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is with respect to the content of the statute. If you adopt the current content of House Bill 240, you will hand these appointed individuals (only a majority of whom need be Alaskans) a blank check to narrow their accountability to all of the citizens of this state in their capacities as shareholders in the GSOC. The express terms of SSHB 240 already give to this Board the strong power position of "classification" meaning that the directors will serve three year terms with the nine members segregated into three classes so that only one third of the membership is up for election by the shareholders at each annual meeting. (See, 10.50.030(a)(b), pp. 2-3 SSHB 240). There is a pragmatic advantage in this proposed classification in that insures to the incumbent board the continuity inherent in the fact that a working majority of the Board will not be facing election. There is also a grave danger. Such a Board could ignore the wishes of a majority of the shareholders and yet maintain effective control and management over the corporation for two years. The people in their role as shareholders would be powerless. This body in its role as representative of the people would be equally powerless. True, it could deny the GSOC cooperation to the extent that it was requesting the legislature to call for an election to authorize a state guarantee of GSOC debt instruments (although see the Memorandum of Attorney General Gross under date of March 20, 1979, raising a question as to whether recourse to the people would actually be required). Yet this is a very indirect way of attempting to discipline the Board or correct the excesses of that body as viewed from the perspective of the legislature. I do not wish to belabor the point: if the members of this House feel that a different distribution of power as between the shareholders and the board, and as between the GSOC and the government of Alaska is desired . . . now is the time to act and the content of the enabling legislation is the proper forum for that action.

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PROPOSALS DESIGNED TO INCREASE THE ACCOUNTABILITY OF INDIVIDUAL DIRECTORS AND THE BOARD AS AN ENTITY:

PROPOSAL NUMBER ONE: THAT DIRECTORS BE SUBJECT TO REMOVAL BY ORDER OF A SUPERIOR COURT UPON SUIT BY 100 OR MORE SHAREHOLDERS OF THE GENERAL STOCK OWNERSHIP CORPORATION.

> I propose that the enabling legislation be amended to provide that a superior court may, at the suit of 100 shareholders or more or upon petition of the attorney general, remove from office any director in case of fraudulent or dishonest acts or gross abuse of authority or discretion with reference to the corporation and may bar from reelection any director so removed for a period prescribed by the court. In any such proceeding the corporation should be made a party to the action.

Explanation: This proposal is based upon Section 304 of the 1977 California Act with two important modifications: first, I propose that you alter the "standing requirement" from California's [". . . shareholders holding at least 10 percent of the number of outstanding shares. . . ."] to one hundred shareholders. To follow the California percentage would be most unreal given the total diffusion of shareholdings in the GSOC (one share per resident). It would require a petition of 40,000 Alaskans or more! In any other private corporation it is perfectly possible for a single shareholder to own 10% or more of the outstanding shares and thus have standing under the California Act. Requiring one hundred Alaskans to join in this suit should ensure that a single angry shareholder could not inaugurate a vexatious complaint. The second modification is to specially grant to the Attorney General standing

to initiate this removal litigation. I do this because while the attorney general may well have personal standing as a resident of Alaska to join in such a suit we must recognize that litigation may be costly and that frequently only the office of the attorney general may have the human and financial resources to prosecute a removal suit upon which may depend the welfare of the corporation (and with that, welfare and interests of Alaskans).

Now it must be immediately evident that this type of removal can only be for the most gross violations of the fiduciary responsibilities assumed by a director and that the statute only grants standing to potential litigants and subject matter jurisdiction to the superior courts. Naturally, the plaintiffs would have to prove the allegations of their complaint by a preponderance of the evidence before the superior court would be warranted in exercising the power vested in it by this statute. I should add that it is quite possible that if the legislature does not act to provide for removal of directors in circumstances such as are covered by this proposal, a superior court might entertain such suits on a theory that such a grave matter is within the court's inherent jurisdiction. There is precedent. See, California Fruit Growers' Assn. v. Superior Court, 8 Cal.App. 711, 97 Pac 769 (1908). In my opinion, this is not a desirable alternative because the legislature would be without control over the vital questions of who had standing to initiate the litigation and what would be deemed sufficient grounds for this grave remedy.

DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor in principle the concept of having directors subject to removal by order of a superior court? YES ____ NO ___. If "yes," is the Committee in favor of the proposed formula

granting standing only to one hundred or more shareholders? YES ____ NO ____. Does the Committee favor granting standing to the Attorney General of Alaska to initiate a removal suit? YES ____ NO ____.

PROPOSAL NUMBER TWO: THAT ANY DIRECTOR OR THE ENTIRE BOARD MAY BE REMOVED BY THE SHAREHOLDERS WITHOUT CAUSE.

I propose that at any annual meeting or a special meeting properly noticed for the purpose at which a quorum is present, a majority of the shares voting in person or by proxy may remove the entire board and elect replacement directors. I further propose that the shareholders have power to remove less than the entire board provided there are appropriate safeguards to minimize the chance that an angry faction of shareholders could oust a single director.

Explanation: Both California and Delaware have found it expedient to pass recent legislation enabling shareholders who have lost confidence in the Board of Directors to remove either the entire Board or individual members at a meeting especially called and noticed to entertain such a motion, and that such removal may be for any cause deemed sufficient by a majority of the shares. In both California and Delaware, the statutes grant the right of removal to an absolute majority of the shares (50% plus 1 share). Again, we must recognize that there may be individuals or institutional shareholders who, though a handful in number, would command an absolute majority of the outstanding shares. Such a potential coalition of large shareholders is a strong check upon the Board of Directors. Unfortunately, there will be no such potential shareholder

coalition in the GSOC. We must deal with the fundamental characteristic of a corporate entity, the shares of which are held in lots of one . . . and by more than 400,000 individuals.

The Kelso Report recognizes the problem of human inertia inherent in such diffuse shareholdings when it proposes to set a quorum for shareholder attendance at annual and special meetings at one-third of the shares voting either in person or by proxy (an absentee ballot). At any meeting at which such a quorum is ascertained to be present, a vote of a majority of that quorum is sufficient to elect directors. Simple arithmetic will reveal that a simple majority of one-third is one-sixth of the shares plus one. Such a scheme is permitted by Sec. 10.05.153 of the Alaska Business Corporation Act if the articles of incorporation are so drafted. I favor this aspect of the proposed articles contained in the Kelso Report because I fear that setting a higher quorum requirement might preclude the shareholders from effectively meeting. How then does this guide us as to the machinery for removal of directors by shareholder vote? I propose that the entire board might be removed for any reason either at an annual or special meeting of shareholders for which notice of such a proposal had been given (as provided in Sec. 10.05.141) upon the vote of a majority of a quorum of the shares present in person or by proxy.

If the shareholders desire to remove less than the entire board, we have a different problem. Here is a danger that a special interest group or other faction might attempt to gang up on a single director for his or her policies and seek to accomplish this at a special meeting which may well be attended by fewer shares than were present at the annual meeting which elected the targeted director. We can guard against this possibility by drafting the statute to provide that in the event that there is an attempt to remove less than the entire board, the resolution shall fail

unless the number of shares cast for removal exceeds the number of shares which originally elected the director. Thus if he was elected by a majority of 261,000 shares at an annual meeting, a special meeting noticed to entertain a removal resolution would not accomplish that objective unless 261,001 shares voted "yes" (in person or by proxy) on that question. If the director was appointed (as in the case of the initial Board), or elected by the Board to fill a vacancy arising by death, incapacity, or resignation mid-term, I would propose that a simple majority of a quorum would be sufficient to remove that director.

DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor in principle the concept of having directors susceptible of removal by vote of the shareholders? YES ____ NO ____. If so, is the Committee content with the suggested formula for that removal? YES ____ NO ____.

PROPOSAL NUMBER THREE: THAT THE ENABLING ACT REGULATE THE STANDING OF SHAREHOLDERS TO INAUGURATE ACTIONS AGAINST DIRECTORS OR OFFICERS BROUGHT FOR THE BENEFIT OF THE CORPORATION (SHAREHOLDER'S DERIVATIVE ACTIONS)

I propose that the enabling act be amended to regulate the standing of shareholders to inaugurate actions seeking declaratory relief or money damages as against officers and directors of the GSOC for the benefit of the corporation (shareholder's derivative actions); lodge discretion in the superior court respecting whether and in what amount a security bond for expenses of litigation should be required of such a plaintiff; preclude non-judicially approved out-of-court settlements of such actions; and, provide for an accounting to the corporation of any proceeds received by the litigating

shareholder(s) whether by judgment, settlement, or compromise.

Explanation: One of the most important developments in the past half century in seeking to hold directors and officers accountable for harm they bring upon the corporation is the concept of the shareholders' action or derivative suit. If you adopt the hypothesis that the Board or certain of its members is guilty of action or inaction which has brought great harm to the GSOC and which violates the duties of care or loyalty to the corporation, it is unrealistic to assume that those very directors will authorize or encourage corporate counsel to bring an action naming them as defendants! For this reason it is necessary to give individual shareholders the right to bring the litigation in the name of the corporation. Any recovery of money damages goes to the corporate treasury, not to the litigating shareholder (save for reimbursing him/her for the costs of the litigation).

Nearly every jurisdiction permits such actions and most regulate the conduct of such litigation by statute. Alaska is one of the few jurisdictions which permits but does not regulate by statute. Fortunately, the Supreme Court has acted to fill this void by providing in Rule 23.1 of the Civil Rules certain regulations for derivative actions by shareholders. (Added by Supreme Court Order 258, November 16, 1976.) The Alaska rule is predicated upon and nearly identical to Rule 23.1 of the Federal Rules of Civil Procedure. In my opinion, it does not go far enough in policing derivative actions by shareholders in the context of the General Stock Ownership Corporation.

The matters which should be covered by statute include:

* Who among the shareholders may bring such an action?

I suggest that standing be limited to a shareholder who held his or her share at the time of the transaction of which complaint is made

else an unscrupulous shareholder might merely "buy a lawsuit." And standing should be limited to a shareholder or shareholders with sufficient resources to be able to vigorously prosecute the action since a judgment will bind all of the other shareholders by its result.

* Should the shareholder be required to exhaust intra-corporate remedies (e.g., make a demand upon the Board that it bring the action) as a precondition to commencing the action?

Modern statutes do not require the shareholder to make demands upon the Board if that would be a futile act (e.g., if the directors are named as the defendants it is unlikely that they would respond to the demand by directing suit against themselves). Thus I would propose that the shareholder be required to make demand upon the Board for corrective action or to allege in his complaint before the superior court the reasons why he deems such a demand to be a futile gesture.

* Should the shareholder be required to post a bond as a precondition to maintaining any derivative action?

Defending a derivative action is time consuming and expensive and there is always a danger that a shareholder will bring an ill-founded or vexatious action simply to harass management or in the hope that he will be "bought off" with an out-of-court settlement. To minimize the instance of such "strike suits," many states in the 1940's adopted the practice of requiring a litigating shareholder to post a bond as a precondition to maintaining the action, a bond which would hold the defendants harmless against their costs of litigation (including attorney's fees) in the event the shareholder should fail to prevail. There is no current Alaska law on this point. Rule 23.1 is silent. My suggestion is that the Committee borrow the best

features of modern California and New York statutes on striking a balance on this vital question. Section 800 of the California Act leaves the trial court with substantial discretion to entertain a timely motion from defendants for the posting of such security. Thus the court could consider the nature of the plaintiff's allegations and project the likelihood of success. It would then exercise sound discretion in requiring that a bond be posted or in denying the request of the defendants. If a bond is required the court has further discretion to determine the amount of the bond. California presently limits the bond to a sum not more than $50,000. This ceiling is viewed as posing some protection against a judge who would simply price the plaintiff out of court with a bond requirement substantially beyond reasonable means. Again, the California Act provides that the amount of the bond may be raised or lowered (subject to the $50,000 ceiling) at any time during the course of the litigation upon the motion of either party or upon the court's own initiative as it seems the interests of fairness to require.

* Should the shareholder who has commenced a derivative action be allowed to compromise or "settle out of court"?

No, not in my opinion. This is very dangerous and tolerates "strike suits"--actions commenced with no solid ground but with the hope that management will tire of the time and expense of defending the litigation and "buy plaintiff off." New York is far ahead of other jurisdictions in warding off this danger. No action in the nature of a derivative suit may be settled or compromised without the approval of the court in which it was commenced and without notice to the other shareholders. This last feature is essential to protect the interests of both the court and the other shareholders. The court is protected

for a judicially approved settlement precludes any shareholder from attempting to relitigate the same questions. The notice requirement permits other shareholders to come forward and object either to the terms of the proposed settlement or to offer to take up the suit and carry it forward in the event of an afterarising unwillingness of the original litigant.

* Should the litigating shareholder in all circumstances be forced to account to the corporation for any proceeds realized from such an action?

Yes. In all jurisdictions this is mandatory if the court returns a judgment against the defendant officers or directors. All proceeds of the judgment are paid into the corporate treasury on the theory that the action has vindicated harm done to the corporation and not the litigating shareholder. The shareholder receives an allowance from these funds sufficient to cover the costs of the litigation. But what if the resolution is by way of an informal settlement? This is the dark side of this type of litigation. Frequently shareholders are offered a tidy sum (e.g., $20,000) if they will dismiss their suit. They keep the money and none of the other shareholders are the wiser. New York simply prevents this. There can be no informal settlement. Any dismissal predicated upon a compromise must be presented to the court, its terms noticed to the other shareholders, and any proceeds paid into the corporate treasury.

If all of these features are incorporated into the enabling act, I am of the view that Alaska will have the best of all possible positions with the virtue of derivative actions and none of the vices inherent in strike litigation.

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DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor in principle the concept of permitting derivative actions by shareholders in the General Stock Ownership Corporation? YES ____ NO ____. If "yes," does the Committee favor regulating the derivative action by special provisions in the enabling act? YES ____ NO ____. If "yes," does the Committee favor:

* The suggested standing rules? YES ____ NO ____.
* The suggested provision on exhaustion of intra corporate remedies? YES ____ NO ____.
* The suggested provision on the posting of a security bond for the defendants' costs of litigation? YES ____ NO ____.
* The suggestion that there be no compromise or dismissal of such an action without court approval? YES ____ NO ____.
* The suggested provision that the litigating shareholder in all circumstances be forced to account to the corporation for any proceeds realized from such a derivative action? YES ____ NO ____.

II. PROPOSALS DESIGNED TO INCREASE THE INFORMATION AVAILABLE TO AND THE POTENTIAL ROLE OF SHAREHOLDERS IN THE GENERAL STOCK OWNERSHIP CORPORATION.

