1979

Corporate Governance in Historical Perspective

Philip A. Loomis Jr.

Beverly K. Rubman

Follow this and additional works at: http://scholarlycommons.law.hofstra.edu/hlr

Recommended Citation
Available at: http://scholarlycommons.law.hofstra.edu/hlr/vol8/iss1/8

This document is brought to you for free and open access by Scholarly Commons at Hofstra Law. It has been accepted for inclusion in Hofstra Law Review by an authorized administrator of Scholarly Commons at Hofstra Law. For more information, please contact lawcls@hofstra.edu.
CORPORATE GOVERNANCE
IN HISTORICAL PERSPECTIVE

Philip A. Loomis, Jr.*
Beverly K. Rubman**†

As this symposium well illustrates, questions about the governance of corporations, the accountability of management, the role and function of the board of directors, and the rights of shareholders are very much alive today.¹ Because little was said about corporate governance in the 1940's or 1950's, there is a tendency, particularly in corporate circles, to regard this concern as something new. The current interest in these issues has been attributed to increasing disillusionment with established institutions, to shareholder activists' demands for a voice in corporate policies that have a social impact,² and to revelations of widespread "questionable

* Commissioner, Securities and Exchange Commission, and member of the California Bar.
** Legal Assistant to Commissioner Loomis, and member of the Pennsylvania and District of Columbia Bars.
† The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its members or employees. The views expressed herein are those of the authors and do not necessarily reflect the views of the Commission.


². The Campaign to Make General Motors Responsible, popularly known as Campaign GM, is a well-known example of this phenomenon. For a general description of Campaign GM by one who was counsel to the project, see Schwartz, The Public-Interest Proxy Contest: Reflections on Campaign GM, 69 MICH. L. REV. 421 (1971).

Campaign GM was launched in 1970 by the Project on Corporate Responsibility, a nonprofit corporation formed to promote corporate responsibility and to educate management and the public about the social role of corporations. Campaign GM at-
and illegal payments and other misuses of corporate funds. Whatever the cause, the recent debate and discussion about corporate accountability and governance at the Securities and Exchange Commission (Commission), in Congress, and in the legal litera-

tempted to mobilize support for its corporate accountability goals through the use of the shareholder proposal mechanism established by rule 14a-8 under the Securities Exchange Act of 1934. 17 C.F.R. § 240.14a-8 (1979). Proposals were submitted by the Project from 1970 through 1975. For example, two proposals were included in General Motor’s proxy statement for the 1970 annual meeting and were voted upon by the company’s shareholders. The first proposal was to amend GM’s bylaws to increase the number of directors on the board by three persons. The second proposal was to create a Shareholder Committee for Corporate Responsibility, to be selected by representatives of GM, the United Auto Workers, and Campaign GM. Its purpose was to conduct a one-year study of a number of basic issues concerning GM’s role in society and to submit a report directly to the corporation’s shareholders. Schwartz, supra, at 424. See also Schwartz & Weiss, An Assessment of the SEC Shareholder Proposal Rule, 65 Geo. L.J. 635 (1977):

In 1976, more shareholder resolutions on social issues (133) came to votes at more corporate annual meetings (88) than ever before. . . . Among the issues raised in 1976 were the Arab boycott of Israel; corporate operations in South Africa, Rhodesia, Korea, and Chile; agriculture in developing countries; corporate political activities and questionable corporate payments abroad; the B-1 bomber program; equal employment opportunity; accuracy in television news broadcasting; corporate-union relations; and strip mining in Appalachia and on Indian lands.

Id. at 637 n.11 (citation omitted).

3. The Securities and Exchange Commission’s use of the term “questionable payments” rather than “bribes” results from two factors: The frequent uncertainty concerning exactly what has been done with money in a foreign country; and additional legal uncertainty as to exactly what varieties of payments are or are not “legal” under the laws of certain nations. See generally SECURITIES AND EXCHANGE COMMISSION, REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (submitted to the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. (Comm. Print 1976)).

4. See generally Address by Commissioner John R. Evans, Corporate Checks and Balances, before the Middle Atl. Regional Group of the Am. Soc’y of Corp. Secretaries, in Washington, D.C. (Jan. 11, 1978); Address by Commissioner John R. Evans, SEC Influence on Corporate Ethics and Governance, before the Southwest Assembly on Corp. Ethics and Governance, in Tanglewood, Tex. (June 9, 1978); Address by Commissioner Roberta S. Karmel, The Nominating Committee as a Corporate Accountability Mechanism, before the Chicago Ass’n of Com. and Indus., in Chicago, Ill. (Apr. 28, 1978); Address by Commissioner Roberta S. Karmel, Politics of Change in the Composition and Structure of Corporate Boards, before the Am. Soc’y of Corp. Secretaries, in Chicago, Ill. (Jan. 11, 1978); Address by Commissioner Philip A. Loomis, Jr., S.E.C.’s Concern with Corporate Governance, before the Fin. Executives Inst., in Pittsburgh, Pa. (Nov. 20, 1978); Address by Chairman Harold M. Williams, Corporate Accountability, before the 5th Ann. Sec. Reg. Inst., in San Diego, Cal. (Jan. 18, 1978); Address by Chairman Harold M. Williams, Corporate Accountability and the Lawyer’s Role, before the Section of Corp., Banking, and Bus. Law of the ABA, in New York, N.Y. (Aug. 8, 1978); Address by Chairman Harold M. Williams, Corporate Accountability—One Year Later, before the 6th Ann. Sec. Reg. Inst., in San Diego, Cal. (Jan. 18, 1979); Address by Chairman Harold M. Williams,
HISTORICAL PERSPECTIVES

The purpose of this Article is to step back from the current commotion and place modern proposals and concerns about how corporations are run in an historical perspective. Many of the issues raised today—federal incorporation, the proxy solicitation process, the role and responsibility of the corporation's board of directors—were widely discussed and analyzed in the popular and legal literature of the late 1920's and 1930's. That debate resulted, in part, in the enactment of the basic federal securities laws.7

Analysis of the corporate condition began then, as it does today, with the position of the shareholder. In 1931, A.A. Berle, Jr., described the stockholder's role in the corporate structure:

The stockholder has changed his position in American financial life so radically that the old rules no longer apply. Originally he was supposed to be a kind of modified partner in a small enterprise, usually a business man of means, able to take care of himself, and to take active part in the counsels of his corporation. During the past generation this situation has almost completely reversed itself. There are about 5,000,000 persons in the United States who today own stock . . . and the number is steadily increasing. An overwhelming majority of these are "little people," that is, members of the investing public who own small blocks of stock, who know little or nothing about the corporate activities; whose advice is not sought in running the corporation and probably would be worth little if it were given. . . . [The stockholder] trusts implicitly to the corporate management; his function is merely to contribute the capital . . . .

The Emerging Responsibilities of the Internal Auditor, before the Inst. of Internal Auditors (June 19, 1978).


6. See authorities note 1 supra.

This system in the aggregate virtually amounts to a new form of property tenure.\(^8\)

This description was developed the following year in a book that has become the classic work on corporate governance theory, *The Modern Corporation and Private Property*,\(^9\) written by Berle, then a professor at Columbia Law School, and subsequently a member of the New Deal Brain Trust, and Columbia University economist Gardiner Means. Berle and Means first documented and then examined the significance of the divorce of beneficial ownership from control of operations in the modern corporation; in their view, "[t]his dissolution of the atom of property destroys the very foundation on which the economic order of the past three centuries has rested."\(^10\) Berle and Means recognized an inherent inevitability in this situation. Once the enterprise grew beyond the actual control of the capital-suppliers, someone had to be deputized to run the business; and once that someone gained control and the business expanded the shareholders were pushed further and further away from a position of managerial authority. As a result, the concept of the corporation, as embodied in many state corporate laws, no longer corresponded with the reality of the large corporation. It may be said that the debate over corporate governance, then and now, is essentially over what should be done about this divergence.

**Problems—Internal and External Abuses**

Corporate governance issues and suggestions for reform cannot be properly appreciated without an understanding of the broader corporate picture that necessitated those reforms. Before describing those corporate abuses that received the most widespread critical commentary, it is necessary to emphasize that these descriptions do not apply to the behavior of all or even most corporations in the 1930's. This Article focuses, as did the commentators, on the lowest common denominator. Although these abuses eventually led to some federal regulation, this does not mean that improper behavior was usual, only that the problem was serious enough to call for a remedy.

---

10. *Id.* at 8.
While the critical literature tended to lump its description of the corporate situation into an undifferentiated mass, two distinct concerns emerged: One focus was upon external controls exerted on the corporation by other persons and entities. The second concern was the internal governance issue of the shareholder's place within the corporation. These factors necessarily reinforce each other, and some, although not all, internal problems occur because of the external control maintained over the corporation; nevertheless, to understand the whole picture, the two strands must first be separated.

**External Controls**

Control of a particular corporation often did not rest within that institution. The prevalent use of holding companies allowed a parent corporation to direct the affairs of its far-flung subsidiaries to whatever purpose it might desire. Particularly frightening was how little the parent had to own of the subsidiary's stock to obtain control. Through the pyramid structure, the parent began by owning a majority share in one corporation that in turn held a majority in another and so on down the line. Moreover, the parent or the intermediate holding company often obtained ownership by issuing bonds and nonvoting stock in lieu of cash contributions to acquire the shares. Ultimately, control was obtained over a large operating company with only a miniscule capital contribution.

While the abusive control often exercised by holding companies over their diverse subsidiaries drew widespread criticism, there was not equal unanimity on how to subdue these giants. One solution was to outlaw them altogether and return to the pristine days that preceded their enabling by New Jersey in 1889. Others preferred the more moderate course of strengthening the internal

11. See id. at 72-75, 203-06. As was true of many of the abusive devices attacked by reformers, the holding company was a creation of the so-called liberal incorporation states, such as New Jersey and Delaware. The common law prohibited one corporation from owning stock in another. But, beginning with New Jersey in 1889, the right of one corporation to invest in another spread throughout the legal world. See W. Ripley, Main Street and Wall Street 73-74 (1926).

12. A. Berle & G. Means, supra note 8, at 72-75. For example, at one time the Insull interests controlled companies at the bottom of the pyramid by owning as little as two hundredths of one percent of the securities of those companies. 1 L. Loss, Securities Regulation 14 n.49 (2d ed. 1961).

13. See note 11 supra. As will be seen, this solution was proposed in several notable bills providing for federal incorporation. See note 67 infra. See generally text accompanying notes 65-85 infra.
corporate processes so that even if the majority of a company's stock were owned by an outsider, that outsider would be obligated to act in the best interests of the particular corporation. For example, Professor William Z. Ripley of Harvard University, an often caustic critic, refused to take the extreme position:

Why not restrain the holding company? "Swat it!" says one public spokesman. I would do so; yet ever with a nice discernment. The fly—bluebottle, horse, domestic, or gad—is always a pest. Not so the finance corporation. It has its proper place and function in the scheme of things. But within that domain it should be rigidly confined. . . . Piling of one corporation upon another . . . simplifies finance and management, augmenting credit and enabling large-scale operation and the employment of higher-paid technicians. But it is also true that a large part of this complexity is the result of a deliberate intent to assume and concentrate power in the hands of an inner circle.  

