dividends in Arrears, 14 U. Chi. L. Rev. 66, 70 (1946).

³⁸ Id. See also Latty, Fairness—The Focal Point in Preferred Stock Arrearage Elimination, 29 Va. L. Rev. 1, 17 (1942).

³⁹ See Note, SEC Action Against Fraudulent Purchasers of Securities, 59 Harv. L.
In an effort to curtail the systematic abuse inherent in recapitalizations, a number of states have amended their laws of incorporation so as to require either a majority or a two-thirds vote of the class which may lose its preference as a result of a recapitalization. Despite this needed reform, disorganized preferred shareholders are little match for unified common shareholders who not only control dividend policy but the proxy machinery as well. Once a decision has been made to judicially contest the recapitalization, the preferred minority must sustain a heavy burden of proof. Furthermore, as Professors Berle and Means observed, "[h]owever oppressive an amendment may be, in nine cases out of ten a dissenting shareholder cannot afford the expense of starting a lawsuit. Scattered shareholders do not easily organize for mutual protection." As to the burden of proof, unfairness alone is generally an insufficient ground for judicial intervention. Bad faith, fraud, or oppression must be proved. The chance of a successful suit is minimal:

If put to their trumps a management can usually make a showing of "business exigency"; and if it is far-seeing it can set the stage to indicate such business exigency long in advance. A shareholder who objects must sustain the burden of proof of unfairness, in which he is commonly at a hopeless disadvantage in coping with the "control" which has both the funds and the information of the corporation at its free disposal.

Thus, because of the preferred stockholders' extreme dependence on regular dividends and the general unwillingness of management to represent both classes of equity security holders fairly and equally, many scholars have called for a departure from the business judgment rule. In 1941, with the era of prolific recapitalizations fresh in mind, Donald Kehl suggested:

With respect to payments of dividends on preferred stock...
when earned, much is to be said for a rule which would place the burden on the corporation of showing why the dividends should not be paid, instead of according directors the same free discretion they have in declaring dividends on common stock.

Berle and Means suggest that a more comprehensive fairness standard should be established:

In every case, corporate action must be twice tested: first, by the technical rules having to do with the existence and proper exercise of corporate power; second by equitable rules somewhat analogous to those which apply in favor of a cestui que trust

B. Valuation of Common Stock

In spite of the fact that capital gains receive preferential tax treatment while dividends are taxed as ordinary income, the overwhelming weight of authority in the field of corporate finance indicates that firms paying high dividends generally sell at a premium, while the shares of low pay-out firms sell at a discount.

There are four principle factors accounting for the profound effect that dividends have on share valuation. These are: (1) the informational content of dividends; (2) the desire for dividends in certain sectors of the stockholding public; (3) general market conditions; and (4) excessive retention and internal reinvestment at less than an optimal rate of return—a practice of many of the large publicly held corporations.

1. The Informational Content of Dividends

Most corporations adhere to a stable dividend policy, avoiding substantial adjustments even when warranted:

45. BERLE & MEANS, supra note 41, at 220.
47. Lihtner, Distributions of Incomes of Corporations Among Dividends, Retained Earnings And Taxes, 46 AM. ECO. REV. 97, 100 (1956). See also Sheehan, The Big Payout, FORTUNE, Nov. 1956, at 147, quoting United States Steel's Robert Tyson:

Any dividend that is set should be set in the expectation that it can be continued
Conservatism and effort to avoid erratic changes in rates . . . resulted in the development of reasonably consistent patterns of behavior in dividend decisions. The principal device used to achieve this consistent pattern was a practice or policy of changing dividends in any given year by only part of the amounts which were indicated by changes in current financial figures. Further partial adjustments in dividend rates were then made in subsequent years if still warranted. This policy of progressive, continuing “partial adaptation” tends to stabilize dividend distributions and provides a consistency in the pattern of dividend action which helps to minimize adverse stockholder reactions. At the same time it enables management to live more comfortably with its unavoidable uncertainties regarding future developments—and this is generally true even during at least a considerable part of most cyclical declines, since the failure of dividends to reflect increasing earnings fully and promptly during the preceding upswing leaves more cushion in the cash flow position as earnings start to decline.