PROPOSAL NUMBER FOUR: THAT THE ENABLING ACT BE AMENDED TO PROVIDE LIABILITY FOR AN OFFICER OR AGENT WHO WRONGFULLY REFUSES TO ALLOW A SHAREHOLDER, OR A SHAREHOLDER'S AGENT OR ATTORNEY, TO EXAMINE AND MAKE EXTRACTS FROM CORPORATE BOOKS AND RECORDS.

I propose that an officer or agent who refuses to allow a shareholder or the agent or attorney of a shareholder to examine and make extracts from corporate books and records

of account, minutes, and record of shareholders, for a proper purpose be made liable to the aggrieved shareholder for the penal sum of $1,000 in addition to other damages or remedy given such shareholder by law.

Explanation: Currently Sec. 10.05.240 of the Alaska Business Corporations Act confers upon shareholders a right to examine books and records. Section 10.05.243 provides a penalty for any officer or agent of the corporation who refuses to permit this inspection. Unfortunately, the penalty there provided (10% of the value of the shares owned by the aggrieved shareholder), is not much of a sanction in the context of the GSOC. In other contexts it may be very effective for it is obvious that the larger the number of shares owned by the aggrieved shareholder the more substantial are the consequences of denying the right of inspection. But a shareholder in the GSOC can never own more than 10 shares. Thus I propose to follow the current content of Alaska law in all particulars save for suggesting that a flat penal sum of $1,000 be established as the sanction.

The effective use of any of the shareholder checks upon management which are set forth in Suggestions One, Two and Three depend upon an effective ability to gain information as to the conduct of corporate affairs by the officers and the Board. Thus an effective right of inspection is essential. Indeed, the Committee might desire to see the penal sum imposed for each day there is a wrongful denial of the statutory right of inspection conferred by Sec. 10.05. 240.

DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor the concept of a statutory right of shareholders in the General Stock Ownership Corporation to inspect corporate books and records? YES ____ NO ____. Should this sum be levied: (a) per

refusal _____; or, for each day of a refusal _____?

PROPOSAL NUMBER FIVE: THAT THE SHAREHOLDERS BE GIVEN THE POWER TO INITIATE AMENDMENTS TO THE BYLAWS.

The current statutes in Alaska provide that the articles may restrict the power to adopt, amend, and repeal bylaws to the Board of Directors. The Kelso Report recommends articles which do so restrict the power to the Board and it is likely that this is what a Board would do. I propose that the enabling act be amended to reserve a power of adoption, amendment or repeal of the bylaws to the vote or written assent of shareholders entitled to exercise a majority of the voting power of the GSOC. I would also propose that the act permit the Board to enjoy this power save for the fact that the Board could not, on its own motion, repeal or amend a bylaw which had been adopted by vote of the shareholders.

Explanation: As was dramatically illustrated by the content of the Kelso Report, the document which is most likely to contain the crucial provisions which govern the structure and operation of the General Stock Ownership Corporation is the bylaws. A significant feature in what is, in my opinion, the excessive grant of power to the Board in SSHB 240 is the potential for vesting this power exclusively in the Board. The balance can be redressed by simply amending the enabling act to provide for a sharing of this power in the case of a General Stock Ownership Corporation.

DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor the concept of permitting the shareholders to adopt, amend or repeal bylaws in the General Stock Ownership Corporation? YES ____ NO ____. If "yes," does the Committee favor the

suggestion that this power be vested by statute in both the shareholders and the Board? YES ____ NO ____.

III. PROPOSALS DESIGNED TO IMPROVE THE QUALITY OF BOARD DECISION MAKING.

PROPOSAL SIX: THAT THE BOARD BE ENABLED TO TRANSACT BUSINESS BY USE OF A CONFERENCE TELEPHONE OR SIMILAR COMMUNICATIONS EQUIPMENT.

Given the significant distances as barriers to travel within the State of Alaska plus the strong likelihood that a minority of the directors will be non-Alaskans, I propose that the enabling act be amended to authorize the board to transact business by use of a conference telephone or similar communications equipment so long as all members participating in such a meeting can hear one another.

Explanation: One of the difficulties inherent in a body of nine members is to physically gather them in the same place at the same time for the transaction of Board business. In large corporate entities this is frequently difficult. The result has been a tendency to permit the Board to divide itself into smaller working committees or an "executive committee" to which is delegated most of the Board's function and authority. There is a price paid for such a solution. Decisions are made without the participation of the full membership. Yet a n classical solution is at hand, and from my personal observation, a very familiar aspect of life in Alaska--the use of modern communications equipment to hold board meetings notwithstanding the fact that the members are not in the same place at the same time. Both California and Delaware now permit this and the reported experience is very satisfactory. I would suggest that such a provision be made a permanent amendment to Sec. 10.05.198 for all corporations formed in Alaska. It certainly merits adoption in the special case of the GSOC.

DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor the concept of permitting the directors to hold meetings via the use of conference telephones or similar communications equipment with participation in such a meeting constituting presence in person? YES ___ NO ___.

PROPOSAL NUMBER SEVEN: THAT REGARDLESS OF COMMITTEE ASSIGNMENTS EVERY DIRECTOR HAVE A RIGHT TO ATTEND THE MEETINGS OF ANY COMMITTEE AND BE PRIVY TO ALL BOOKS AND RECORDS.

Current Alaska law permits the Board to divide itself into committees including an executive committee and to delegate board functions and authority. I have no quarrel with this concept but do suggest that the enabling act be amended to make it clear that regardless of committee assignments any director shall have the right to attend (but not participate in) any meeting of any committee and to have access to books and records pertaining to the activities or responsibilities of such committees as may, from time to time, be created.

Explanation: Again we illustrate what one jurist has termed the "law of laws" . . . that every advantage is purchased at a price. The desire to streamline and specialize the functions of directors is understandable but the price is the exclusion of those directors who are not appointed to key committees. Sometimes this problem assumes serious dimension as those directors who are perceived by the majority as raising vexing questions and airing dissenting views are simply shunted aside by exclusion from committee assignments. The legislature can go some distance toward minimizing this harm by providing by statute a right of each director to attend the meeting of any committee and to have access to books and records.

DIRECTIONS TO YOUR DRAFTING AIDES: Does the Committee favor the concept of granting directors a statutory right to attend the meetings of any Board committee and to have access to minutes and records? YES ____ NO ____.

END OF THIS TRANSMISSION -- SEPARATE LETTER BEING TRANSMITTED NEXT.

SUMMARY OF TESTIMONY

Robert D. Hamrin

In 1976, the Joint Economic Committee recommended to Congress that it "be made national policy to pursue the goal of broadened capital ownership" and a follow-up staff study concluded that "serious consideration should be given to plans that are open to all individuals."

I wish to congratulate the state of Alaska for taking the first bold steps toward implementing such a plan. I also wish to emphasize that a primary virtue of the proposed AGSOC is its simplicity in dealing with one class of stock distributed equally to all citizens. It is most likely that refinements will be made over time but for now, it is important that a track record begins to be established and people's reactions gauged. I firmly believe that the AGSOC, if established, will long be heralded as the first move toward "economic democracy."

As an economist who has examined all the major ideas for broadening capital ownership, I feel the AGSOC is the right step at the right time. The current national policy for broadening capital ownership, ESOPs and TRASOPs, is good so far as it goes, but that is not far enough since the majority of individuals would not significantly benefit from such employee-centered plans.