Thus Ripley would permit one company to acquire all the stock of another operating company but would view an attempt at control through only a minimal investment with suspicion as an attempted concentration of control in restraint of trade. Instead of an outright prohibition of this latter form of holding company, Ripley proposed expanded voting rights for shareholders and even bondholders. Presumably, Ripley thought that if the masses of now-uninvolved shareholders would make more effective use of their voting rights, it would at least prevent a holding company from exercising effective control based on less than majority ownership.

Another aspect of external corporate structure highlighted by critics was the identity of those who controlled these complex holding company empires: Far too often, control was vested in the investment banking community. The rallying cry against the dominance of the so-called "Money Trust" in all of corporate affairs was most eloquently sounded by Louis Brandeis in *Other People's Money*, written in 1913. Brandeis viewed the combined roles of money lender, financial adviser, stock underwriter, and corporate

15. W. RIPLEY, supra note 11, at 101-02. Ripley used 51% of the outstanding stock as an example. Id. at 101. Of course, control was obtained over many corporations by a far smaller ownership interest. See note 12 supra and accompanying text.
16. W. RIPLEY, supra note 11, at 102-09.
17. L. BRANDEIS, OTHER PEOPLE'S MONEY (1913).
insider as wholly incompatible. In the aggregate they produced a financial oligarchy that imperiled not only sound business but industrial and political liberty.  

"Though properly but midlemen, these bankers bestride as masters America's business world, so that practically no large enterprise can be undertaken successfully without their participation or approval."  

In a similar vein, the questioning at the Pecora Hearings, held in 1933 to investigate contemporary corporate practices, evinced congressional concern for the influence wielded by bankers in their role as corporate directors.  

Although the investment bankers who testified, including J.P. Morgan, all denied that their position on a company's board was anything but beneficial to the interests of that company, their testimony also provided a fascinating glimpse at the range of their involvement in the general corporate world. For example, J.P. Morgan noted that while he sat on but seven boards, his firm as a whole held 167 directorships.  

Brandeis virulently attacked the entire system of interlocking directorates that cemented the Money Trust together. Brandeis' attacks, 

---

18. Id. at 62.  
19. Id. at 4. Brandeis recognized that the holding company system culminated in the money trust, and thus the way to stop the latter was by controlling the former. He advocated, for example, strengthening the antitrust laws to dissolve the illegal monoliths and prevent new ones from being created. Id. at 160-61.  
21. See id. at 26, 33, 54 (statement of J.P. Morgan, member of J.P. Morgan & Co.); id. at 369, 389-95, 555-56 (statement of George Whitney, member of J.P. Morgan & Co.); id. at 1781, 1836-51 (statement of Ernest B. Tracy). Similarly, in a 1937 study the Commission concluded that bankers have been the spokesmen for management and a dominating force in reorganizations. SECURITIES AND EXCHANGE COMM’N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, Pt. 1 at 342 (1937).  
22. For example, the following exchange took place between J.P. Morgan and two Senators:  
Senator MacAdoo. Mr. Morgan, does your firm have a dominating interest in the policies of these various corporations in which the members of the firm are directors?  
Mr. Morgan. We have no more domination than one vote gives us.  
Senator Gore. Unless they are borrowers?  
Mr. Morgan. Even if they are borrowers. Pecora Hearings, supra note 20, at 26, 33 (exchange between Senators MacAdoo and Gore, and J.P. Morgan, member of J.P. Morgan & Co.); see id. at 467, 555-56 (statement of George Whitney, member of J.P. Morgan & Co.).  
23. Id. at 26, 29-32, 52, 54 (statement of J.P. Morgan, member of J.P. Morgan & Co.).
tack was not only directed against those boards of various corporations with common directors; his definition of interlock included "all intertwined conflicting interests, whatever the form, and by whatever device effected." 24 Brandeis sought to forbid all such interlocks, in the interests of both the corporation and society at large:

The practice . . . is the root of many evils. It offends laws human and divine. Applied to rival corporations, it tends to the suppression of competition and to violation of the Sherman law. Applied to corporations which deal with each other, it tends to disloyalty and to violation of the fundamental law that no man can serve two masters. 25 In either event it tends to inefficiency; for it removes incentive and destroys soundness of judgment. It is undemocratic, for it rejects the platform: "A fair field and no favors,"—substituting the pull of privilege for the push of manhood. It is the most potent instrument of the Money Trust. Break the control so exercised by the investment bankers over railroads, public-service and industrial corporations, over banks, life insurance and trust companies, and a long step will have been taken toward attainment of the New Freedom. 26

These, then, were the basic sides to the external corporate picture. As already noted, they cannot be separated from the inter-

24. L. BRANDEIS, supra note 17, at 51-52.
25. Brandeis disagreed vehemently with two particular judicial rules that permitted potential conflicts of interest by allowing common directors, albeit under limited circumstances. Id. at 57-60. The first rule held valid a contract between a corporation and its director or between two corporations with a common director where the corporation was represented by independent directors and the interested director’s vote was unnecessary. For a vast expansion on this judicial rule, see note 34 infra. In the second instance, courts held that a contract between two corporations in which a common director actively participated was voidable at the corporation’s election, not void per se.
26. L. BRANDEIS, supra note 17, at 51. Berle and Means take a more moderate position on the subject of interlocking directorships in general:

From a business point of view the result is the final test; if what [the common director] does on the whole makes for a sound development of both companies, the fact that he acts for two adverse interests at the same time is rather to his credit than otherwise. The one ethical point on which everyone is agreed is that the adverse interest, if any, must be disclosed.

A. BERLE & C. MEANS, supra note 8, at 230-31 (footnote omitted). However, those authors agreed with Brandeis that where a director is an important factor in the "control" of two corporations at once, an untenable conflict of interest position arises. Id at 231 n.15, quoted with approval in Douglas, Directors Who Do Not Direct, 47 HARV. L. REV. 1305, 1313 n.27 (1934). See Clayton Act, ch. 323, § 8, 38 Stat. 732 (1914) (current version at 15 U.S.C. § 19 (1976)) (forbids, inter alia, one person from serving as director on boards of two or more qualifying competing corporations). See also SCM Corp. v. FTC, 565 F.2d 807 (2d Cir. 1977).
nal aspects; indeed, that many corporations were controlled by individuals whose interests were, at best, devoted to more than the single corporate entity helps explain why so many abuses existed. On the other hand, the tools that state law put into the hands of corporate boards, regardless of their identity, made it possible for shareholders to be abused by internal, as well as external, management.

Internal Factors

During the 1920's and early 1930's corporate managers were often given free reign to manage the corporation's affairs untrammeled by shareholder scrutiny or control. Virtually all commentators in that period condemned management's ability to deprive shareholders of full and accurate information about the condition of their corporation. The annual reports that did exist were "distinguished for [their] vagueness and generality and for [their] capacity to conceal and suppress vital facts." One basic problem with those reports was the lack of any standardized system of account-

27. E.g., A. BERLE & G. MEANS, supra note 8, at 330; W. RIPLEY, supra note 11, at 109-11, 156-207; H. SEAGER & C. GULICK, TRUST AND CORPORATION PROBLEMS 636-37 (1929); Douglas, supra note 26, at 1323-24. Douglas advocated disclosure of more than basic financial information; he urged that full publicity be given to "the activities of the managers and the board in relation to the shareholders' money." Id. at 1324. Berle and Means urged full disclosure of all material facts to prevent insiders from trading on the basis of nonpublic information. A. BERLE & G. MEANS, supra, at 330. Even Henry W. Ballantine, who disagreed with Ripley's presumption (and presumably that of Berle and Means, although his articles preceded their book) that shareholders did own the corporation in any fundamental sense apart from what was allowed them in the charter, did agree that the most valuable part of what he called "Ripley's polemic" was that directed to a shareholder's right to adequate information. Ballantine, Ripley's Indictment of Corporate Skullduggery, 62 AM. L. REV. 826, 831 (1928). For a discussion of federal chartering or incorporation proposals by several noted commentators over the years, see notes 65-89 infra and accompanying text.

28. Douglas, supra note 26, at 1324. Professor Ripley of Harvard who, as will be seen throughout this Article, was a fervent and spirited critic of the corporate abuses of his time described some companies' annual reports as being, "like Tristram Shandy, 'all obfuscated and darkened over with fuliginous matter.'" W. RIPLEY, supra note 11, at 164. See id. at 109-10, 115. Ripley adds that:

"[m]any [annual reports] do more to deaden than to arouse stockholders' interest. Whether by accident or design, such reports are drawn so as to withhold from the stockholder what he most desires to know . . . . When he reads that 'the decrease in miscellaneous accounts payable is due to withdrawals by affiliated companies to reduce their indebtedness for construction and other purposes,' he refrains from calling the report a mess of tripe only for fear of insulting an industrious and self-respecting farmyard animal."

Id. at 164 (quoting Wall St. J., issue unidentified).
companies were therefore free to portray their financial condition as they saw fit.\(^{30}\)

The unavailability of accurate corporate information reflected and helped perpetuate an even more serious problem: The scandal of insiders, officers, and directors taking advantage of their position to the detriment of the corporation, the shareholders, or both. The practice of issuing stock for overvalued assets, particularly to insiders, appears to have been widespread.\(^{31}\) Commentators also cited

\(^{29}\) W. Ripley, supra note 11, at 171-207; H. Seager & C. Gulick, supra note 27, at 638-40.

\(^{30}\) The one notable exception to this unfortunate state of affairs to which commentators continually cited seems to have been the United States Steel Corporation: "From the first annual statement, outspread over entire newspaper pages in 1903, down to the present time, its record has been consistently admirable." W. Ripley, supra note 11, at 164-65. See also H. Seager & C. Gulick, supra note 27, at 637.

During this period, commentators looked toward the newly consolidated English Companies Act as a model. One provision required that the directors of a company produce a balance sheet and profit and loss account in every calendar year to be presented to the company (that is, the shareholders) at the annual meeting. Companies Act, 1929, 19 & 20 Geo. 5, c. 23, § 123. The Act also provided that an auditor be selected at the annual meeting. Id. § 132(1). The auditor would examine the accounts and the balance sheet and report whether all the necessary information and explanations had been obtained, and whether, in their opinion, the balance sheet was properly drawn so as to exhibit a true and correct view of the state of the company's affairs, according to the best of their information. Id. § 134. Each shareholder was entitled to inspect the balance sheet and auditor's report upon request. Id. § 129(1).

Another British view of the obligation of corporate management to its shareholders is provided by the then-famous case wherein Lord Kylsant, "one of the most distinguished figures in English financial life," was found guilty of publishing a misleading prospectus of the Royal Mail Steam Packet Company and sentenced to 12 months in prison: I.M. Wormser, Frankenstein, Incorporated 112 (1931). The case involved false accounting methods that distorted the company's financial position. The King v. Kylsant (Lord) [1932] 1 K.B. 442 (1931). For further discussion, see I.M. Wormser, supra, at 112-14. However, what is interesting in the context of reporting requirements is the observation made by the Economist:

The board did not sufficiently trust the shareholders. . . . It is far too common for boards to assume that shareholders, either because they are ignorant and rapacious, or because they are irresponsible, or because they do not understand their own interests, or because they are spies from a competitive camp, or in general because they are a necessary nuisance, should be put off with the minimum of information. The attitude of mind which says "keep them quiet with a reasonable dividend and carry on" is utterly wrong, and unfortunately it is most common in the boards of the most prosperous companies. . . . Directors must realise that their shareholders are not schoolboys whom they are appointed to discipline, but fellow proprietors entitled to confidence and a proper share in the control of their own destiny.