Consequently, when a company has maintained a stable dividend policy, investors would not be unreasonable were they to attribute a radical change in the established dividend rate to a change in management’s views regarding future business prospects. While it may be said that the dividend change is merely the occasion for the price adjustment and not its cause, it is the dividend change which informs many investors of the underlying business exigencies. Moreover, the “informational effect” of dividend adjustment has a more profound impact on the small investor whose modest portfolio is not under the watchful eyes of a personal market analyst. This disadvantage is compounded by the fact that the market acknowledges tiers of corporate disclosure of information material to sound investor judgments. Thus,

48. Miller & Modigliani, supra note 46, at 411.
49. Id.
50. SEC REPORT, supra note 6, at XXIX.

[The large financial] institutions or their managers, by reason of their ability to influence the outcome of efforts to transfer corporate control, appear in a number of cases to receive preferential treatment as compared with individual investors. This preferential treatment appears to have taken two principal forms. First, the acquiring company may afford special treatment to institutions in the form of premium prices, guaranteed profits and other incentives in order to attract their support. Second, institutions may receive nonpublic advance information concerning takeover efforts which may be utilized in purchasing securities either of the target company or the acquiring company with a view to
curtailing dividends will send shock waves through less informed sectors of the stockholding public, although the economic viability of the firm may in fact be unimpaired.

2. The Desire for Dividends in Certain Sectors of the Stockholding Public

Institutional investors have continuously expanded their corporate stock holdings since the 1950's, but individuals still retain approximately 60 percent of all outstanding shares. Undoubtedly many of these individuals are in high tax brackets. For them, capital gains may be more desirable than dividends. For certain groups of shareholders, including the elderly and the less affluent, however, dividends continue to be an attractive source of income.

For some investors, transactions costs make it desirable that there be a steady and substantial flow of dividend payments. If a shareholder lives on his dividends and therefore needs the constant flow of funds for his income payments, the transactions costs involved in disposing on a regular schedule of a small proportion of his security holdings makes the latter a prohibitively expensive alternative. Thus, even if retained earnings do yield their full value to him in the form of capital gains on his securities he may find that a decision to reduce dividend payments works out to his disadvantage. We conclude that the interests of some stockholders may be served by the use of funds derived from the stock market in preference to increased earnings retention.

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profiting from the market impact of the takeover effort once its existence is publicly disclosed.

Id.

51. Three successive Census of Shareownership surveys conducted by the New York Stock Exchange of the ownership of securities listed on that Exchange show that from 1962 to 1965 and 1970, institutional holdings increased from 31.1 percent to 35.5 percent and 39.4 percent, respectively.

SEC REPORT, supra note 6, at IX.


53. Dividend income is extremely important to several large classes of investors. It is important to equity common trust funds designed for income beneficiaries, to individual investors seeking dividend income, to income oriented common stock mutual funds and to corporations desiring partially tax-exempt dividend income.

Murphy & Johnson, Predicting Dividend Changes, 111 TRUSFS & ESTATES, 638 (1972).

For most stockholders, however, profitable reinvestment of dividends is more advantageous. Those investors who do desire dividends tend to gravitate to utility and other high pay-out stocks. Nevertheless, such investors remain vulnerable to unfaithful management, which by omitting a dividend, can strike at the very heart of such a stock's value and thereby drive the market price down. Apart from relief under federal securities law, the stockholder has little chance of securing redress in the courts, for absent clear evidence of abuse, a shareholder's suit to compel the declaration of a dividend will likely fail due to the application of the business judgment rule.

3. General Market Conditions

Market conditions are of overriding importance in considering the incremental benefit of earnings retention to the shareholder. If the stock market is depressed and does not react to internal reinvestment with appreciation of share values, the stockholder does not receive an immediate benefit. But during periods of rapid economic growth, as was the case during the "bull market" of the 1960's and early 1970's, investors place greater emphasis on growth with correspondingly little attention paid to dividends. Indeed, during such growth periods, an optimal dividend policy may be zero dividend pay-out coupled with profitable internal reinvestment. During periods of little or no growth, the investor's periodic cash dividend becomes more valuable and less certain.

For most of the sixties and well into the seventies it was fashionable to regard payouts as passe. Few cared much about

55. Id. at 73.
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
57. Specifically because of the nature of capital gains taxation and because of the considerable transactions costs incurred in raising funds by means other than retention, a company which can profitably invest all of its earnings may well have an optimal dividend level equal to zero—it will serve both stockholder and managerial interests to keep dividend payments down to zero.
the cash return when capital gains were growing wildly in every portfolio. When it finally dawned on investors that stocks could go down for long periods as well as up, everybody became dividend-conscious. A good yield was at least some comfort in an uncertain stock market.