The AGSOC would benefit every citizen; it would allow all Alaskans to share directly in their highly productive economy; it should establish a stronger foundation for future economic growth due to the increased consumption demand flowing from the augmented incomes of consumers; it is the best plan for providing a more equitable distribution of income and wealth without disturbing present holdings; and by enabling all citizens to "participate" in production through capital ownership, they should gain a better understanding of the workings of the private enterprise system.

The full text of my prepared statement presents a critique of the Kelso study which focuses on a number of inaccurate statements made in the "economic reasoning" section. My statement also contains some specific comments regarding the AGSOC bill: I question whether an emigrating shareholder, particularly in the first few years, should be allowed to take stock with him; there should be provisions for how the stock shares from future major investments would be distributed as well as for repayment of the loan; the question of who the beneficiaries should be in the future and whether shares should be equally distributed needs to be examined.

Testimony for Division of Legislative Finance
regarding
Alaska General Stock Ownership Corporation (AGSOC)

Robert D. Hamrin

The Right Step at the Right Time

In its 1976 Annual Report, the Joint Economic Committee made the following recommendation to Congress:

> To provide a realistic opportunity for more U.S. citizens to become owners of capital, and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership.

Four months later, the Committee published a staff study which after examining numerous means by which to achieve broadened capital ownership concluded:

> Since this is a goal for all Americans and not just employees of corporations, serious consideration should be given to plans that are open to all individuals...

Three years later, the state of Alaska is to be congratulated for taking the first bold steps toward implementing such a plan. Talk, especially in Washington, D.C., comes cheap and there is much talk regarding the ills of our society and even a fair amount regarding possible remedies. But 95% of talk ends there. Of the 5% that does result in new policies or actions, 90-95% is simply a replay of old ideas, perhaps slightly modified. Rare, extremely rare, is the example of a bold, creative new solution actually being implemented. This is the primary point that should be remembered in the midst of the specific details which follow.

In the same vein, although a few "complicating" suggestions are offered below, a primary virtue of the proposed plan is its simplicity. It deals with one class of stock distributed equally to all citizens. This is as it should be for the initial general plan for broadened capital ownership.

If, for example, a choice of stocks from a diversified portfolio were offered to households, wise or simply early recipients could quickly deplete the supply of "choice stock" and individuals who are not knowledgeable and perhaps have never owned stock would be handicapped in making wise choices on a diversified portfolio.

The ACSOC, if established, will be long remembered as the first concrete step towards "economic democracy." The intent of this phrase has been incisively portrayed by Winnett Boyd:

> If a country in which only a few men and women are citizens is politically unjust, the remedy is not to abolish citizenship but to make all men and women citizens. If an industrialized country in which only a few own all the capital is economically unjust, the remedy is not to abolish private capital but to make it possible for all to become owners of some of it.

An Economic Perspective

Statistics show that in the early 1970s, nearly one out of every eight American families had essentially no financial net worth and the majority had a financial net worth of less than $10,000. This illustrates the fragile, debt-underwritten affluence of American households and the fact that the economic democracy spoken of above is far from a reality.

If economic democracy is to be the goal, then ESOPs and TRASOPs which constitute the current national policy for broadening capital ownership cannot be the final answer. Because the majority of individuals would not significantly benefit from such employee-centered plans, there is a lack of interest and support for them. This again points to the need for a plan that reaches everyone. There is much to be said for the excitement stemming from a commonly shared experience among all Alaskan citizens that such a plan is likely to generate.

The ACSOC has many attractive features. It can benefit everyone or be targeted to whatever groups may be desired. It does not favor corporate

officers or executives, or persons employed by the most successful or most capital-intensive corporations. It does not force a rift between a worker and his or her union nor does it create a climate in which union leaders might take control of corporations. It does not depend, as ESOPs and TRASOPs do, upon tax subsidies, tax benefits, or the loss of tax revenues.

What the ACSOC does do is most important. It allows all Alaskans to share directly in their highly productive economy, thus increasing purchasing power as more dollars flow as dividends to lower and middle income households. Relatedly, it should establish a stronger foundation for future economic growth which would be stimulated by the increased consumption demand flowing from the augmented incomes of consumers. It also does more in terms of providing a more equitable distribution of income and wealth without disturbing present holdings than any other plan that has been suggested to date. A final important non-economic benefit is that by enabling all citizens to "participate" in production not only through their labor but also through capital ownership, the ACSOC will lead to a better understanding by Alaskans of the workings of the private enterprise system.

Basically, the ACSOC is recognizing that some portion of the state's immense "public wealth" should be distributed directly to the people. The state government can facilitate this by providing a mechanism whereby all individuals have equal access to credit in order to obtain stock on the basis of its anticipated future earnings.

Critique of the Kelso Study

My general reaction to the Kelso study was one of disappointment. In specifying the legal and financial design of the ACSOC, it did not go much

beyond the provisions specified in the Revenue Act of 1978. The other major part - the economic reasoning supporting the bill - was riddled with incorrect statements, some of a serious nature which should be divorced from the considerations on establishing an ACSOC. What was needed was not simply the "design" of an ACSOC but an analysis of it which would specify first why this type of corporation should be established over other means of broadening capital ownership and second its numerous effects.

Before highlighting the incorrect statements in the "economic reasoning" section, I have two questions regarding the design of this project as proposed by Kelso. The first regards his statement on page 5 that the proposed design permits an "emigrating shareholder to take his stock with him in order to continue to enjoy its income in the future." This seems to violate the spirit of the ACSOC proposal. It does not seem right that someone who recently moved to Alaska with the intent of staying only a few years can leave with a share of stock within a couple of years.

The more serious matter regards the question of future financing and distribution of newly created stock. On page 28, the Kelso study discusses new residents purchasing shares from the initial distribution which the corporation had bought back. I could find no discussion, however, of how the shares from a second major investment a few years hence would be distributed. Would just new residents receive such shares? Would all residents receive the shares? If so, would they all receive equal shares? This point needs to be clarified in the bill.

Regarding the economic reasoning section, the most serious problem is the insertion of Kelso's two factor theory contention that we have been operating under one factor (labor) theory and policy: "The notion that labor is the only, or chief, factor of production is the keystone of the

conventional economic wisdom." (p. 17) This is patently false as capital has been at the forefront of economic analysis for most of this century. The danger is that linking the ACSOC to two-factor theory would instantly discredit the ACSOC. Furthermore, there is no need to bring one factor, two factor or even three factor (which is what economics has emphasized for 200 years) theory into a discussion of a plan to broaden capital ownership.

It should also be noted that the so-called two factor theory is really the clearest example one could hope to see of a one factor theory: "an age when wealth is chiefly produced by things" (p. 21) or "affluence is not the product of the human factor but the non-human factor." (p. 22) Such statements have no basis in reality.

Other statements that are incorrect are: "still pretending to believe that labor's productivity is rising" (pp. 16-17) because everyone has acknowledged for years the decade long decline in labor productivity; "there could be no physical shortage of purchasing power..." (p. 23) because the concept of a physical shortage cannot relate to purchasing power; and "since the corporate sector produces 87% of non-agricultural, non-governmental goods and services, it also generates 87% of the economy's' purchasing power" (p. 25) because purchasing power and production are not equivalent to each other, being two distinct phenomena. There is also a factual error on p. 10 for the maximum corporate income tax rate is now 46%.

Specific Comments and Recommendations

I have a number of concerns regarding dividends. First, it is unclear to me when they start being distributed. Also, does the 90% mandatory payout refer to net income after the loan payment has been made? Relatedly, I could find no provisions in the bill related to repayment of the loan, particularly regarding the time period. This should be clearly specified.