The Kylsant Case, Economist, Aug. 1, 1931, at 211, 212.

\(^{31}\) See I.M. Wormser, supra note 30, at 141-53. According to Berle and
cases of excessive remuneration paid to officers and directors, and instances of insiders trading on inside information and on a non-arm's-length basis with their corporation. In addition, provisions began to appear in corporate charters that waived or released insiders from liability to the company for willful or negligent misconduct. Although in theory state corporate law should have been able to deal with many of these practices as breaches of fiduciary

Means, state laws requiring a fixed minimum contribution to a corporation's assets by each purchaser of original issue stock were eliminated in favor of no-par stock after 1912.

Thus, by the terms of the statute and the charter-contract, authority is commonly handed over to the board of directors to dilute at will. If there are any limitations on this (and there are), they come only from some common law check or balance on an apparently absolute power of dilution granted to the directors, involving both asset value and shares in earnings.


32. Excessive renumeration was a particularly common practice because so little information about the corporation's business and financial condition was available to the public. One of the most egregious examples cited by commentators involved the Bethlehem Steel Corporation. Between 1917 and 1928, corporate officers were paid over $31 million in bonuses while shareholders received less than $41 million in dividends. In 3 of the years shareholders received no dividends, while the corporation's president received a bonus that averaged $814,933 over 13 years. Federal Licensing of Corporations: Hearings on S. 10 and S. 3072 Before a Subcomm. of the Senate Comm. on the Judiciary, 75th Cong., 3d Sess. 509, 541 (1938) (statement of Willis J. Ballinger, economic adviser for FTC) [hereinafter cited as Hearings on S. 10 and S. 3072].

33. As described by Berle and Means, the then-accepted rule did not view directors as violating any fiduciary duty to shareholders if only individual shareholders, and not the corporation itself, were harmed. A director was, therefore, entitled to keep any profits made from trading on inside information. A. BERLE & G. MEANS, supra note 8, at 223-30. Nonetheless, courts were beginning to take the opposite view; and there was also a middle position that a director should be so liable if peculiar circumstances or special facts make it inequitable to act at the shareholders' expense. See Strong v. Repide, 213 U.S. 419 (1909); Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904). All three cases involved dealings between a shareholder and a corporate director who also controlled the relevant company.

34. Ripley and Seager and Gulick provide examples of corporate charters that specifically gave directors the right to vote upon transactions in which they were interested. Such a vote could not invalidate the deal or subject the director to liability. W. RIPLEY, supra note 11, at 44-61; H. SEAGER & C. GULICK, supra note 27, at 634. See also Pecora Hearings, supra note 20, at 1781, 1816-21 (statement of Ernest B. Tracy). This development stood in sharp contrast to the English Companies Act of 1929, which expressly prohibited such exculpatory provisions. Companies Act, 1929, 19 & 20 Geo. 5, c. 23, § 152. Furthermore the British law mandated disclosure by directors of their interests in all corporate contracts. Id. § 149. However, under the British law, once the director made any conflict of interest public, he or she was not barred from voting upon that matter at the board meeting.
duty, in reality the practice existed without sufficient legal control.\textsuperscript{35}

To many critics, most notably Professor Ripley, "the crowning infamy of all" was the disenfranchisement of, or emasculated version of suffrage allowed to, the vast majority of shareholders.\textsuperscript{36} The shareholder could easily be denied the right to vote by selling only nonvoting common stock to the public while issuing all the voting stock to a limited group of insiders.\textsuperscript{37} Perhaps the most egregious example occurred in the issuance of nonvoting common stock of the Dodge Brothers, Inc., in 1925. Dillon, Read and Company was able to gain control of the $130 million Dodge company by an investment of only $2.25 million. This was possible because Dillon, Read retained a majority of the voting common, and neither the preferred nor four-fifths of the company's common stock, both of which had been sold to the public, had the right to vote.\textsuperscript{38}

In a series of articles in the mid-1920's, Professor Ripley was among the first to denounce the horrors of the widespread use of nonvoting stock. Surprisingly, his cries were not in vain. The New York Stock Exchange and the New York Curb both refused to list issues of nonvoting common stock,\textsuperscript{39} and condemnation of the prac-

\textsuperscript{35} One of the issues that received considerable attention in the courts and from legal commentators was the precise relationship of the director to the corporation. While cases varied greatly, especially in result, commentators concluded that courts were in the process of evolving "a new jural relationship," which would impose stricter obligations upon a director to be determined on a case-by-case basis. See, e.g., Note, The Director of a Corporation as a Fiduciary, 20 IOWA L. REV. 808 (1935); Editorial Note, This Ubiquitous Director, 12 U. CINN. L. REV. 399 (1938); Note, Liability of Directors for Negligent Mismanagement, 82 U. PA. L. REV. 364 (1934).

\textsuperscript{36} W. RIPLEY, supra note 11, at 77. According to one commentator,
[n]one of the cynicism towards the importance of corporate voting elsewhere rampant has entered the courts. In the opinions of the judges the right to vote is "a property right," "a vested interest," "a vital right,"... "an essential attribute" of the stock itself, ... indeed, the stockholder's "supreme right and main protection."

Rohrlich, Corporate Voting: Majority Control, 7 St. John's L. Rev. 218, 219 (1933) (footnote omitted).

\textsuperscript{37} For a description of this practice, see A. BERLE & G. MEANS, supra note 8, at 75-76; I.M. WORMSER, supra note 30, at 91-92.

\textsuperscript{38} A. BERLE & G. MEANS, supra note 8, at 75-76; W. RIPLEY, supra note 11, at 86-87, 103-04; H. SEAGER & C. GULICK, supra note 27, at 631. Although the exact numbers differ depending upon which of these commentators is relied on, the point is the same.

\textsuperscript{39} See Berle, supra note 8, at 379. New York Stock Exchange prohibitions continue to the present day. NEW YORK STOCK EXCHANGE, COMPANY MANUAL Ch. A2, Part VI, at A-30 (Jan. 25, 1978).
tice appeared on all fronts. In fact, by the time Ripley's articles were collected into book form in 1926, the professor securely proclaimed that "[n]onvoting common stock . . . bears every appearance of being dead—dead beyond recall."41

The demise of nonvoting common resulted from outside pressure and outrage, not from a reformed consciousness on the part of certain corporate managers. Therefore, management soon invented other devices to perpetuate their control. These included issuing shares to the controlling group, who held voting power disproportionately greater than that possessed by ordinary publicly held common stock, and organizing voting trusts.42 In a typical voting trust a majority of a corporation's voting stock was placed in a trust run by chosen trustees. In turn, the public was offered trust certificates enabling them to share in the disbursements of trust income as determined by the trustees. The votes belonged to the trustees, not to the public investors. While such an arrangement was initially viewed with hostility, it was eventually given state statutory approval although the maximum length of time such a trust could run was often limited by statute.43 Even this control could be emasculated by having the trust agreement provide for renewal of the trust for additional terms at the discretion of the trustee.44

As recounted above, many felt that the worst possible situation was presented when shareholders were totally deprived of their right to vote. But what of those fortunate enough to have their

40. Ripley reproduced a lovely poem from the New York World, entitled, "On Waiting in Vain for the New Masses to Denounce Nonvoting Stocks":

Then you drive the fractious nail,  
And you lay the heavy rail,  
And all who bear the dinner pail,  
And daily punch the clock—  
Shall it be said your hearts are stone?  
They are your brethren and they groan!  
Oh, drop a tear for those who own  
Nonvoting corporate stock.

W. RIPLEY, supra note 11, at 121 (author unidentified). See generally Berle, supra note 8, at 379.

41. W. RIPLEY, supra note 11, at 122. While Berle and Means agreed with that assessment, A. BERLE & G. MEANS, supra note 8, at 76, another commentator who had more faith that management would behave honestly and honorably towards its shareholders than either Ripley or Berle and Means, was less sure that the practice had ended. J. SEARS, supra note 14, at 27.

42. A. BERLE & G. MEANS, supra note 8, at 76-77.

43. See, e.g., N.Y. BUS. CORP. LAW § 621 (McKinney 1963).

44. Id. § 621(d). See A. BERLE & G. MEANS, supra note 8, at 77-79.

45. Ripley analogizes the shareholder's acceptance of nonvoting stock in ex-
suffrage intact? The blossoming of stock ownership by more than a select group and the widespread dispersion of those shareholders meant that oversight of management and corporate affairs in general had to be delegated to a representative group, the board of directors. In selecting these representatives, the shareholder was generally not in a position, and was not encouraged, to attend the annual meeting where that representative was chosen and other business decisions were approved. Hence the proxy process, whereby the shareholder was given the opportunity to have someone vote in his or her stead for a representative who, in turn, existed in theory to protect the shareholder’s interests. It was well-recognized in the critical literature of the time that this two-step process meant that shareholder suffrage was really nonexistent. Berle and Means aptly described the process:

[C]ontrol will tend to be in the hands of those who select the proxy committee by whom, in turn, the election of directors for the ensuing period may be made. Since the proxy committee is appointed by the existing management, the latter can virtually dictate their own successors. Where ownership is sufficiently subdivided, the management can thus become a self-perpetuating body even though its share in the ownership is negligible.49

change for preferred status or set dividends to Esau’s sale of his birthright to Jacob for “a mess of pottage.” W. RIPLEY, supra note 11, at 78-117.

46. Professor Ripley describes this as the meeting of Main Street with Wall Street. Id. at 156-57.

47. Berle and Means describe this distant form of ownership: The growth of corporations, the dispersion of shareholders, the manifest impossibility for the vast majority of shareholders to attend meetings, have made the right to vote, in reality, a right to delegate the voting power to someone else—and the proxy is almost invariably a dummy chosen either by the management, by the “control,” or by a committee seeking to assume control. The proxy machinery has thus become one of the principal instruments not by which a stockholder exercises power over the management of the enterprise, but by which his power is separated from him.

A. BERLE & G. MEANS, supra note 8, at 139.

48. I.M. WORMSER, supra note 30, at 157-58; TEMPORARY NAT’L ECONOMIC COMM., 76th CONG., 3d Sess., BUREAUCRACY AND TRUSTEESHIP IN LARGE CORPORATIONS (Monograph No. 11) 19-21 (Comm. Print 1940) [hereinafter cited as TNEC, Monograph No. 11]; Douglas, supra note 26, at 1315-16. Note also Ripley’s observation: “The average stockholder is entirely unqualified to engage actively in management. For a surprisingly large number of great corporations more than half of the shareholders are women . . . . Such a multitude are ill-fitted by training—begging the moot point of sex[]—to govern directly, less so than in politics.” W. RIPLEY, supra note 11, at 129.