Historically, there has been a correlation between periods of economic uncertainty and high dividend yields on common stock. From 1936 until 1958 dividend yields were actually higher than bond interest rates.\(^5^9\) This was due to the belief that equity, being risk capital, warranted a higher yield than the relatively more secure debt. Since low growth periods result in only slight appreciation in the market value of stock, dividends are the only increment the shareholder may actually receive. Nevertheless, there is little likelihood that dividend yields will approach that of corporate debt in today's economy. Dividend yields did rise sharply in 1974,\(^6^0\) but it is likely that this was caused by the sharp decline in market prices coupled with relative dividend stability due to a "dividend cushion."\(^6^1\) In fact, recent Department of Commerce statistics indicate that since 1970, corporations have actually been paying proportionately less of their profits to shareholders by way of dividends.\(^6^2\) Furthermore, all signs indicate that retention, now as high as 60 percent not counting capital consumption allowances, shall continue to rise. The effect of a policy whereby management retains more of the earnings, while the market fails to respond with capital gains, is to eliminate the shareholder's return on his investment.


60. The Returning Allure of Dividends, Bus. Week, Oct. 5, 1974, at 74, noted that: This year is starting to look more like the 1930's. The Standard & Poors 425 is up to 5.6 percent, and the Dow Industrial Average, near 600 [in Oct. 1974] was up to 6.4 percent.

61. See text accompanying note 47 supra.

62. Metz, Dividends Seen Trailing Rising Profits, N.Y. Times, July 11, 1975, at 36, col. 3:

Specifically, corporate profits more than doubled from $39.3 billion in 1970 to $95 billion in 1974. Dividends, meanwhile, rose from $24.7 billion to $32.7 billion, a gain of about a third. Thus the dividend payout, which represented 63 per cent of profits in 1970, fell to 38 per cent in 1974.
4. Internal Reinvestment at Less Than an Optimal Rate of Return

Retention of corporate earnings, when coupled with profitable reinvestment, results in growth and consequently in capital gains. However, "[i]t is far from being true that all forms of corporate expansion tend to increase the profits of stockholders..." If the corporation is unable to earn greater profits on its retained earnings than the stockholder could himself earn elsewhere had those funds been paid to him by way of a corporate dividend, the shareholder is harmed by retention. When the shareholder is in search of potential investment opportunities his sole interest is in maximizing the return on his capital. For him,

[t]here is a complete absence of the sort of identification with a single company which management feels. The concept of "[shareholder] loyalty," if it can be used in this context, is loyalty to superior financial performance (past and/or expected) and to nothing else. Consequently, the shareholder is very willing to consider the question that management is emotionally incapable of asking: Is there another company and another management which can make better use of the available funds?

Management, on the other hand, generally articulates its investment policy in terms of the cost of capital: [A] company will be willing to [invest] as long as the return is in excess of the cost of the funds required to finance the project... It will reject proposals which fall short of the company's cost of capital.

Aside from capital budgeting considerations which may cause management to conserve capital for more profitable future investment opportunities, management tends to pursue any investment whose return will exceed its cost to the firm. Furthermore, management tends to treat retained earnings as capital free of cost to the corporation since it is not a charge on future earnings, as is debt, nor will it result in dilution of that barometer of corporate growth—earnings per share—as would the issuance of additional equity securities.

Conversely, the shareholder values "his" capital by compar-
ing the yield derived pursuant to internal reinvestment with the potential yield obtained through external reinvestment subject to the same degree of risk. For example, the shareholder is aware that if placed in a federally-insured savings account, his capital will earn approximately five percent, whereas investments involving some inherent risk will yield substantially greater returns. By comparing the potential external yield on his capital, otherwise known as "opportunity cost," to the yield currently derived, the investor can gauge which investment opportunity is more profitable.

Management does not pursue a policy of maximization of profit as vigorously as might be expected. Rather than seeking out the most profitable investment opportunities, it tends to reinvest corporate earnings within the enterprise, either in expansion of existing enterprises or in diversification. Each management thereby maximizes the funds kept under its direct control:

Corporations that have accumulated large amounts of risk capital allocate it to those enterprises most convenient and profitable in connection with their own enterprises, not where it is most needed. Their capital accumulations do not rove the market seeking the highest profit or the most useful allocation available on the economic scene.