Regarding the distribution of dividends, I have noted that a one share per citizen distribution is appropriate in the beginning. However, if the goal is to provide capital ownership to those who otherwise would likely never own capital, the idea of distributing future shares according to income level should be explored. It is hard to justify giving free shares to that top 5% Kelso so often refers to who own most of the income-producing capital today. Perhaps a simple sliding scale would be most equitable: 3 shares to those making $0 - 12000; 2 shares for $12 - 25000, 1 share for $25 - 40000 and no shares for $40000 and above. The question of whether all citizens or just adults should be share recipients needs to be examined. Also, should long-standing Alaskan citizens receive favored treatment over newcomers? Such questions would become more significant as future investments are undertaken by AGSOC.

My other set of comments relate to project evaluation. Senator Gravel has suggested the type of evaluation he would like to see in the Congressional Record of October 24, 1978. I encourage the Alaskan State Legislature to incorporate these requirements into the legislation establishing the AGSOC: that the annual report of the GSOC filed with the Treasury Department include studies of the effect of the GSOC on distribution of income and wealth, the level of transfer payments made or required, the social and demographic profiles of GSOC shareholders, the level of economic understanding of GSOC shareholders, and possible beneficial revisions to the GSOC legislation. The legislature may also want to more closely examine the effect on state revenues and outlays as well as conduct a more in-depth survey of a sample of recipients which could be used as input to an annual "Report from the People" which could be distributed to all Alaskans.

Robert D. Hamrin

Biographical Sketch

Received his B.A. Magna Cum Laude from St. Olaf College in 1968 and his Ph.D. in Economics from the University of Wisconsin in 1972. Served as Assistant Professor at Hong Kong Baptist College (1972-73) and University of Idaho (1973-74). Came to the Joint Economic Committee as a staff economist where his two major areas from 1974-78 were broadening capital ownership and long-run U. S. economic growth prospects. His principal duties regarding the capital ownership area were to staff the J.E.C. hearings in December 1975 and author the staff study Broadening the Ownership of New Capital: ESOPs and Other Alternatives. In 1978, he wrote a book under a Rockefeller Foundation grant titled Rethinking Economics: The Realities of the 1980s which will be published by Praeger in late 1979. He is currently serving as the Senior Policy Economist at the U.S. Environmental Protection Agency.

James Aller were able to create and fund the Economic and Development Corporation, a separate Swiss company, and pay $750,000 to Dr. Hubert Weisbrod, a Swiss attorney, to stimulate West German jet sales without the knowledge of the board or, apparently, other senior executives.

At 3M, chairman Bert Cross and finances vice president Irwin Hansen ordered the company insurance department to pay out $509,000 for imaginary insurance and the bookkeeper to fraudulently record the payments as a "necessary and proper" business expense for tax purposes. Although the transactions lacked required documentation, they were approved by both departments and later "verified" by Haskins and Sells, the outside auditor.

Ashland Oil Corporation's chief executive officer, Orwin E. Atkins, involved at least eight executives in illegally generating and distributing $801,165 in domestic political contributions, also without question. Not only was the board not informed until the Special Prosecutor's Office and Internal Revenue Service compelled Atkins to dribble out details of the misappropriation of funds, but Ernst and Ernst, Ashland's accountants, did not effectively investigate any of half a dozen separate accounts it discovered that suggested Ashland's illegal course of action.

The Legal Basis of Management Power

The legal basis for such a consolidation of power in the hands of the corporation's chief executive is the proxy election. Annually the shareholders of each publicly held corporation are given the opportunity of either attending a meeting to nominate and elect directors or returning proxy cards to management or its challengers signing over their right to vote. Few shareholders personally attend meetings. Sylvan Silver, a Reuters correspondent who covers over 100 Wilmington annual meetings each year, described representative 1974 meetings in an interview: At Cities Service Company, the 77th largest industrial corporation with some 135,000 shareholders, 25 shareholders actually attended the meeting; El Paso Natural Gas with 125,000 shareholders had 50 shareholders; at Coca Cola, the 69th largest corporation with 70,000 shareholders, 25 shareholders

SOURCE: TAMING THE GIANT CORPORATION

NADER, GREEN AND SELIGMAN

attended the annual meeting; at Bristol Meyers with 60,000 shareholders a like 25 shareholders appeared. Even "Campaign GM," the most publicized shareholder challenge of the past two decades, attracted no more than 3,000 of General Motors' 1,400,000 shareholders, or roughly two-tenths of one percent.

Thus, corporate directors are almost invariably chosen by written proxies. Yet management so totally dominates the proxy machinery that corporate elections have come to resemble the Soviet Union's euphemistic "Communist ballot"—that is, a ballot which lists only one slate of candidates. Although federal and state laws require the annual performance of an elaborate series of rituals pretending there is "corporate democracy," in 1973, 99.7 percent of the directorial elections in our largest corporations were uncontested.

Of the 6,744 corporations required to file data with the Securities and Exchange Commission, incumbent management retained control in at least 6,734 companies, or 99.9 percent. In the 500 largest industrial corporations—corporations which account for some 66 percent of the sales of all industrial corporations in the United States—no incumbent management was even challenged in 1973. One-sided as these results are, they are entirely typical for the largest business corporations. During the 18 years for which data are available, 1956–73, management has won 99.9 percent of all proxy solicitations in 10 out of 18 years.

THE BEST DEMOCRACY MONEY CAN BUY

The key to management's hegemony is money. Effectively, only incumbent management can nominate directors—because it has a nearly unlimited power to use corporate funds to win board elections while opponents must prepare separate proxies and campaign literature entirely at their own expense.

There is first management's power to print and post written communications to shareholders. In a typical proxy contest, management will "follow up" its initial proxy solicitation with a bombardment of five to ten subsequent mailings. As attorneys Edward Aranow and Herb Einhorn explain in their treatise, *Proxy Contests for Corporate Control:*

Perhaps the most important aspect of the follow-up letter is its role in the all-important efforts of a soliciting group to secure the *latest-dated* proxy from a stockholder. It is characteristic of every proxy contest that a large number of stockholders will sign and return proxies to one faction and then change their minds and want to have their stock used for the opposing faction.

The techniques of the Northern States Power Company in 1973 are illustrative. At that time, Northern States Power Company voluntarily employed cumulative voting, which meant that only 7.2 percent of outstanding shares was necessary to elect one director to Northern's 14-person board. Troubled by Northern's record on environmental and consumer issues, a broadly based coalition of public interest groups called the Citizens' Advocate for Public Utility Responsibility (CAPUR) nominated Ms. Alpha Snaby, a former Minnesota state legislator, to run for director. These groups then successfully solicited the votes of over 14 percent of all shareholders, or more than twice the votes necessary to elect her to the board.

Northern States then bought back the election. By soliciting proxies a second, and then a third time, the Power Company was able to persuade (or confuse) the shareholders of 71 percent of the 2.8 million shares cast for Ms. Snaby to change their votes.

Larger, more experienced corporations are usually less heavy-handed. Typically, they will begin a proxy campaign with a series of "build-up" letters preliminary to the first proxy solicitation. In Campaign GM, General Motors elevated this strategy to a new plateau by encasing the Project on Corporate Responsibility's single 100-word proxy solicitation within a 21-page booklet specifically rebutting each of the Project's charges. The Project, of course, could never afford to respond to GM's campaign. The postage costs of soliciting GM's 1,400 000 shareholders alone would have exceeded $100 000. The cost of printing a document comparable to GM's 21-page booklet, mailing it out, accompanied by a proxy statement, a proxy card, and a stamped return envelope to each shareholder might have run as high as $500,000.