49. A. BERLE & G. MEANS, supra note 8, at 87-88 (footnote omitted).
In a similar vein, Thomas G. Corcoran, one of the proponents of what was to be the Securities Exchange Act of 1934, candidly asserted that:

Proxies, as solicitations are made now, are a joke. The persons who control the machinery for sending out the proxies, with practically no interest in the corporation, can simply keep other people from organizing, can get enough proxies to run the company. At most stockholders’ meetings, no one turns up, and the proxy is always very carefully worded to approve all acts of the officers and directors for the preceding fiscal year.50

Given their method of selection it is hardly surprising that often the directors did not serve the shareholders’ interests. In the 1930’s, as is true today, critics viewed the proper functioning of the board as a key element in meaningful corporate accountability. The following section will, therefore, describe the problems the critics saw in implementing effective board oversight over management.

PROBLEMS—THE BOARD OF DIRECTORS

A general theme running throughout the critical literature of the time was that directors were not living up to their duties of obedience, diligence, and loyalty to the corporation.51 While most boards were composed of a combination of management and non-management directors, true oversight could come only from this second group. Unfortunately, as critics recognized, many boards were filled with “window-dressing directors” and “financial gigolos,” whose names appeared on board rosters but who served no one.52

50. Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 82, 140 (1934) (statement of Thomas G. Corcoran, member of Office of Counsel, Reconstruction Finance Corp.) [hereinafter cited as Hearing on H.R. 7852 and H.R. 8720]. One example of the proxy process in action was provided at the Pecora Hearings. Pecora Hearings, supra note 20, at 6206, 6206-16 (statement of Russell R. Brown, board chairman of American Commercial Alcohol Corp.) Not a single shareholder appeared at the particular meeting in question; instead all 179,614 shares of stock were represented by one man. The letter that solicited the proxies briefly described the action to be taken at the special meeting, mainly authorizing an increase in the amount of common stock, and asked for blanket ratification of all acts taken by the company’s officers and directors. The letter omitted all mention of “previously granted secret options in the corporation’s stock, and the president’s individual interest in an underwriting agreement made by the corporation, which furnished the real motive behind the request for ratification.” S. REP. No. 792, 73d Cong., 2d Sess. 12 (1934).

51. See, e.g., Wormser, Directors—Or Figures of Earth?, 1 BROOKLYN L. REV. 28 (1932).

52. I.M. WomISER, supra note 30, at 126-27; Douglas, supra note 26, at 1318.
This problem was apparently not limited to the United States. For example, the following wonderfully honest advertisement appeared in the London Daily Telegraph of October 4, 1932: "A Titled Gentleman is invited to communicate with a progressive company with a view to installing him as a director."53

The problem with these directors was not their lack of loyalty or obedience but the total absence of diligence in fulfilling their roles as directors. An often-cited case involved one George J. Gould, who agreed to be a director of a company upon the express understanding that he was not expected to attend meetings or to take an active part in the company's business. When the company suffered heavy losses during Gould's tenure as director due to improper dealings by the president, a shareholder sued Gould for damages. The New York Court of Appeals agreed that a director could be held liable for failing to exercise "reasonable care."54

Thus the courts recognized, at least in the most egregious cases, that directors were liable to their corporations for more than just willful misconduct. However, the more common reality of boardroom behavior in the 1930's was aptly described by Maurice Wormser: "On the stage of the corporate directory there is generally but one thinking and speaking part"—the corporate manager.55

Commentators discussed other factors contributing to the board's ineffectiveness: The practice of holding multiple director-

In England, those men were also called "guinea-pig directors" because they received a traditional fee of one guinea per meeting, accompanied by a free lunch. H. Samuel, Shareholders' Money 111 n.1 (1933). There exists, in a large sense, a symbiotic relationship between corrupt management and a docile, nonfunctioning board: Management, through control of the nominating and proxy process, appoints the board and it, in turn, gives legitimacy to management's improper acts.

53. Douglas, supra note 26, at 1318 (quoting H. Samuel, supra note 52, at 112). Much of Douglas' article consists of describing Samuel's suggested cures for those British corporate ills that were all too familiar to American readers. Contrary to popular belief, Douglas found the English system of corporate control to be grossly inadequate:

We [Americans] incline to the view that England is years ahead of us in control over corporations and that the directors of British companies are conservative, respectable, and above reproach. . . . Such implicit confidence in the efficacy of the English system is considerably shaken by this report. It reveals a condition of depravity in the management of British companies which is at times beyond the imagination of the American reformer.

Id. at 1318.


55. I.M. Wormser, supra note 30, at 129-30. This same description was used by the Economist in its commentary on the Kylsant case. See note 30 supra.
ships,\textsuperscript{56} owning only nominal amounts of stock in corporations in which they served as directors,\textsuperscript{57} and receiving minimal compensation for serving as board members.\textsuperscript{58} In a study done in 1939-1940 for the Temporary National Economic Committee (TNEC),\textsuperscript{59} the researchers, without assigning reasons for the phenomenon, stated that in roughly three-fourths of the companies studied the board had only a small role to play:\textsuperscript{60} "[I]n practice many boards today are little more than formal ratifying bodies for the decisions of management. In many cases they could be eliminated and almost no one would realize it. Their important functions have been largely removed; a nearly inanimate body remains."\textsuperscript{61}

Ironically, the TNEC study and others found that the only boards that functioned were those with "a heavy sprinkling of members who were officers."\textsuperscript{62} This occurred, in part, in reaction

\textsuperscript{56} TNEC, Monograph No. 11, supra note 48, at 125-26; Patterson, \textit{Wanted: Directors Who Direct}, N.Y. Times, Jan. 21, 1940, § 7 (Magazine), at 6, 18. \textit{See generally} TNEC, Monograph No. 11, supra, at 6 (chart II: Interlocking Directorates Among 100 Large Corporations, 1935).

\textsuperscript{57} For 1928 figures, see Schell, \textit{Trends in the Functions and Composition of Boards of Directors}, in \textit{HANDBOOK OF BUSINESS ADMINISTRATION} 401, 406-07. \textit{See also} I.M. Worman, supra note 30, at 126; Douglas, supra note 26, at 1319 n.38.

\textsuperscript{58} Schell's 1928 figures on directorial reimbursement are shocking. Of the 36 manufacturing companies he examined with sales of over $5 million, the most frequently cited fee paid to directors was $20. Schell, supra note 57, at 409. A 1940 New York Times Magazine article stated that the average director's salary was then $285 per year. Patterson, supra note 56, at 18; \textit{see TNEC, Monograph No. 11, supra note 48, at 126.}

\textsuperscript{59} The Temporary National Economic Committee (TNEC) was created by congressional resolution in 1938 to make "a full and complete study ... [of] monopoly and the concentration of economic power in and financial control over production and distribution of goods and services." S.J. Res. 300, 75th Cong., 3d Sess., ch. 456, § 2, 52 Stat. 705 (1938). The TNEC was composed of three members each from the House and Senate and one representative each from the Departments of Justice, Treasury, Labor, Commerce, the Federal Trade Commission, and the Securities and Exchange Commission. The Committee was chaired by Senator Joseph O'Mahoney of Wyoming, who advocated a federal licensing statute combining strict antitrust principles with corporate accountability measures. \textit{See notes} 77-89 \textit{infra} and accompanying text. The TNEC held almost 800 hours of hearings from 1938 through 1940 and, under its auspices, 43 monographs were prepared on a wide range of subjects. The Committee's work ended as the United States' attention shifted to the more pressing problems of World War II. \textit{See TEMPORARY NAT'L ECONOMIC COMM., FINAL REPORT AND RECOMMENDATIONS, S. DOC. NO. 35, 77th Cong., 1st Sess. 691-729 (1941).} \textit{See generally id.}

\textsuperscript{60} TNEC, Monograph No. 11, supra note 48, at 23-24.

\textsuperscript{61} \textit{Id.} at 124.

\textsuperscript{62} \textit{Id.} at 24; Douglas, supra note 26, at 1313-14. Douglas characterized "boards wholly or dominantly filled with 'shirtsleeve' directors" as "apt to suffer from myopia and lack of perspective." \textit{Id.} at 1314; \textit{see Patterson, supra note 56, at 18.}
to the window-dressing directors and also as an attempt to regain control of the corporation from the past influences of investment bankers and other outsiders. While in some respects this process was a healthy one, insider boards did not cure the anomalous situation of management acting without anyone exercising effective control over them on the shareholders' behalf.63

Because many of the problems with directors stemmed from inaction rather than from active malfeasance, commentators were most eloquent in denouncing the results of directorial abdication rather than in giving concrete reasons for their inadequacies:

The moral which adorns this tale is simple . . . [D]irectors must be vigilant, they must be faithful, they must perform their important functions, they must be diligent and prudent, and, when tried in the balance, they must be found not wanting. If they fall short, they must be prepared to pay the penalty in meal and in malt. If it be objected that this responsibility is too stringent, the answer is simple: corporate business life otherwise cannot go on.64

SOLUTIONS—FEDERAL INCORPORATION OR LICENSING

Proposals in the early twentieth century for federal action, like the abuses they addressed, tended to be broad. Critics attempted to reform more than the way corporations treated their shareholders; they also sought to change the broad role that those corporations played in the economic and social life of the United States. For that reason, antitrust limits and internal corporate accountability recommendations have been common themes running through most of the proposals for federal licensing or incorporation.

This was evident as early as the 1880's, when the public first became concerned about the growing economic and political power of the trusts, and some reformers advocated a form of federal licensing to control their excesses.65 Instead, Congress passed the Sherman Act in 1890.66 When that failed to control the corpora-

63. See TNEC, Monograph No. 11, supra note 48, at 25; Patterson, supra note 56, at 18.
64. Wormser, supra note 51, at 35.
tions, proposals for federal incorporation and licensing reemerged; proponents often saw these both as a tool for stamping out the abuses perpetrated by management on unknowing shareholders and as part of a strengthened antitrust attack on the national power of corporate America. These proposals would have the federal government either (1) require corporations engaging in interstate commerce to obtain a federal license or corporate charter after meeting certain substantive standards, or (2) take over the business of incorporation altogether and totally displace the states' role.

The first official endorsement of this form of federal remedy came from James R. Garfield, Commissioner of Corporations. In his 1904 report, Garfield recommended that a compulsory federal franchise or license system for corporations in interstate commerce be enacted "to reform the present condition of corporate business


We favor the declaration by law of the conditions upon which corporations shall be permitted to engage in interstate trade, including among others the prevention of holding companies, of interlocking directors, of stock watering, of discrimination in price, and the control by any one corporation of so large a proportion of any industry as to make it a menace to competitive conditions.

Democratic Platform of 1912, reprinted in part in FTC Report, supra, at 44, 44. A 1933 FTC memorandum on this early period found that:

The weight of what might properly be designated as official opinion was in favor of Federal licensing. ... Strange as it may seem, leading men of industry and leading scholars stood side by side for Federal incorporation—but for different reasons. Industry ... advocated Federal incorporation chiefly to avoid the annoyance of conflicting legislation and jurisdictions. The scholars advocated Federal incorporation chiefly as the best method in the public interest. All seemed agreed that what was then commonly referred to as "pitiless publicity" was desirable as to corporate matters.

Memorandum from William T. Chantland and Anna Boyle to Robert E. Healy, Chief Counsel, FTC (Mar. 3, 1933), reprinted in FTC Report, supra, at 3, 4. Another commentator explained that before 1910 or 1911, industry "felt they would like to have [incorporation] in the hands of a friendly and benevolent centralized government. Then somehow or other, they began to make their peace with the States, and they have gotten along rather well." Hearings on S. 10, supra, at 49, 55 (statement of John T. Flynn, economist); see Thacher, Federal Control of Corporations, 14 Yale L.J. 301 (1905).