In their vital work Earnings Retention, New Capital And The Growth of the Firm, Baumol, Heim, Malkiel and Quandt undertake a statistical examination of the relationship between reinvestment of retained earnings and growth. The extreme importance of this issue is evident for "if retained earnings have a negligible influence on future earnings, the efficiency of the process of capital formation becomes questionable." The results of the study of the past quarter-century of corporate experience, while tentative pending additional research, are indeed startling:

We observe immediately that the rate of return on equity

66. Id.
68. Baumol, Heim, Malkiel & Quandt, Earnings Retention, New Capital And The Growth Of The Firm, 52 REV. Econ. & STAT. 345 (1970). The principal data employed by this study consisted of accounting information from corporate income statements and figures on stock prices obtained from Standard and Poor's Compustat industrial tape, revealing the rates of return of hundreds of publicly held corporations for the past 25 years.
69. Id.
70. Id. at 353.
capital is higher by a substantial margin than that on the other two forms of capital. Depending on the lag involved, the rate of return on equity capital ranged from 14.5 per cent to 20.8 per cent. The rate of return on ploughback, however, ranged from 3.0 to 4.6 per cent; while the rate of return on debt ranges from 4.2 to 14 per cent.

These results are significant in several ways. First, they indicate that management has consistently retained or "ploughed back" funds which were excessive from the standpoint of the shareholder and of society. If the study's findings even approach accuracy, it is clear that the stockholder has gained little from retention. Had more of those funds been returned to him by way of dividends, his overall return would have been greater since the rate of return on retained earnings was generally less than what the investor could have earned by simply placing his dividends in a risk-free savings account or government security. True, he would have had to pay additional tax on the dividend, but nevertheless, in light of the inefficiency of management's internal reinvestment of earnings it would not have been profitable for the shareholder to leave his funds in the typical enterprise. As long as the corporation profitably reinvests its earnings at a rate commensurate with inherent risks and expectations, the common stockholder will not be prejudiced by the absence of direct cash dividends. The increasing market price itself is the return on his investment and his cash requirements can be satisfied by periodically selling some of his appreciating shares. When corporate managers are faced with the alternatives of either declaring a dividend or retaining earnings, however, the investor is deprived of a part of his profit if the return on ploughback is less than the corporation's overall return on its capital or below that which the shareholder could earn if he invested his funds externally. Furthermore, as is indicated by Baumol's findings, the corporation could have earned a higher rate of return simply by repurchasing its own shares on the market instead of ploughing back earnings in investments which are marginally profitable.

Second, the findings indicate that society is hampered by inefficient utilization of capital by large publicly held corporations. Freed by internal generation of capital from having to go to the equity market for additional funds in all but rare instances, management can "apparently, proceed to make its [investment] decisions confident in its immunity from . . . the discipline of
III. MANAGEMENT AND STOCKHOLDERS: A CONFLICT OF INTEREST

Most corporate managers maintain that their primary responsibility is the advancement of the shareholders' economic interests. Although control of the enterprise has long been divorced from ownership, \[72\]

[few corporate officers have been disposed (or have dared) to make an open break with the historic posture of ultimate allegiance to the owner group—a posture reflected in corporate law and organization as well as in the conventions of financial reporting.

The realities of the modern corporation, however, have precipitated a serious and perplexing fiduciary dilemma. The much heralded separation of ownership from control has resulted in a great potential for conflicts of interest. \[73\] These conflicts arise from management's role in the modern corporation and from pursuit of its self-interests.

A. The Role of Management

In 1931 Adolph Berle wrote that: \[74\]

[All powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears (emphasis added).

Despite the fact that corporate law still recognizes management's fiduciary duty to its shareholders, the nature of this duty has undergone a radical transformation. Thus, one noted commentator on corporate affairs has observed: \[75\]

Shareholder democracy, so-called, is misconceived because the shareholders are not the governed of the corporation whose consent must be sought. If they are, it is only in the most limited sense . . . . A priori, there is no reason for them to have any

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71. Baumol, supra note 54, at 70.
voice, direct or representational in the catalogue of corporate decisions . . . . They are no more affected than nonshareholding neighbors by these decisions [and] they deserve the voiceless position in which the modern development left them.

The demise of "shareholder democracy" as a realistic corporate goal and the rise of "corporate statesmanship" in its stead have done much to exacerbate the divergence of economic interests which now separates management from the passive ownership class. Today the shareholder is only one of a number of groups to whom management owes a duty. Management has come to be viewed by some as an arbitrator of diverse and often competing interests including those of labor and the consumer as well as the shareholder. As a result, the shareholders' right to demand fidelity from their corporate representatives is uncertain. Thirty-one years after Berle articulated his case for shareholder supremacy in the corporate system, he acknowledged the limited role which the shareholder has come to play in the modern corporation. Thus Berle noted that "[a] purchase of stock is, in effect, a bet between outsiders on success or failure [of the corporation]—when it is not a blind bet on the 'market.'"