Nor is it likely that the Project or any other outside shareholder could match GM's ability to hire "professional" proxy solicitors such as Georgeson & Company, which can deploy up to 100 solicitors throughout the country to personally contact shareholders, give them a campaign speech, and urge them to return their proxies. By daily tabulation of returned proxies, professional solicitors are able to identify on a day-by-day basis the largest blocks of stock outstanding which have yet to return a favorable vote.

Management's "army" in a proxy contest will also include attorneys to prepare necessary documents for the SEC and distract the opposition with costly litigation; accountants and statisticians to prepare the most self-serving financial analysis allowable; and public relations advisors to prepare advertisements for trade journals and the financial section of major newspapers. In the past 25 years there have been no more than a dozen instances in which insurgents have been able to match management expenses in a major proxy fight. Over the past decade, only the MGM proxy contest of 1967 has seen insurgents match management expenses in a large corporation's proxy contest for control.

A second advantage—and one that no outsider can match—is management's ability to use corporate personnel on its own behalf. Clerical help and clerical facilities including printing presses, photocopying machines, and addressing machines are invariably employed. Salespersons skilled in talking to customers are frequently assigned to the telephones to answer inquiries and to supplement the professional proxy solicitors by making direct calls to shareholders. Moreover, senior executives can be assigned to telephone particularly important shareholders who may be impressed by the personal call of a top executive.

State corporations law has done nothing to correct this inequality of corporate resources. Although leading cases in Delaware and New York have engaged in much gnashing of teeth about limiting management expenditures to: (a) proxy contests involving a "policy" issue, (b) expenditures necessary to inform shareholders about the "policy" issue, and/or (c) "reasonable" expenses—no decision since 1967 in either jurisdiction has denied management the power to expend corporate funds or use corporate personnel exactly as management chooses. Even such seemingly "unreasonable"

expenditures as public relations counsel, "entertainments," chartered airlines, limousines, and the indirect cost to the corporation of using officers and employees on behalf of an incumbent director slate have survived judicial scrutiny. By contrast, state courts have firmly established the rule that insurgents, unlike management, are not entitled to reimbursement of any campaign expenses as a matter of right. Challengers must defray all their own expenses, with the single slim hope of later being reimbursed *if* they are successful and the stockholders approve.

MANAGEMENT CONTROL OF INFORMATION

Management's grip on corporate power is tightened by its authority to print and distribute annual, quarterly, and other reports to shareholders. Besides the formal proxy statement, these reports usually embody the only detailed information shareholders receive about their corporation.

Neither state nor federal law places any meaningful restrictions on the amount of money management may spend reporting to shareholders. SEC Proxy Rules *do* require certification of financial statements. The report, however, "may be in any form deemed suitable by the management" and is not subject to the same standards of truthfulness that the text of a proxy solicitation is subjected to. Consequently, though every word of an insurgent shareholder's communications with other shareholders may be challenged if it is arguably "false or misleading," most management reports are subject to no textual regulation whatever.

Unfortunately, management reports are frequently "false and misleading." They are often written in an upbeat public relations jargon which emphasizes "positive" aspects of the past business year while rationalizing or ignoring management mistakes, financial losses, corporate or executive criminal violations, or civil actions successfully prosecuted against the corporation. Frequently, as much as half of the text of an annual report is represented by oversized charts, colored illustrations, and kindred public relations gimmickry.

There is often little difference between the text of a failing corporation's annual report and a healthy corporation's report. For example, although subsequent congressional testimony made clear that Lockheed would have gone bankrupt unless it received an emergency loan guarantee from the federal government, Lockheed's 1969 annual report managed to ignore the prominent debate in Congress over whether the federal government should "bail out" the firm. Instead shareholders read the following:

> It is disappointing to have to record a net loss for the year. Yet setbacks like this are singularly possible in an industry so dependent upon government policy and the ebb and flow of domestic and international developments.
>
> We have experienced them before and in each case have emerged stronger than ever. We are confident this will be so again. We say this not out of easy optimism but from the knowledge that we have many broadly based defense and commercial programs with high business potential and that we are expending more technical effort to meet the nation's future needs.

The report then spent six pages suggesting that Lockheed's financial difficulties were primarily the result of contractual misunderstandings with the federal government. It strongly suggested that the federal government would compromise in these disputes. It was only *after* the Senate voted an Emergency Loan Guarantee by the razor-thin margin of 49–48 in August 1971 that Lockheed reported to its shareholders that without this congressional subsidy the corporation would have collapsed.

A similar lack of veracity appeared in the 1973 Annual Report of the Franklin New York Corporation, whose principal subsidiary was the Franklin National Bank, the largest state bank ever to fail in the United States. Just a few months before the Comptroller declared the Franklin National Bank insolvent, the corporation's management reported to its shareholders that "In 1973 Franklin crossed an important threshold so that it is now in a position to move forward in establishing itself as a major worldwide financial institution and a leading money center banking operation." Nowhere in the report was any mention made of the foreign currency speculation or improvident real estate loans which four months later caused the bank's demise. This was a serious omission, for the largest tolerance of financial loss caused by Franklin's collapse was

absorbed by the shareholder-readers of this report, not the management or the public relations firm which wrote it. These shareholder-readers were given absolutely no warning of what was coming, no opportunity to exert their prerogative to change management or to vote a more timely dissolution.

Nor can insurgent shareholders obtain much additional information from their own corporation when they prepare for a proxy challenge. They lack the legal tools to gain access to live interviews with corporate executives, board meetings, or memoranda which could document internal debate, management error, derogations of law, sloppy execution of policy, or even the content of management's policy formulations.

All of which is a bizarre commentary on the Securities and Exchange Commission. The federal security laws emphasize disclosure. The Commission has claimed that its Proxy Rules "represent an effective contribution to corporate democracy" because disclosure enables individual investors to exercise some measure of control over the management of their corporation. Although the Securities and Exchange Act of 1934 authorizes the SEC to require annual and quarterly reports, including the authority to prescribe "the items or details to be shown in the balance sheet and the earnings statement . . . ," shareholders can not compel their corporation to give a product line or division accounting so as to uncover unprofitable operations. Specific management mistakes may thus be submerged in consolidated financial reports. Shareholders may wish to know whether executives are using expense accounts improperly or are being indemnified for certain civil or criminal liabilities. They cannot find out. They may wish to read minutes of the meetings of corporate directors—whom they elect—or reports of decisions by executives respecting corporate property—which shareholders own. Under federal securities laws, they have no legal rights to do so.

Under state statutory law, shareholders theoretically have broad rights to examine corporate records. State statutes typically authorize inspection of shareholder lists—without which a shareholder could not even begin a proxy solicitation—and "other books and records." But this access is circumscribed by legal requirements of "good faith," "proper purpose," and minimum share ownership, as well as ample opportunities for management to delay compliance with legitimate shareholder demands by forcing expensive court tests.