68. The Bureau of Corporations, which Garfield headed, was part of the Department of Commerce and Labor.
in all its important features." The system sought to address four basic abuses: Nonexistent financial statements, overcapitalization through the issuance of watered stock, secrecy and dishonesty in stock promotion and in the subsequent administration of the corporation, and unfair methods of competition. The report proposed requiring corporations to disclose the consideration paid for any property taken by the company at its inception, the details of the organization, the arrangement of stock interests, the bond indebtedness, and information about the management personnel. The report also increased the personal responsibility of corporate managers, prohibited methods of unfair competition, and imposed certain limits on a corporation's capital structure.

As public debate on the incorporation question continued, President Taft and his Attorney General George Wickersham proposed a variant form of federal regulation of internal corporate activity. While comprehensive in scope, the bills relied on voluntary corporate participation to achieve their goals. The bills sought to regulate the participants by outlawing the holding company by prohibiting one corporation from acquiring or holding stock in any other, prohibited corporations from engaging in the business of banking, mandated the filing of annual reports, and attempted to deal with the problem of watered stock by requiring filings with the corporation commissioner before stock could be issued for property. Despite the wide-ranging interest and debate over fed-


70. See id. at 304. Thacher was adamantly opposed to any form of federal licensing or incorporation. He thought that the states alone could remedy any defects that might exist in current corporate management, stock promotion, and the like, and that the only possible jurisdiction for such a federal statute rested on antitrust grounds. Id. at 309.


72. Id.


74. Washington Notes, 18 J. POL. ECON. 220, 221-22 (1910), quoted in FTC REPORT, supra note 67, at 9. Wickersham explained in a 1912 article that a uniform federal law would remove all the scandal of corporate organization, of inflated capitalization, of deceit of the public through lack of information or dissemination of misinformation, and would thus enable the business of the country to be conducted on a safe and sane basis. The Federal corporation, being a creature of the Federal law, would be entirely subject to Federal control; and from time to time, as tendencies developed which seemed to run counter to the public interests, they could be checked by appropriate legislation.
eral incorporation during the Progressive Era, such a statute was never enacted. Instead those energies were diverted into pure antitrust channels, resulting in the Clayton and Federal Trade Commission Acts of 1914.75

Nonetheless, during the next twenty years federal incorporation and licensing proposals held a central place in the debate over corporate governance. Prior to enactinent of the federal securities laws, critics viewed federal licensing as the only viable alternative to the laxity permitted by the "charter mongering" states, notably Delaware.76 Once again, however, Congress chose to travel a different route. The proponents of the Securities Exchange Act recognized the difficulty in obtaining a federal incorporation law and opted instead for a more limited approach. Once in place, the disclosure mandated by the federal securities laws and other corporate reforms did much to stamp out the worst of the current abuses, temporarily muting the cries for an incorporation solution.

Prior to current efforts, the last notable push for federal licensing occurred in the late 1930's. Again, the impetus came from antitrust interests. In 1938 Senators Borah and O'Mahoney introduced and held extensive hearings on two bills that would have required all corporations with substantial gross assets that were engaging in interstate commerce to obtain a federal license.77

Wickersham, The Enforcement of the Anti-Trust Law: Its Merits, Its Operation, and the Means to Supplement It, 83 CENTURY MAG., 616, 618-19 (1912), reprinted in part in FTC REPORT, supra note 67, at 18, 18-19. However, Seager and Gulick assert that the main purpose of the recommendation was to secure compliance with the antitrust laws. H. SEAGER & C. GULICK, supra note 27, at 635-36.


76. See, e.g., H. SEAGER & C. GULICK, supra note 27, at 629, 633-36, 640-53; Flynn, Why Corporations Leave Home, 150 ATLANTIC MONTHLY 268 (1932). Seager and Gulick favored immediate mandatory federal incorporation for railroads and other interstate service companies, and voluntary incorporation for all others, with the ultimate goal to be mandatory incorporation for all: "The states have demonstrated their incompetence; the resulting disharmony is spread over thousands of pages of court records. The federal government must act." H. SEAGER & C. GULICK, supra, at 649. Even Richard Whitney, president of the New York Stock Exchange, spoke in favor of a law mandating federal incorporation. Pecora Hearings, supra note 20, at 6709, 6715-16 (statement of Richard Whitney, president of NYSE).

77. S. 10, Federal Licensing of Corporations: Hearings on S. 10 Before a Subcomm. of the Senate Comm. on the Judiciary, 75th Cong., 1st Sess. 1 (1937) [hereinafter cited as S. 10]; S. 3072, Federal Licensing of Corporations: Hearings on S. 10 and S. 3072 Before a Subcomm. of the Senate Comm. on the Judiciary, 75th Cong., 3d Sess. 351 (1938) [hereinafter cited as S. 3072]. Senator O'Mahoney gives the reader a fascinating glimpse into some of the forces at work behind this new effort at federal
Discussion will focus on S. 3072, the later bill and the one that reflects the more polished version of the drafters' thoughts.\textsuperscript{78}

The Senators' antitrust perspective is found in the bill's "Findings of Fact and Declarations of Policy," which provided, \textit{inter alia}:

That a constantly increasing proportion of the national wealth has been falling under the control of a constantly decreasing number of corporations, and that the growth of such corporations and such concentration of wealth in corporate hands has effectively impaired the economic bargaining power of labor employed by such corporations.\textsuperscript{79}

One commentator at the hearings on S. 3072 noted that the bill would require the Federal Trade Commission\textsuperscript{80} to conduct an anti-incorporation. According to his account, after the Supreme Court invalidated the National Industrial Recovery Act of 1933, ch. 90, 48 Stat. 195, in A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935), O'Mahoney met with President Roosevelt to outline his suggestions "to meet the pressing national problem of commerce among the States," via a federal incorporation statute. This visit received press attention and O'Mahoney was soon called by Charlton Ogburn, General Counsel to the American Federation of Labor. The AFL favored a federal licensing approach; Ogburn presented a draft statute to O'Mahoney. That draft, with few differences, became Title I of S. 10. \textit{Hearings on S. 10, supra} note 67, at 80, 80-81 (remarks of Sen. O'Mahoney during statement of Charlton Ogburn, general counsel for AFL).

\textsuperscript{78} S. 10, the earlier bill, was a much more complicated document, combining mandatory antitrust and licensing standards with a detailed voluntary federal incorporation law. In S. 3072, Senator O'Mahoney simplified the requirements to attack those abuses that he felt had to be eliminated. \textit{Compare S. 10, supra} note 77 with S. 3072, \textit{supra} note 77.

\textsuperscript{79} S. 3072, \textit{supra} note 77, § 1(4). \textit{See Hearings on S. 10 and S. 3072, supra} note 32, at 594, 600 (remarks of Sen. O'Mahoney during statement of A.P. Haake, managing director of Nat'l Ass'n of Furniture Manufacturers); \textit{id.} at 705, 707 (remarks of Sen. O'Mahoney during statement of Lelia Thompson, attorney). At those hearings, Senator O'Mahoney explained his reasons for proposing the legislation as he did:

\begin{quote}
For 50 years every political party in the United States has proclaimed its devotion to the antitrust laws. For 50 years every candidate for public office in the Federal field, practically without exception, has announced his intention, if elected, to do what he could to enforce the antitrust laws.
\end{quote}

\begin{quote}
\ldots\ldots In the meantime, the concentration of economic power and wealth has proceeded, because of the ineffective means of enforcing these laws. \ldots\ldots The purpose of this bill is merely to limit at the beginning certain practices which nobody will defend, and to say that no corporation engaged in interstate commerce shall be permitted to practice these devices.
\end{quote}

\textit{Id.} at 594, 600 (remarks of Sen. O'Mahoney during statement of A.P. Haake).

\textsuperscript{80} The bill's focus can probably be discerned from the fact that jurisdiction was given to the Federal Trade Commission and not the Securities and Exchange
trust investigation of virtually every American corporation before it
could issue a license, thus giving new bite and urgency to enforce-
ment of the antitrust laws. The bill also contained a detailed list
of prerequisites for the issuance of a federal license. These in-
cluded requirements that women be paid the same as men for
equivalent work, prohibitions against child labor, and a require-
ment that employees be given the right to organize, join, or assist
labor unions and bargain collectively. The proponents also
reached more traditional corporate accountability issues. The bill
prohibited holding companies, mandated that annual reports be
made to shareholders, gave all shareholders the right to vote the
number of shares they held, required shareholder approval at
regularly scheduled meetings for any extra compensation for offi-
cers or directors, and provided procedures designed to prevent a
company that issued stock for property or services from over-
valuing those assets. The bill further required corporate officers
and directors to own stock in their company and prohibited stock

81. Hearings on S. 10 and S. 3072, supra note 32, at 377, 385 (statement of
Elmer T. Cunningham, member of Nat'l Assoc. of Manufacturers). This antitrust im-
petus can most readily be seen in the requirement, which preceded all others, that
no applicant is entitled to a license if found to be
an unlawful trust or combination in violation of the antitrust laws . . . , a
party to any contract, combination . . . , or conspiracy in restraint of com-
merce in violation of such laws, or if it is monopolizing, or attempting to mo-
nopolize, or combining or conspiring with any other person to monopolize,
any part of such commerce.
S. 3072, supra note 77, § 4(a); accord, S. 10, supra note 77, § 5(f).
82. S. 3072, supra note 77, § 5(a)-(c); accord, S. 10, supra note 77, § 5(a)-(c).
83. At the hearings, various commentators highlighted that, despite the disclo-
sure orientation of the federal securities laws, the laws did not and could not elimi-
nate many abuses expressly permitted by state law. Hearings on S. 10, supra note 67,
at 49, 53-55 (statement of John T. Flynn, economist); id. at 80, 83 (statement of
Charlton Ogburn, general counsel for AFL); id. at 263, 270-71, 276-77 (statement of
William F. Ripley, professor of economics at Harvard University); Hearings on S. 10
and S. 3072, supra note 32, at 360, 370-74 (statement of Robert H. O'Brien, assistant
director of Registration Division, SEC). One example of this deficiency was given in
the area of nonvoting stock. Sinclair Oil Co. had filed a registration statement for
100,000 shares of Class A stock, with no voting power, to be issued to the public at
$2.50 per share. The Class A stock did have a dividend preference. The 10,000 shares
of Class B stock, issued to company promoters at $.01 per share, held the corpora-
tion's voting power. Since this was quite legal, the Commission could not intervene
once proper disclosure had been made. Id. at 373-74 (statement of Robert H.
O'Brien).
84. S. 3072, supra note 77, § 5(f)-(i).
ownership in rival corporations or in any corporation lending money or property to their corporation.85

S. 3072 also dealt with proxies, a more traditional corporate governance issue. The Senators were apparently unsatisfied with the powers given to the Securities and Exchange Commission by section 14(a) of the Securities Exchange Act of 1934 as remedies for the abuses in proxy voting.86 They proposed that any shareholder be permitted to deliver his or her proxy to any person whom the Civil Service Commission certified as a “corporation representative.”87 Although the sponsors of S. 3072 did not elaborate on their intentions, this provision appears to have been an attempt to coalesce scattered shareholder interest into a meaningful organization that could counteract management control of the proxy process.88

Once again the drive to federal licensing was derailed, this time by the coming of World War II. It is hardly surprising, however, that several variants on the federal licensing/incorporation theme have been revived in this decade during the renewed corporate governance debate.89

85. Id. § 19. This section also stated that “[n]o officer or director of any licensee shall, directly or indirectly, or by any device whatsoever take any profit to himself as a result of the trust reposed in him save only such compensation as may be regularly awarded to him by vote of the board of directors.” Id.