While the corporate statesmanship doctrine has been recognized by scholars of corporation law, its existence, by and large, has not been acknowledged by management. For management to recognize this doctrine would be to declare its independence from those whom it has claimed to have diligently served. Accordingly, the myth of the vitality of the fiduciary bond and the unity of interest of shareholders and management is perpetuated in corporate literature and at annual stockholder meetings. For example, proponents of professional managerialism have often pointed to the stock option to demonstrate the convergence of pecuniary interest between management and shareholder. It has been ex-

76. See, e.g., A.A. BERLE, THE TWENTIETH CENTURY CAPITALIST REVOLUTION (1954); W.O. DOUGLAS, DEMOCRACY AND FINANCE 53 (1940); BERLE & MEANS, supra note 41, at 312. But see Dodd, supra note 63, at 194. See also Dodd, For Whom Are Corporate Managers Trustees?, 45 HARV. L. REV. 1145, 1156 (1932); Weiner, The Berle-Dodd Dialogue On the Concept of the Corporation, 64 COLUM. L. REV. 1458 (1964).


78. See generally W. LEWELLEN, EXECUTIVE COMPENSATION IN LARGE INDUSTRIAL CORPORATIONS (1968); Lewellen, Executives Lose Out Even With Options, 46 HARV. BUS. REV. 127 (Jan.-Feb. 1968).

Notwithstanding the comprehensive tax revision of the stock option undertaken in the Tax Reform Act of 1969, wherein the "statutory" form of the option was changed in a number of ways, stock options are still very much in existence. See Rothschild & Salwen, Stock Option Plans in Transition, 10 CONF. BD. REC. 17 (June 1978).
plained as follows:79

[If the corporate executive's] income is that sensitive to the market behavior of his company's stock, it is not unreasonable to believe that he is apt to view his job responsibilities in terms of the impact of his decisions on the well-being of shareholders. If he can administer the corporation's affairs so as to influence the investment community to place a higher value on its stock, he benefits as much as the stockholders do.

Yet one would be unwise to overemphasize the prophylactic effect that stock options have upon managerial fidelity. While "[t]he stock option will at least in some cases produce . . . an imperfect coincidence between stockholder and managerial interests,"80 it does not sufficiently bridge the gap between ownership and control, nor does it diminish the potential for conflicts of interest. Until such time as the option is exercised, the holder of the stock option has no shares upon which dividends may be paid. Consequently, the holder of the option stands to benefit by a policy of maximum retention while the shareholder may be better off with larger dividends:81

It follows that any dividend level which is optimal from the point of [view of] the option holder will not generally be optimal for the stockholder [and] a dividend level whose marginal yield to the former is zero must still promise a positive incremental gain to the latter.

Thus, in its corporate role, the interests of management may be adverse to those of the shareholders with respect to dividend policy:82

To say that management and the shareholder have much in common is only to state the obvious. So do management and the labor force, consumers, or any other group having a vested interest in the corporate entity. But to extend this by saying that management, in pursuing corporate objectives as it sees them, necessarily serves the best interests of the stockholders, . . . misstates the facts in certain important respects. It also leads to confusion in and misinterpretation of financial policy.

This leaves corporate law with two possible remedies for the fidu-

79. Lewellen, supra note 78, at 134.
80. BAUMOL, supra note 54, at 86.
81. Id. at 88.
82. Donaldson, supra note 52, at 116.
ciary imbalance inherent in the present system. It can either avoid shareholder oppression by placing management’s discretion (as it pertains to dividend policy) within defined parameters; or, it can legitimatize management’s new societal role.

B. *The Motivation of Management*

Those factors most important in attracting competent management are adequate remuneration, a reasonable degree of job security, and a stimulating and prestigious position within the enterprise. It has been widely noted that executive compensation is more often related to corporate size than to profitability. In one study, it was concluded that “[e]xecutive compensation appears to be virtually unrelated to company profit as measured by profit rate, but significantly related to corporate size as measured by sales.” Therefore, corporate growth is management’s uppermost priority and maximum profitability tends to be relegated to secondary importance. J.M. Keynes observed:

"The shareholders . . . are almost entirely dissociated from the management, with the result that the direct personal interest of the latter in the making of great profit becomes quite secondary.

Managerial security is also served by a policy of corporate growth, even if the enterprise’s profitability is only marginally enhanced.