Almost invariably shareholders prevail in court battles to secure a shareholder list, for, as a leading Pennsylvania decision put it, ". . . the right to examine the stockholders' list is a basic privilege of every stockholder of a corporation and should be given the widest recognition as fundamental to corporate democracy." But the courts are reluctant to enforce shareholder demands for other information. Doctrinally, this has been rationalized as deterring excessive "stockholder agitation." The Supreme Court of Minnesota rather melodramatically explained why in the leading case of *State Ex rel. Pillsbury v. Honeywell:*

> In terms of the corporate norm, inspection is merely the act of the concerned owner checking on what is in part his property. In the context of the large firm, inspection can be more akin to a weapon in corporate warfare. The effectiveness of the weapon is considerable: "considering the huge size of many modern corporations and the necessarily complicated nature of their bookkeeping, it is plain that to permit thousands of shareholders to roam at will through their records will render impossible not only any attempt to keep their records efficiently, but the proper carrying on of their business." . . . Because the power to inspect may be the power to destroy, it is important that only those with a bona fide interest in the corporation enjoy the power. . . .

Alarming as the specter of "thousands of shareholders roaming at will" through once efficient corporations may be, it can only be conjured up by courts so cunning as to overlook their inherent judicial power to restrict any shareholder access to corporate data to reasonable numbers of shareholders at reasonable times and reasonable places. Yet phantom or not, this rationale has been employed in recent decisions to deny one A&P shareholder access to the minutes of board meetings and information relevant to store closings; to deny Ralston Purina shareholders access to monthly profit analyses employed by management; and to deny shareholders of Gulf Sulphur Corporation information concerning a firm with which Gulf proposed to merge.

MANAGEMENT CONTROL OF THE LAW

Management power is further entrenched by three significant legal advantages.

First, in approximately 90 percent of all large industrial corporations, cumulative voting is not required. In these corporations, a minority of shareholders—even a minority as substantial as 49.9 percent—may be precluded from electing even one director to the board.

Under cumulative voting, each shareholder is entitled to votes equal to the number of his or her shares multiplied by the number of directors to be elected. The shareholder may cast all his or her votes for a single candidate or distribute them among two or more candidates as he or she sees fit. Cumulative voting, therefore, helps to protect the *financial* interest of minority shareholders by assuring them voice on the board of directors. And it protects the *political* interest of minority shareholders. For without cumulative voting, the tendency of large industrial corporations to perpetuate one-party rule is powerfully enhanced. As Professor Charles M. Williams demonstrated after analyzing proxy contests for the years 1943–1948, corporations with cumulative voting were more than twice as likely to have proxy contests as those without.

Because of these benefits, cumulative voting has enjoyed considerable popularity. From 1870, when Illinois became the first state to require cumulative voting, until 1955, 23 states had established absolute requirements for cumulative voting. Additionally, federal law requires cumulative voting for over 5,000 banks subject to the Federal Banking Act of 1933 (although the intent of this law has often been frustrated by bank holding company structures); and the Securities and Exchange Commission has consistently required cumulative voting for corporations subject to the Public Utility Holding Act of 1935 and corporations undergoing reorganization under Chapter X of the Bankruptcy Act. As an attorney snapped in 1950 in frustration at Wisconsin's refusal to enact cumulative voting, "Cumulative voting is so obviously in accord with our basic political philosophy of group representation and the party system that it is difficult to understand the [illegible]

ture's repeated rejection of it, except in terms of a response to the pressure of corporate management's interest."

Unfortunately, "the pressure of corporate management's interest" often does prevail in state corporation law. Between 1955 and 1972, five states dropped mandatory cumulative voting. In 1973, Michigan changed from mandatory to permissive cumulative voting; in 1974 both California and Ohio considered—but did not enact—similar legislation. Today, in Delaware, as well as 32 other states, cumulative voting is not required. True, in most of these states, cumulative voting is permitted. In practice, however, permissive cumulative voting offers little but an illusory right. Studies by Professor Williams in 1951 [illegible] the Conference Board in 1973 indicate that only about 15 percent of the corporations in states with permissive cumulative voting have provided for this right.

And even in those few corporations which voluntarily institute cumulative voting, most states provide ample devices to subvert it. Although cumulative voting aims to prevent a simple majority from maintaining absolute corporate control, Delaware permits a simple majority to amend the corporate charter to repeal cumulative voting. And Delaware and some 42 other jurisdictions allow the "classification" of the board of directors. This device reduces to one third or one half the number of directors required to stand for election anually and thus increases the minimum vote necessary to elect a director.

Management's second legal edge is its power to issue nonvoting stock or classes of stock with unequal voting rights. For example, prior to December 1, 1955, there were three classes of stock in Ford Motor Company: common, Class A, and Class B. Only the Class B shares (4.94 percent of total equity), all of which were owned by Ford family interests, were entitled to vote.

Only Illinois and a few other states forbid the issuance of classes or series of stock without voting rights. But the refusal of both the New York Stock Exchange and the American Stock Exchange to list corporations with nonvoting stock has substantially reduced the number of corporations which may totally eviscerate shareholder suffrage, although neither exchange actively enforces equal voting rights.

The third statutory device for impairing shareholder suffrage

rights is a provision common to the law of Delaware and apparently every other jurisdiction requiring the submission of proxy materials only to *shareholders of record*. This innocent sounding requirement effectively disenfranchises approximately 50 percent of the beneficial owners of corporate stock in the largest industrial corporations. For approximately 50 percent of the stock in the 1,800 companies traded on the New York Stock Exchange is held by mutual funds, life insurance or property and casualty insurance companies, private pension funds (usually administered through commercial bank trust departments), state and local pension funds, foundations, university endowment funds or other institutional investors. The result is a mockery of shareholder democracy: *Approximately 50 percent of the votes in our largest industrial corporations are cast by financial intermediaries—not the real owners.*

These institutional shareholders provide virtually no check to corporate management. Most financial institutions, according to the SEC's 1971 *Institutional Investor Study*, follow what is known as "The Wall Street Rule": An investment in a business corporation is considered an investment in that corporation's management; if the financial institution ceases to like what management is doing, the institution sells the stock. By examining the voting practices of 215 large institutions between January 1, 1967 and September 30, 1969, the SEC determined that approximately 30 percent of these institutions *always* voted for management (in elections other than votes for directors). For the remaining institutions, both voting against management and abstention were found "to be a relatively infrequent phenomenon." For example, in only 26 instances did any of the 215 institutions vote against an acquisition favored by management, "a miniscule fraction of such transactions."

The SEC conducted its study before the proliferation of shareholder proposals directed at social issues and precipitated by Campaign GM. In the past five years, some financial institutions have established formal procedures to consider shareholder public policy or ethical proposals. According to newsletters published by the Council on Economic Priorities and the Investor Responsibility Research Center, a small number of church-related funds, foundations, and universities have supported shareholder proposals respecting disclosure of political contributions; withdrawal from South Africa, Rhodesia, or Namibia; opposition to military production; or review of corporate safety, environment, occupational discrimination, or community programs. Since most institutional shares are voted by banks, insurance companies, and mutual funds, and these financial institutions have shown only a negligibly greater willingness to oppose management, the overall pattern of institutional voting has changed little in the past five years.

MANAGEMENT CONTROL OF OTHER FUNDAMENTAL DECISION-MAKING

Historically, shareholders controlled the business corporation not only through the election of directors but also through shareholders' power to initiate and vote upon all fundamental changes in the character of the corporation. Management's ability to initiate change was carefully circumscribed by requiring two-thirds or three-fourths affirmative votes for charter amendments, bylaw changes, mergers, sales of assets, stock issuance, recapitalization, or dissolution and was further limited by shareholder appraisal and preemptive rights.

Under Delaware's General Corporation Law, shareholders have lost nearly all power to initiate corporate change. Only the board of directors may propose charter amendments, a merger, or a sale of assets. The SEC Proxy Rules complement Delaware's corporation law by denying shareholders opportunity to communicate opposition to management proposals or to suggest modifications in management's formal proxy proposals.