86. See notes 113-115 infra and accompanying text.

87. S. 3072, supra note 77, §§ 5(j), 20. The bill required that corporate representatives be “properly qualified and familiar with corporation and commercial law and corporate accounting.” Id. § 20. Senator O'Mahoney described this as “an attempt to set up a sort of professional class like certified public accountants,” to help shareholders exercise their right to vote, and not, as critics charged, to bring government into the voting process. Hearings on S. 10 and S. 3072, supra note 32, at 630, 633 (remarks of Sen. O'Mahoney during statement of William B. Harrison).

88. Justice Douglas proposed a similar idea for an effective shareholder-protective association. See Douglas, supra note 26, at 1330-34.


Professor Cary argues that federal standards, in addition to state laws, are needed to achieve meaningful control over the modern corporation. He envisions a uniform federal act that could include: Federal fiduciary standards for directors, officers, and controlling shareholders; an interested directors provision prescribing fairness as a prerequisite to any transaction; requirements of certain uniform provisions in the certificate of incorporation; provisions requiring more frequent shareholder approval of corporate transactions; the abolition of nonvoting stock; and a specifically prescribed scope of indemnification for directors. Cary, Federalism and Corporate Law, supra, at 702.

Professor Schwartz would go one step further. He advocates an exclusive and comprehensive federal incorporation statute, “applying federal standards consistently to all facets of corporation law.” Schwartz, supra, at 1139. Like Cary’s proposal, Schwartz’s statute is confined to the traditional field of corporation law, not
SOLUTIONS—THE FEDERAL SECURITIES LAWS

In the preceding section, it was noted that federal incorporation or chartering was one alternative put forth in the early 1930's to deal with many of the weaknesses in corporate governance revealed by contemporary events. Given the devastation wrought by the stockmarket crash and the onset of the Depression, the country launched a reinvigorated search for appropriate solutions. Proponents of direct federal control over corporations sought enactment of federal incorporation or chartering statutes; at the other end of the spectrum were those who sought to leave all such regulation to the individual states.

The proponents of what were to become the federal securities laws cut a pragmatic course through the thicket of the wide-ranging debate on what to do with the American corporate management. Their approach is epitomized in an exchange between Ferdinand D. Pecora, counsel to the Senate Banking and Currency Committee, and Richard Whitney, president of the New York Stock Exchange. Whitney argued against the piecemeal approach venturing, for example, into the antitrust field. Id. at 1140-41. However, Schwartz does suggest "modest reforms" aimed at increasing the responsibility of the corporation to society at large. Id. at 1141-45.

Other modern proponents of federal chartering do seek to combine corporate governance and accountability proposals with broader societal concerns, including antitrust policy. See H.R. 7481, 94th Cong., 1st Sess., 121 CONG. REC. 15, 948 (1975) (Corporate Citizenship and Competition Bill) (provides for federal chartering to achieve antitrust objectives), summarized in DIGEST OF PUBLIC GENERAL BILLS AND RESOLUTIONS, 94th CONG., 1st Sess. E-696 (1975); Hearings on Corporate Rights, supra note 5. Finally, the proposals of Nader and his associates include various measures to give added powers to the board of directors, R. NADER, M. GREEN & J. SELIGMAN, supra, at 118-28; new shareholder voting rights, id. at 127-30; additional disclosure items to be included in reports sent to shareholders, id. at 140-57, 173-79; community involvement in certain kinds of corporate decisionmaking, id. at 130-31; and last but not least, rigorous new antitrust requirements designed to combat perceived concentration of economic power, id. at 232-36.

See notes 76-77 supra and accompanying text.

One very personal reaction can be found in a devastating volume wherein the author conducted a mock trial seeking to have Wall Street itself declared insane. W. FLOYD, PEOPLE VS. WALL STREET (1930).


of the Securities Exchange Act, which combined accounting, disclosure, and proxy regulations with a statute dealing mostly with trading securities on stock exchanges; these former measures, the Exchange and others claimed, should be part of a uniform federal incorporation law.94 Certain proponents of the Act described this tactic as “a dilatory plea” or “red herring”95 designed to put off action until the possibly never-to-be-day of federal incorporation. Pecora’s reaction recognized the political reality: “If there is a rainstorm, and an umbrella is not handy, a newspaper might sometimes give shelter temporarily . . . .”96

The framers of the Securities Act of 1933 (1933 Act) hoped that sunlight and legal exposure would alter the existing relationships of power and responsibility within the corporate structure. President Roosevelt espoused this in a message to Congress promoting the 1933 Act: “What we seek is a return to a clearer understanding of the ancient truth that those who manage . . . corporations . . . handling or using other people’s money are trustees acting for others.”97 Congress recognized that the Act’s liability provisions “will have a direct tendency to preclude persons from acting as nominal directors while shirking their duty to know and guide the affairs of the corporation,”98 and concluded: “If it be said that the imposition of such responsibilities upon [directors, experts, and underwriters] will be to alter corporate organization and corpo-

94. See Pecora Hearings, supra note 20, at 6709, 6715-16 (exchange between Ferdinand D. Pecora, counsel to Senate Banking and Currency Comm., and Richard Whitney, president of NYSE); id. at 6677, 6678 (statement of Frank Altschul, chairman of Stock List Comm., NYSE); id. at 6936, 6939-40 (statement of Alfred L. Bernheim, director of securities market survey, Twentieth Century Fund, Inc.).

95. Id. at 6463, 6536 (statement of Thomas G. Corcoran, member of Office Counsel, Reconstruction Finance Corp.).

96. Id. at 6709, 6716 (remarks of Ferdinand D. Pecora, counsel to Senate Banking and Currency Comm., during statement of Richard Whitney, president of NYSE).

97. MESSAGE FROM THE PRESIDENT OF THE UNITED STATES, H.R. DOC. NO. 12, 73d Cong., 1st Sess. 2 (1933). In using these words, Roosevelt reflected the influence of Brandeis’ Other Peoples’ Money, L. BRANDEIS, supra note 26, 20 years after it was written. See R. DE BEDTS, THE NEW DEAL’S SEC 34 (1964) (discussing Brandeis’ influence).

98. S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933). The Report went on to state that “[w]e cannot but believe that many recent disastrous events in the investment world would not have taken place if those whose names have appeared as directors had known themselves to be under a legal, as well as a moral, responsibility to the investing public.” Id.
rate practice in this country, such a result is only what your committee expects.”

As already noted, one of the major propositions to which almost all commentators subscribed was that secrecy in corporate affairs, particularly financial ones, must be banished from the corporate scene. The 1933 Act was among the earliest laws to attempt to ensure that persons asked to invest in corporate America, at least in initial public offerings, could do so on the basis of concrete information contained in a mandated prospectus and not on blind faith, rumor, or misinformation. Furthermore, the 1933 Act imposed liability upon corporate insiders, including directors, for material omissions and misrepresentations contained in those disclosure documents.

Surprisingly, William O. Douglas, the articulate critic of directorial nonaction, was not in favor of the liability imposed upon corporate directors:

[Though there may be some or many directors who do not “direct” (in the sense that they merely draw prestige and fees from the position) there are a great many, particularly of the larger and more complicated enterprises, who do and yet are not personally familiar with all details of operation. Nor could their services be obtained in most cases if they were required to investigate details of the enterprise. The experience and judgment of men of affairs is of great value to most of our more important corporations. To deprive enterprises of this asset would seem uneconomic in view of the slight gains which may be expected.]


By compelling full publicity of “every essentially important element attending the issue of new securities” so that the public may have an opportunity to understand what it buys, the Act seeks to promote standards of competence and candor in dealing with the public. . .

. . . . There is a shrinking quality to such transactions [bonuses, excessive commissions, preferential lists]; to force knowledge of them into the open is largely to restrain their happening. Many practices safely pursued in private lose their justification in public. Thus social standards newly defined gradually establish themselves as new business habits.

100. See notes 27 & 28 supra. Ripley, in particular, argued that a federal law mandating full publicity of corporate affairs was imperative, because the states would or could not act. W. RIPLEY, supra note 11, at 217-28.


It is possible to safeguard the accuracy and completeness of the registration statement without subjecting every director to the burden of proof that after reasonable investigation he had reasonable ground for believing and did believe the registration statement to be free from actionable untruths or omissions.\textsuperscript{103}

The Securities Exchange Act of 1934 (1934 Act) continued the process by which internal corporate workings were exposed to public scrutiny. As recounted in the Senate report, the principal problems the 1934 Act was designed to address were:\textsuperscript{104} (1) Excessive use of credit for speculation, (2) unfair trading practices employed in speculation, and (3) the secrecy then surrounding the financial condition of public corporations. Although the 1934 Act's primary focus was on exchange trading practices, it included many provisions significant for their effect on corporate governance issues. The 1934 Act's reporting system for all exchange-listed stocks\textsuperscript{105} complemented the registration provisions for new issues mandated by the 1933 Act; the 1934 Act further permitted the newly created

\begin{footnotesize}
\begin{enumerate}
\item Douglas & Bates, \textit{The Federal Securities Act of 1933}, 43 \textit{Yale L.J.} 171, 195-96 (1933) (footnotes omitted). This thought is also found in Douglas' later article, \textit{Directors Who Do Not Direct}. Douglas, \textit{supra} note 26, at 1314. After describing his ideal board of outside, "expert" directors who do not "manage" the corporation but who "supervis[e] those who do and ... formulat[e] the general commercial and financial policies under which the business is to be conducted," Douglas went on to say that:

Such a body of men would not always be in a position to know the details of the business in such a way as to satisfy the standards which the Securities Act, for example, imposes on them. But they would be in a position of dominance and power to serve the stockholders effectively.

\textit{Id.} (footnote omitted). Another part of Douglas' criticism of § 11 of the 1933 Act seems more out of character: "Here, as at many other points in the Act, it is tolerably clear that Congress intended to accomplish certain ends wholly ancillary to the avowed purpose of the Act of requiring the truth about securities to be given investors 'with the least possible interference to honest business.'" Douglas & Bates, \textit{supra}, at 195 n.137.

\item S. REP. No. 792, \textit{supra} note 50, at 5.