There are two reasons why management is encouraged to be conservative in its investment approach and overly concerned with corporate growth. Should the corporate executive pursue an aggressive investment policy in an attempt to maximize the profitability of the firm, the stockholders will “receive the profits which may result from taking [the] chance, while [the executive’s] position in the firm may be jeopardized in the event of serious loss.” Therefore, a conservative investment approach permeates the decision-making process of the large, publicly held corporation, and the imprimatur of self-interest is impressed upon dividend and investment policy. From board of directors meetings to the day-to-day operation of the firm by its techno-

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84. See Marris, supra note 73, at 46-109; D.R. Roberts, Executive Compensation 64 (1959).
85. Roberts, supra note 84, at 64.
86. Keynes, supra note 73, at 314-15.
87. Gordon, supra note 83, at 324.
crats, prevention of loss is of more vital concern than maximization of profit.88

The other factor which encourages management on all levels to strive for perpetual (even if not highly profitable) growth is that existing management personnel tend to fill newly created positions. This provides a means by which promotions accrue without jeopardizing positions already attained by others. This does not mean that self-interested managements can ignore profit, since growth is necessarily dependent upon a minimum level of profit. "But it does mean that [one] is unlikely to be judged by his ability as a profit maximiser. By contrast he may well be judged by his ability to maximise, or at least promote, organisational growth."89 Furthermore, management's prestige tends to be enhanced more by corporate size than by its rate of return.90 As John Kenneth Galbraith notes, "[a]t the center of the corporation compensation is only a part of a larger motivational system. . . ."91 Power, prestige and one's identification with the corporate enterprise he or she manages are all motivationally significant and strongly influence management's dividend and investment policies.92

C. Dividends: A Conflict of Interest

Management's desire for growth is often adverse to the shareholder's quest for profit. Management strives towards maximum retention of corporate earnings despite low profitability with the result that "weak management [tends] to perpetuate itself—in its inefficiency, its errors of judgment, and its conservatism beyond what would be permitted by stockholder-oriented decision

89. Marris, supra note 73, at 102 (emphasis in original).
92. Gordon, supra note 83, at 305-06, observes that:
One of the most important of the non-financial incentives offered by the large corporation is the opportunity to satisfy the urge for personal power. The corporate executive possesses power by virtue of his position of authority in the firm which is itself powerful. His power is a product of his position rather than his personal wealth. . . . Power thus secured increases with the size of the firm. Here lies an important explanation of the tendency of many firms to become larger, even if sometimes the profitability of such expansion is open to serious question.
rules. In other words, wastage of the stockholder’s property values may result from a defensive effort to preserve an inefficient corporate structure for management, more closely identified with the corporation than are its often transitory shareholders. Thus, in the marginally profitable enterprise, fund will be pumped in and stock values diluted in efforts to shore up sagging sales and profits, develop product or market diversification, and so on when from the viewpoint of stockholders (and the economy as a whole) the funds might be better diverted to other, more promising investment opportunities. Investment standards will be lowered when they should be raised [and] dividends will be reduced when they should be increased . . . .

Stockholders are virtually helpless to alter the course of investment and dividend policy, thus sale of their shares at perhaps depressed market values is their only real alternative. There is little likelihood that scattered stockholders can achieve the requisite unity of numbers and purpose necessary to oust existing management and redirect corporate policy. Furthermore, legal action to compel the declaration of a dividend is virtually destined to fail since it is extremely difficult to prove dividend policy was pursued solely in the interests of management or controlling shareholders. Nor is it likely that the mechanism of the market place will exert sufficient pressure on management to force a reevaluation of its dividend and investment policies. Insulated from the stock market due to the corporation’s capacity to internally generate as much as 85 percent of its capital requirements, and pursuing a systematic policy of “stock market avoidance,” management is free to embark upon any policy it deems advisable and need not be responsive to the shareholder or the market.

The ascent of the institutional investor to the apex of the equity market has further exacerbated this state of affairs.

93. Donaldson, supra note 52, at 129.
94. Id.
96. SEC REPORT, supra note 6.
97. BAUMOL, supra note 54, at 70-75. See also SEC REPORT, supra note 6, at 73: Corporate reluctance to issue new equity securities has long been observed; seemingly, it has persisted even during periods when high stock price multiples and high interest rates would appear to offer attractive opportunities for new equity issues.
98. See SEC REPORT, supra note 6, at 2844-45:
While the large institutional investor is perhaps the only economic force capable of offsetting the vast powers of management, institutions tend not to participate in corporate policy and decision making. Rather than struggle with management over policy matters, institutions prefer to simply dispose of their holdings in companies pursuing policies which they find objectionable. In addition, despite the fact that institutions such as bank trust departments and mutual funds collectivize disparate investor interests, "the interpositioning of institutions between beneficiaries and corporations effectively eliminates the exercise of ultimate investor judgment." Notwithstanding the fact that many rely on institutions to maximize their investment holdings, it is not clear whether institutional shareholders in fact represent the economic interests of their beneficiaries at the seat of corporate power, or use their influence to advance their own economic