\item Securities Exchange Act of 1934, ch. 404, §§ 12-13, 48 Stat. 892 (current version at 15 U.S.C. §§ 78l-78m (1976 & Supp. I 1977)). Among other provisions these sections permitted the Commission to require disclosure of such corporate information as: (1) the remuneration of all "directors, officers, and underwriters, and each security holder of record holding more than 10 per centum of any class of any equity security of the issuer ... [as well as] their interests in the securities of [the issuer], and their material contracts with, the issuer; (2) "bonus and profit-sharing arrangements"; (3) "management and service contracts"; (4) profit and loss statements for the preceding three years, certified by independent public accountants; and (5) "any further financial statements ... deem[ed] necessary or appropriate for the protection of investors." \textit{Id.} § 12(b)(1) (current version at 15 U.S.C. § 78l(b)(1) (1976)).
\end{enumerate}
\end{footnotesize}
Securities and Exchange Commission to require that mandated annual reports be certified by independent public accountants, addressing an abuse long denounced by reformers. The 1934 Act established proxy and insider-trading rules to deal with overreaching by corporate insiders. Indeed, the House report, using the language of Berle and Means, eloquently explained the pressing need for regulating certain relationships between shareholders and the management of their corporations:

[A]s management became divorced from ownership and came under the control of banking groups, men forgot that they were dealing with the savings of men and the making of profits became an impersonal thing. When men do not know the victims of their aggression they are not always conscious of their wrongs.

The practice of insider trading was described by one Senate report as "[a]mong the most vicious practices unearthed at the hearings." The 1934 Act imposed reporting requirements on corporate officers, directors, and beneficial owners of more than ten percent of the issuer's stock. It also provided that all "short swing"

106. Id. § 13(a)(2) (current version at 15 U.S.C. § 78m(a)(2) (1976)). The 1934 Act further provided that the Commission may prescribe the appropriate accounting methods to be used in reports filed with the Commission. Id. § 13(b) (current version at 15 U.S.C. § 78m(b) (1976 & Supp. I 1977)). See notes 29-30 supra and accompanying text.

107. At the same time that the Senate Banking and Currency Committee began studying stock exchange practices, the Secretary of Commerce created a committee to examine those same problems. Its solution, like several early versions of the 1934 Act, was to license stock exchanges if those exchanges imposed certain specified listing standards upon corporations seeking the privilege of exchange trading for their securities. Those standards included annual audits of corporate reports by independent accountants; quarterly reports of securities transactions filed by each corporate officer and director, open to inspection by any shareholder; and prohibitions upon officers and directors participating in or revealing nonpublic information to a pool to manipulate the public trading market. Interestingly, though A.A. Berle, Jr., was on the committee, its report contained no suggestions regarding corporate governance issues, not even regarding proxy regulation, an issue then being considered by Congress. Comm. on Stock Exchange Regulation, U.S. Dep't of Commerce, Report to the Secretary of Commerce 17-18 (1934), reprinted in 5 Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934, Item 16 (J. Ellenberger & E. Mahar eds. 1973).

108. Note that quiet reference to the money trust. See notes 17-26 supra and accompanying text.


profits obtained by trading in such stock would be recoverable by the corporation.\footnote{111}

As previously discussed, there was a general awareness of the shortcomings of the proxy process as it then existed.\footnote{112} In keeping with the general philosophy of the securities laws, the basic thrust of the proxy provision of the 1934 Act\footnote{113} was on disclosure:

[It] is essential that [the stockholder] be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders’ meetings. Too often proxies are solicited without explanation to the stockholder of the real nature of the matters for which authority to cast his vote is sought.\footnote{114}


\footnote{112. See notes 47-50 supra and accompanying text.}

\footnote{113. Securities Act of 1934, ch. 404, § 14, 48 Stat. 895 (current version at 15 U.S.C. § 78n (1976)). Section 14(a) provides that:

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange 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.

\textit{Id.} § 14(a) (current version at 15 U.S.C. § 78n(a) (1976)).

\footnote{114. S. REP. No. 1455, supra note 110, at 74. In a similar vein, the House report stated:

Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate disclosure of their interest and without an adequate explanation of the management policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights.

H.R. REP. No. 1383, supra note 109, at 13-14.}
However, it was also recognized that the power given the Commission to deal with the proxy-solicitation process extends beyond disclosure: "[T]he proposed bill gives the . . . Commission power to control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders." 115

SOLUTIONS—THE BOARD OF DIRECTOR'S ROLE

The federal securities laws tried to solve, or at least ameliorate, some of the well-recognized problems besetting the corporate enterprise system. One commentator observed that "[t]he brunt of the New Deal appears to have fallen most heavily on corporate directors." 116 This emphasis only mirrored the prevalent theme of critics and reformers. Indeed, one writer attributed a fundamental cause for corporate abuses to "stockholders who do not vote, directors who do not direct, and officers who do not obey," 117 with

115. Id. at 14. From virtually the beginning of its history, the Commission has interpreted § 14(a) as conferring authority to go beyond disclosure to deal with the conditions under which proxies are solicited. Proposed Amendments to the Securities Exchange Act of 1934: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce, 78th Cong., 1st Sess. 10, 89-90, 178-79 (1943) (statement of Ganson Purcell, chairman of SEC); id. at 217, 236-39 (statement of Baldwin B. Bane, director of Corporation Finance Division, SEC). See 2 L. Loss, supra note 12, at 868. While the Commission's first set of proxy rules set out rudimentary disclosure requirements, Securities Exchange Act Release No. 34-378 (Sept. 24, 1935) (current version at 17 C.F.R. § 240.14a (1979)) the Commission quickly went beyond that approach. In 1938, in its first revision of the rules, the Commission mandated that a proxy statement, providing set items of disclosure, including information regarding persons nominated to be directors, be given to each person from whom proxies were solicited. The rules also provided, in a mixture of disclosure and control of conditions, that the proxy contain a definite means for the security holder to indicate how he or she desires his or her vote to be cast on a given proposition, although a full discretionary proxy could still be authorized. Securities Exchange Act Release No. 34-1823, 3 Fed. Reg. 1991 (1938) (current version at 17 C.F.R. § 240.14a (1979)). By 1940, the Commission had added an amendment to the rules requiring that the proxy card mailed as part of management's proxy soliciting materials provide a means for shareholders to vote on nonmanagement proposals, Securities Exchange Act Release No. 34-2376, 5 Fed. Reg. 174 (1940) (current version at 17 C.F.R. § 240.14a (1979)), which ultimately became a specific rule requiring management to include in its materials any shareholder proposal which is "a proper subject for action by the security holders" under state law. Securities Exchange Act Release No. 34-3347, 7 Fed. Reg. 10,655, 10,656 (1942) (current version at 17 C.F.R. § 240.14a-8 (1979)). This shareholder proposal rule has been a significant and durable tool for those seeking to direct the attention of management and their fellow shareholders to a wide range of issues. See note 2 supra.


117. I.M. WORMSER, supra note 30, at 87.
the vast majority of his criticism going to the role of the director.\textsuperscript{118} This same emphasis is true in the debate on corporate governance issues today.

Not only the critics, but also the thoughtful representatives of business recognized that the board of directors must act in a fiduciary capacity for all shareholders. Thus its obligations include setting general corporate goals, establishing major policies, and checking on the operations of management in administering those goals and policies.\textsuperscript{119} In a broad sense the role directors were expected to play in the 1930's is no different from our expectations today. The difficult question, for which current commentators are striving with at least as much zeal and urgency as their brethren of the 1930's, is how to ensure that directors do fulfill the obligations that their unique position places upon them.\textsuperscript{120}

Several suggestions for improving the board's functioning were put forth in the 1930's. These included reducing the size of the board to obtain more effective oversight,\textsuperscript{121} increasing directors' salaries in recognition of the importance of their role,\textsuperscript{122} and requiring that a percentage of the board be composed of nonofficers or nonemployees.\textsuperscript{123} One suggestion was that public directors

\begin{itemize}
\item \textsuperscript{118}Id. at 124-41.
\item \textsuperscript{119}McKinsey, Functions of Boards of Directors, Board Committees, and Officers in \textit{Handbook of Business Administration} 391, 392 (1931).
\item \textsuperscript{120}In fact, it seems that the modern commentators are studying the problem of what makes an effective board of directors in a more analytical framework than was done in the 1930's, and much of their focus rests upon the role of the outside director. See note 123 infra and accompanying text. See generally M. MACE, \textit{Directors: Myth and Reality} (1971); I & II \textit{National Ass'n of Corporate Directors, Corporate Directors' Special Reports Series}; Caplin, \textit{Outside Directors and their Responsibilities: A Program for the Exercise of Due Care}, 1 J. Corporation L. 57 (1975); \textit{Corporate Director's Guidebook}, 33 Bus. Law. 1591 (1978); Leech & Mundheim, \textit{The Outside Director of the Publicly Held Corporation}, 31 Bus. Law. 1799 (1967).
\item \textsuperscript{121}TNEC, Monograph No. 11, supra note 48, at 126.
\item \textsuperscript{122}Id. See also A. BERLE & G. MEANS, supra note 8, at 225 n.6 (proposal of profit-sharing plan for corporate directors to reduce temptation to engage in trading based on inside information).
\item \textsuperscript{123}TNEC, Monograph No. 11, supra note 48, at 124-25; Douglas, supra note 26, at 1314-15. James O. McKinsey, an industry commentator who had basic faith in the ability of the corporate world to behave properly, agreed that the board should not be composed solely of insiders. He suggested a board composed of both insiders and executives from other companies. McKinsey, supra note 119, at 395-96.
\item One significant focus of the current debate on how to make corporations accountable to their shareholders has been the role and potential power of the so-called "outside" director. See R. FERRARA & M. GOLDFUS, supra note 1, at 169-81; authorities note 120 supra. Commission Chairman Harold M. Williams, for example,
\end{itemize}
be chosen by the government or that they be selected to represent particular sets of interests or constituencies. Interestingly, most commentators who mentioned this possibility were quick to put forth the reasons against it. The dangers of governmental interference, the impossibility of knowing who accurately represents the public interest, and the problems caused by a director taking the parochial rather than corporatewide view of his or her job. Another reform suggestion was that of cumulative voting. By casting all of his or her votes for a single nominee rather than voting on the entire slate, a shareholder might be able to join with other noninsiders and choose one or two directors outside the management list.

While the importance of full disclosure regarding all corporate matters was well-recognized, the proponents of the 1934 Act knew that publicity was only a first step towards accountability. Their hopes for further improvement rested on the beliefs first, that disclosure would change behavior, and second, that if the misconduct continued, public information could be used by a sophisticated investor.


TNEC, Monograph No. 11, supra note 48, at 125; Patterson, supra note 56, at 18. Wormser was one of the few who did think that public representation on the board might well be appropriate:

[I]f "big business" refuses or at least neglects to regulate itself; if great corporations persist in vicious practices; if the community thereby grievously suffers, Frankenstein must prevent the destruction of himself and his social order by his own artificially created persons. This destruction only can be prevented by giving to the nation and the state a genuine measure of real control over their great corporate creations.

I.M. WORMSER, supra note 30, at 138.

125. This idea was endorsed by W. RIPLEY, supra note 11, at 104-06, and discussed by Douglas, supra note 26, at 1330. However, in a large corporation with thousands of small, scattered stockholders, cumulative voting is unlikely to be a useful tool unless there are large stockholders unaligned with management. In this situation, cumulative voting may allow them to elect a seat on the board. Whether this is desirable from the viewpoint of the small stockholder, however, is debatable.
vestor to wage a fight on behalf of all shareholders.  

William O. Douglas explained that "[t]here are great practical limitations on setting forth the 'truth' about people up for election or about the proxyholders. . . . The basic effects of absentee ownership will remain the same." 