The Study found that the institutions in the Study's sample held 727 of the 800 representative stocks. The sample stocks include New York Stock Exchange stocks constituting about 58 percent of the value of all such stocks, American Stock Exchange stocks constituting about 23 percent of the value of all such stocks, and over-the-counter stocks estimated to constitute about 13 percent of the value of all such stocks. Excluding the 71 smallest companies, there were 348 companies in the sample in which ten or fewer institutions surveyed together held at least 10 percent of each such company's outstanding shares. (The data does not indicate that the same group of institutions held shares in every such company). There were 303 companies in which five or fewer institutions held 10 percent of each company's outstanding shares. Ten or fewer institutions held at least 15 percent of the outstanding shares of 247 companies, while five or fewer institutions held 15 percent of the outstanding shares of 182 companies. Ten or fewer institutions held at least 20 percent of the outstanding shares of 159 companies, while five or fewer institutions held 20 percent of the outstanding shares of 76 companies.

Comparable data for institutional holdings coupled with sole or partial voting authority show that of the 656 largest sample companies, ten or fewer institutions held at least 10 percent of 316 companies, 15 percent of 203 companies and 20 percent of 100 companies. Five or fewer institutions held at least 10 percent of 260 companies, 15 percent of 131 companies and 20 percent of 49 companies. In general, a larger proportion of concentrated institutional holdings were represented by investments in large companies.

The concentration analysis thus establishes that large institutions, particularly banks, have the potential economic power to exert significant influence over many companies whose securities comprise their portfolios, particularly large companies. Ordinarily, however, no individual institution would be in a position to exert this type of influence and it is necessary to aggregate the holdings of several institutions before these constitute a substantial percentage of a particular company's outstanding shares.

99. Id. at XXVIII.
100. Id. at 2530.
interests to the detriment of those whom they are supposed to represent.\textsuperscript{101}

IV. CONCLUSION

The ability of the modern corporation to efficiently employ the vast capital resources under its dominion is of vital concern to the individual investor and to society-at-large. Corporate growth coupled with profitability maximizes the wealth of the shareholder and injects vitality into the economic system. If expansion is only marginally profitable, however, corporate growth becomes a self-serving process which merely advances the economic interests of management and the technostructure at the shareholder's expense. Thus, the corporate dividend is at the center of the process of efficient capital formation. If corporate earnings can be efficiently employed internally, the value of the shareholder's holdings are maximized. If the corporation can earn only a low rate of return, however, the stockholder himself should be free to determine where those funds, paid to him as a dividend, should be deployed. In addition to increasing the shareholder's return on his investment, this would facilitate the efficient distribution of capital within the economy.

A number of solutions have been suggested which would liberate the shareholder from managements whose interests in corporate dividend policy are adverse to their own. In 1940, Justice William O. Douglas called for the establishment of full-time professional directors who would revitalize management's fiduciary duty to its stockholders.\textsuperscript{102}

[\text{T}]he paid director would revive and strengthen the tradition of trusteeship. His job would not be to represent the management or to represent himself. It would be primarily to represent the stockholders—to return to the stockholder the protection which today's stockholder has too frequently lost.

This internal reform of the corporate system, however, is unlikely to do more than create yet another level of self-interested corporate bureaucrats. Others have urged the establishment of stockholder committees or councils which would collectivize and thereby maximize their hitherto insignificant voting strength and thus cause dividend policy to conform to their interests.\textsuperscript{103} While

\textsuperscript{101} Id.
\textsuperscript{102} DOUGLAS, supra note 76, at 53.
\textsuperscript{103} See, e.g., L.D. GILBERT, DIVIDENDS AND DEMOCRACY 231-32 (1956).
theoretically inviting, this solution is not practicable. It is unlikely that sufficient numbers of scattered shareholders, many with modest portfolios, will be able to achieve the requisite unity of numbers and purpose necessary to contest management's control or the influence of the institutional investor. Another potential solution to the problem of excessive retention is the extension to publicly held corporations of the accumulated earnings tax applicable only to close corporations, coupled with personal liability befalling directors whose policies subject the corporation to the tax liability. However, this would not adequately resolve the problem herein. Despite the fact that the corporate taxpayer has the burden of proving the reasonableness of the firm's earnings retention when tax liability is assessed under section 531 of the Internal Revenue Code of 1954, great weight is given to the business judgment of the board of directors as it pertains to the capital requirements of the corporation.

A better solution to unwarranted retention would be to delimit the parameters of the business judgment rule as it applies to the declaration of corporate dividends, thereby minimizing management's potential for abuse of its powers. This departure from the historic application of the business judgment rule to dividends would be in conformity with the traditional legal approach to a conflict of interest between management and shareholder. Thus, should management fail to declare a dividend on

104. INT. REV. CODE OF 1954, § 531.

The only cases in which section 531 of the Internal Revenue Code has been applied to a publicly held corporation were Trico Products Corp. v. McGowan, 169 F.2d 343 (2d Cir.), cert. denied, 335 U.S. 899 (1948); and Trico Products Corp. v. Commissioner, 137 F.2d 424 (2d Cir.), cert. denied, 320 U.S. 799 (1943).

107. See, e.g., Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405, 409 (Sup. Ct. 1962), where the court noted that when a corporation purchases its own shares to remove a threat to corporate policy coupled with a threat to management's continued control of the enterprise, the directors are of necessity confronted with a conflict of interest, and an objective decision is difficult . . . . Hence, in our opinion, the burden should be on the directors to justify such a purchase as one primarily in the corporate interest.

See also 3 FLETCHER CYC. CORP. § 1039, at 626 (Perm. ed. 1965) ("[T]he 'business judgment rule' yields to the rule of undivided loyalty."); Kennedy, Transactions By A Corporation In Its Own Shares, 19 BUS. LAWYER 319 (1964); Note, Buying Out Insurgent
its preferred stock when such a dividend has in fact been earned, the board of directors would assume the burden of proof as to why such a dividend should not be compelled.

If the board of directors failed to declare a dividend on the common stock or declared a dividend of less than 50 percent of net earnings, including any preferred dividends that may have been declared, the burden of proof would be on management to prove the reasonableness of their policy. Good faith alone would not be sufficient to defend management’s failure to declare dividends. Proof derived from examination of the corporation’s expected rate of return on ploughback would be evaluated to determine whether the anticipated return on reinvested earnings is sufficient to compensate the investor for dividends not received. No longer would the uncertainties of the business world act as an absolute bar to judicial review of a corporation’s financial policy contested in a shareholder suit.

Today, an increasing body of knowledge pertaining to corporate dividend policy and economic growth is available to courts.

Quantitative methods permeate the discipline of business administration, and management, it has been said, is becoming a science. Prior to the development of this kind of expertise, judicial hesitancy in reviewing business decisions [was] perhaps understandable. But it would seem that both legislature and court should now better than ever be able to define more precise legal standards for the protection of minority shareholders.

In order to implement the aforementioned reform of the law of dividend declaration, tax laws, which subject corporate earnings to double taxation, must be re-evaluated. The public cost of complete deductibility of corporate dividends would be approximately 15 billion dollars annually. It is doubtful whether deficit-ridden government could withstand the loss of so substantial a sum. Additionally, full deductibility would have the effect of causing the tax structure to become less progressive since

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108. Although retention of 50 percent of earnings may be excessive in certain instances, it does strike a workable balance between avoidance of shareholder oppression and conservation of judicial resources.


110. Id.

the affluent would be the primary beneficiaries of an increase in dividend pay-out coupled with a tax deduction accruing to the corporation. Yet, the consequence to society of the current status of dividend declaration and double taxation of corporate earnings is the inefficient allocation of capital resources. Imaginative manipulation of the tax structure could result in encouragement of greater dividends without loss of needed revenues to the state. Dividends paid by corporations could be deducted from their taxable income and the corporate tax rate increased to compensate the government for revenues lost. This would encourage the declaration of dividends without reducing overall corporate tax liability. But such a change in the tax law could work a hardship on those firms unable to declare a dividend. Perhaps the better solution would be to tax corporate dividends at the same rate as capital gains but concomitantly lessen the distinction between ordinary income and capital gains. This would result in providing dividends with a tax preference while minimizing the government's overall loss of revenue.

Despite the fact that delimitation of management's discretion to declare or pass a dividend would be a welcome reform, individual states could not enact such a provision without precipitating an exodus of corporations incorporated under the laws of the state, causing a loss of state revenues. As Professor William L. Cary observes, the competition among states to attract the most incorporations, with their attendant payment of fees into state treasuries, has resulted in a "race for the bottom," with each state vying against the others to appear least restrictive. Thus there is a need for the enactment of a federal corporate minimum standards act incorporating dividend reforms which when coupled with appropriate tax reforms, would facilitate the declaration of dividends and result in a more efficient deployment of capital.

David Michael Israel