Following the approach of the federal securities laws, several critics insisted that shareholders should, at the minimum, receive more information about the persons nominated to be directors. For example, one monograph submitted to the TNEC recommended disclosing the qualifications of each board nominee, the number and company names of other directorates held, and the attendance records of present board members. Douglas extensively reviewed the reform suggestions of the British critic Horace A. Samuel. Douglas cited with seeming approval Samuel's recommendation that certain information about directors be fully disclosed. This information included loans or any remuneration received from the company, all trading done in company shares, the affiliations of every director, and the general role each was expected to play on the board. These recommendations dealt primarily with objective factors that could help shareholders to make informed deci-
sions about directors; many are now mandated by the Commission under the authority of the proxy and reporting provisions of the 1934 Act.132

Commentators of the 1930's and of today have recognized that there are important subjective problems inherent in motivating directors to perform their watchdog role with diligence and competence. A.A. Berle, Jr., explained that development of directorial responsibility must proceed simultaneously along two lines: First, "standards of dealing must be embodied in rules of law and in common ideas of ethics, whose breach will entail both legal liability and social condemnation;"133 and second, "the mechanics of the situation must be adapted towards enforcing the standards thus created and protecting the individuals."134

On the legal front, Berle argued in numerous articles that corporate powers are powers held in trust for the benefit of shareholders; while corporate charters purport to give boards of directors virtually unlimited authority in many areas, courts should step in and use their powers of equity to ensure that such authority is not abused.135 One of the most important legal developments during

132. See, e.g., Securities Act Release No. 33-6003, 43 Fed. Reg. 58,181, 58,186 (1978) (current version at 17 C.F.R. § 229.20 (Item 4) (1979)), in which the Commission substantially revised the management remuneration provisions in its forms for registration statements, periodic reports, and proxy statements under the 1933 and 1934 Acts to obtain increased disclosure of all benefits given management; and Securities Exchange Act Release No. 34-15384, 43 Fed. Reg. 58,522 (1978) (current version at 17 C.F.R. § 240.14a-101 (Item 6) (1979)), which requires disclosure in proxy statements of certain significant economic and personal relationships between a person nominated to be director and the corporation; of whether the company has standing audit, compensation, and nominating committees and a brief description of their functions; of any director who has attended fewer than 75% of the aggregate number of meetings of the board of directors and the committees on which he or she sits; of any directors who have resigned or declined to stand for reelection if the director furnished the company with a letter describing a disagreement over business operations, policies, or practices and requested that the matter be disclosed. Id. at 58,531.

133. A. BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE 35 (1928).

134. Id. at 35-36.

135. See generally A. BERLE, supra note 133, at 26-40; A. BERLE & G. MEANS, supra note 8, at 248-76; Berle, Corporate Powers as Powers in Trust, 44 HARV. L.
the 1930’s was the expanding recognition that directors are fiduciaries and must be held to a rigorous standard of responsibility for their actions.\footnote{136} Despite great legal gains, commentators still realized that the basic fact of absentee ownership remained, and the law could only be a backstop to remedy the most egregious abuses: In fact, if not in law, “a stockholder’s right lies in the expectation of fair dealing rather than in the ability to enforce a series of supposed legal claims.”\footnote{137}

Although not all commentators expressed this conclusion so starkly, many of them recognized that some mechanism was needed outside the legal system to enforce shareholders’ rights. Some writers sought recourse in ethics, as Berle seemed to recommend above. In a generalized fashion, they advocated the creation of a code of conduct for directors and company executives. Douglas explained that “[n]ot the least difficult problem here is the development of a social mindedness hitherto sadly lacking both among business men and their legal advisers.”\footnote{138} Even such a reluctant critic as Henry Ballantine admitted:

What is needed is something which will operate as a reasonable check or balance upon the sovereignty of management; something to stimulate the sense of trusteeship and responsibility on the part of those in supreme authority to the passive investors whom they are supposed to represent, but with whom they often deal at arm’s length.\footnote{139}

However, meaningful solutions had to progress beyond homilies and wishful thinking. One approach advocated the creation of an audit or “checkup” committee of the board;\footnote{140} significantly, this is the very body upon which so many of today’s aspirations for accountability rest.\footnote{141}
As a general matter, the 1930's witnessed a trend towards the formation of board committees, each charged with responsibility for applying institutional policy to a given field of activity. The banking industry provided the model for other companies. Banks often had executive or finance committees, which handled all business arising between board meetings and had jurisdiction over loan decisions, new business committees, and auditing committees to supervise bank records. Other corporations imitated the executive committee, which was generally composed of insiders.

William Z. Ripley suggested that another body as diligent as the corporate insiders but independent from them be created to protect shareholder interests. The supervisory committee's most important function would be to receive reports from the company's independent auditor and ensure that adequate information about the company's real financial condition was transmitted to the shareholders. While such an audit was not then required, Ripley was a staunch advocate of one.

Similarly, in 1940 the Commission publicly recommended that every corporation establish a committee of nonofficer board members whose responsibilities would include selection of the independent auditor and supervision over the audit engagement. This recommendation appeared in a Commission report concerning the massive falsification of the inventory, accounts receivable, and cash-on-hand records of McKesson & Robbins, Inc., a company whose stock was listed and traded on the New York Stock Exchange. The Commission found that approximately $19,000,000 of the corporation's reported total assets of $87,000,000 were entirely fictitious and that the company's independent auditors, while substantially complying with then-accepted auditing standards, had failed to discover the fraud. The Commission's report attacked

---

142. Patterson, supra note 56, at 18; see McKinsey, supra note 119, at 396-97.
144. W. RIPLEY, supra note 11, at 132-43, 214-16.
145. See notes 28 & 30 supra. As noted earlier, the 1934 Act gave the Commission authority to require annual reports audited by an independent auditor. See note 106 supra and accompanying text.
146. SECURITIES AND EXCHANGE COMM’N, REPORT ON INVESTIGATION: IN THE MATTER OF MCKESSON & ROBBINS, INC. 5 (1940), summarized in Release No. 19 (Dec. 5, 1940), in SECURITIES AND EXCHANGE COMM’N ACCOUNTING SERIES RELEASES 26, 30 (1948).
147. Id. at 3, 443, summarized in Release No. 19 (Dec. 5, 1940), in SECURITIES AND EXCHANGE COMM’N, ACCOUNTING SERIES RELEASES 26, 28, 34 (1948).
the inadequacy of current auditing practices and recommended the formation of an audit committee as a step towards ensuring proper auditor independence.\textsuperscript{148}

A.A. Berle, Jr., and William O. Douglas both considered other nonlegal methods of restraining management's broad powers. In 1928 Berle suggested three possible means of achieving appropriate oversight. First, an organization of investment bankers could scrutinize the behavior of those companies whose securities they float and set appropriate standards to ensure that shareholder rights were not unnecessarily impaired.\textsuperscript{149} This faith in the goodness of investment bankers stands in contrast to their indictment by Brandeis\textsuperscript{150} and the actual control they held over many corporations through holding companies and other pernicious practices.

---


\textsuperscript{149} A. BERLE, supra note 133, at 37.

\textsuperscript{150} Brandeis' distrust of investment bankers is indicated by the full title of his book: Other People's Money: And How the Bankers Use It. L. BRANDEIS, supra note 17.
Second, the stock exchanges "are in a position to require information, to analyze it thoroughly, and to suspend or withhold listing privileges where power has been abused."\textsuperscript{151} Although Berle did not mention it, an obvious example is the outlawing of nonvoting common stock by several exchanges, which, in effect, killed the practice.\textsuperscript{152}

In his third suggestion, Berle was an acknowledged influence upon Douglas' later ideas. Berle saw protection for shareholders' interest coming from larger shareholders, notably insurance companies, trust companies, and other intermediaries.\textsuperscript{153} In Berle's opinion, these "big boys" owned a great deal of stock, had the financial muscle to obtain accurate information, and, should abuses occur, had the power to counteract those abuses: "In fact, such an institution would be a permanent protective committee."\textsuperscript{154}

CONCLUSION

This Article has shown that widespread concern over corporate governance is far from new. It is not a recent invention of a few social activists aided and abetted by the Securities and Exchange Commission, nor is it a byproduct of the recent disclosure of extensive illegal or questionable payments by corporations. Indeed, in some respects, the question of how to control the impersonal corporate entity, both from within by the shareholders and from without by the interests of society as a whole, has existed almost as long as has the corporation itself. Not only have the same questions arisen throughout this century, but many of the current answers have a familiar ring.

Moreover, the participation of the Commission in the current debate is not surprising. The Commission was created during the last era of major concern with corporate conduct and governance, and, in a real sense, the establishment of the Commission was a congressional and administrative response to that concern, though some, such as William O. Douglas, thought it to be inadequate. Nonetheless, in comparing the suggestions for reform put forward by commentators in the 1930's with those of today, several conclusions emerge.

\textsuperscript{151} A. BERLE, supra note 133, at 38.
\textsuperscript{152} See notes 37-41 supra and accompanying text.
\textsuperscript{153} A. BERLE, supra note 133, at 38-39.
\textsuperscript{154} Id. at 39. See generally note 126 supra and accompanying text for the opinions of Ripley and Corcoran that the real value of full disclosure lies in giving some sophisticated investor an opportunity to learn the true facts and fight for his or her interests, thereby benefitting all shareholders.
First, probably the most notable contrast between the movements for increased corporate accountability in the 1930's and 1970's has been the current availability of meaningful corporate information. While human nature has not changed, the full disclosure philosophy of the federal securities laws and the rigorous enforcement of these laws by the Commission has made the egregious practices of the earlier period far more difficult to achieve. When, for example, the Commission realized that corporate insiders were abusing their position to the detriment of the corporation by receiving certain perquisites of office, such as houses, cars, charge accounts, and the like, it issued a series of releases on the subject,\(^{155}\) commenced a number of well-publicized enforcement cases,\(^{156}\) and revised its disclosure rules to elicit more detailed information about the total package of remuneration received by corporate managers.\(^{157}\) Thus, the disclosure rules have publicized certain corporate practices and, in so doing, have helped to eliminate those unable to withstand public scrutiny.

Corporate governance problems have always extended beyond full disclosure, however. While the general conditions under which corporations operate have changed quite dramatically since the 1930's, an historical review reveals that commentators of today are still wrestling with many of the issues articulated in the 1930's concerning the factors that make for a well-governed corporation. Specifically, the same questions are still raised about the mechanisms that can be created to make the corporation accountable, the appropriate role of the board of directors, and how directors can be motivated to provide effective oversight over management.

The major distinction between the current effort to study and improve corporate accountability and that of the earlier decade may well rest upon the differing priorities. Reformers in the 1930's attacked a largely unregulated corporate community containing a host of such basic problems as secrecy in corporate affairs and control of corporations by holding-company pyramids. Those problems have been attacked pragmatically and gradually over the years; forty years of effort has narrowed the corporate governance is-


\(^{157}\) See note 132 supra.
sues. They are in some sense severable from antitrust issues and questions of social policy, such as consumer protection or labor relations, which are being dealt with in other forums. Under these circumstances, corporate managements can—and many do—participate in the debate in a constructive way, rather than simply taking a defensive posture and digging in. Consequently the time may have finally come for meaningful progress in improving corporate governance and accountability.