This rout has been substantially replicated in all other leading chartering states. Indeed, the trend of recent revisions to state corporation law has been to attempt to deny the shareholder any vote at all! Modern corporate draftsmen invariably write short, purely formal certificates of incorporation and then place most of a corporation's actual governing rules in its bylaws, which the certificate establishes can be revised by the corporation's directors without any shareholder vote. For example, when ITT reincorporated in Delaware in 1967, it did so by creating a Delaware corporation called the "DeLitt Corporation" and by then merging ITT, previously a Maryland corporation, into DeLitt. The certificate of incorporation of DeLitt was only 1½ pages long. It reads in toto:

CERTIFICATE OF INCORPORATION OF DELITT CORPORATION

Article 1

The name of the corporation is Delitt Corporation (hereinafter called the "Corporation"). The name and mailing address of its incorporators are as follows:

NAME	MAILING ADDRESS
John J. Navin	320 Park Avenue, New York, N.Y. 10022
William J. Donovan	320 Park Avenue, New York, N.Y. 10022
DeForest Billyou	320 Park Avenue, New York, N.Y. 10022

Article 2

The address of the registered office of the Corporation in the State of Delaware is No. 100 West Tenth Street, in the City of Wilmington, County of New Castle. The name of its registered agent at such address is The Corporation Trust Company.

Article 3

The purpose of the Corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware.

Article 4

The total number of shares of stock which the Corporation has authority to issue is 100 shares of capital stock of the par value of $100 per share.

Article 5

Whenever the vote of stockholders at a meeting thereof is required or permitted to be taken for or in connection with any corporate action by any provision of the General Corporation Law of Delaware, the meeting and vote of stockholders may be dispensed with if the holders of stock having not less than the minimum percentage of the vote required by statute for the proposed corporate action shall consent in writing to such corporate action being taken, provided that prompt notice must be given to all stockholders of the taking of such corporate action without a meeting and by less than unanimous written consent.

Article 6

In furtherance and not in limitation of the powers conferred by law, the Board of Directors is expressly authorized:

(a) To make, alter, amend or repeal the By-Laws of the Corporation.

(b) To direct and determine the use and disposition of any annual net profits or net assets in excess of capital; to set apart out of any of the funds of the Corporation available for dividends a reserve or reserves for any proper purpose; and to abolish any such reserve in the manner in which it was created.

(c) To establish bonus, profit-sharing, stock option, retirement or other types of incentive or compensation plans for the employees (including officers and directors) of the Corporation and to fix the amount of the profits to be distributed or shared and to determine the persons to participate in any such plans and the amounts of their respective participations.

(d) From time to time to determine whether and to what extent, and at what time and places and under what conditions and regulations, the accounts and books of the Corporation (other than the stock ledger), or any of them, shall be open to the inspection of the stockholders; and no stockholder shall have any right to inspect any account or book or document of the Corporation, except as conferred by statute or authorized by the Board of Directors or by a resolution of the stockholders.

(e) To authorize, and cause to be executed, mortgages and liens upon the real and personal property of the Corporation.

Article 7

The corporation reserves the right to amend, alter, change or repeal any provision contained in this Certificate of Incorporation, in the manner now or hereafter prescribed by statute, and all rights conferred upon stockholders herein are granted subject to this reservation.

The key sentence is contained in Article 6: "In furtherance and not in limitation of the powers conferred by law, the Board of Directors is expressly authorized: (a) To make, alter, amend or repeal the By-Laws of the corporation. . . ." What ITT tried to do, as so many other giant Delaware corporations have tried to do, was to totally shut shareholders out of the governing process except in those rare instances in which the Delaware General Corporation Law explicitly requires a shareholder vote—which is not very often.

True, technically, section 251(c) grants shareholders a vote on management merger proposals. But this, in fact, is a mere snare

for the dim-witted. Only a small minority of corporate [illegible] actually trigger this shareholder vote. The overwhelming majority employ one of three conventional loopholes (discussed in the Source[illegible]

Similarly, section 271 limits shareholder suffrage in a sale, lease, or exchange of assets to transactions involving "all or substantially all" of a corporation's property and assets. Since most large industrial corporations are highly diversified, this provision effectively insures their shareholders will never vote. For example, General Motors could sell an automobile division such as Pontiac or Cadillac and not require a vote. It could liquidate hundred-million-dollar plants which manufacture refrigerators, diesel engines, and trucks or auction off all of its Detroit real estate and relocate in the Peoples Republic of China, and shareholders would have no choice in the matter. Only if GM sold *all* assets used to manufacture "automotive products" (about 75 percent of the corporation) would a sale of assets require a shareholder vote.

Moreover, section 271 is the only Delaware statute concerning corporate divisions. A Delaware corporation may create and fund new subsidiary corporations, regardless of size; liquidate these subsidiaries or comparable divisions and distribute assets to shareholders; or spin-off new corporations altogether without any shareholder vote. As business corporations have evolved these new forms, Delaware and other principal chartering states have deliberately not kept pace. Corporate executives have not hesitated to take advantage of this laxity. In the past three years many Delaware corporations have "gone private" and bought up minority shareholdings at bargain prices during a depressed stock market. This will allow favored shareholders or the firm itself to reap the profits when the company's stock price rises. Other senior managements have used the merger provisions to prevent take-over bids—which can benefit all shareholders—by requiring super-majorities, such as 75 or 90 percent, to consent to any consolidation or sale of the companies assets.

Whither/Wither the Board of Directors?

But does not the board of directors with its sweeping statutory mandate "to manage the business and affairs of every corporation"

provide an internal check on the power of corporate executives? So long ago the grandiloquent words of the statutes ceased to have any operative meaning. "Directors," William O. Douglas complained in 1934, "do not direct." "[T]here is one thing all boards have in common, regardless of their legal position," Peter Drucker has written. "*They do not function.*" In Robert Townsend's tart analysis, "[M]ost big companies have turned their boards of directors into nonboards. . . . In the years that I've spent on various boards I've never head a single suggestion from a director (made as a director *at* a board meeting) that produced any result at all."

Recently these views were corroborated by Professor Myles Mace of the Harvard Business School, the nation's leading authority on the performance of boards of directors. In *Directors—Myth and Reality*, Mace summarized the results of hundreds of interviews with corporate officers and directors.

Directors do not establish the basic objectives, corporate strategies or broad policies of large and medium-sized corporations, Mace found. Management creates the policies. The board has a right of veto but rarely exercises it. As one executive said, "Nine hundred and ninety-nine times out of a thousand, the board goes along with management. . . ." Or another, "I can't think of a single time when the board has failed to support a proposed policy of management or failed to endorse the recommendation of management."

The board does not select the president or other chief executive officers. "What is perhaps the most common definition of a function of the board of directors—namely, to select the president—was found to be the greatest myth," reported Mace. "The board of directors in most companies, except in a crisis, does not select the president. The president usually chooses the man who succeeds him to that position, and the board complies with the legal amenities in endorsing and voting his election." A corporate president agreed: "The former company president tapped me to be president, and I assure you that I will select my successor when the time comes." Even seeming exceptions such as RCA's 1975 ouster of Robert Sarnoff frequently turn out to be at the instigation of senior operating executives rather than an aroused board.

The board's role as disciplinarian of the corporation is more apparent than real. As the business-supported Conference Board conceded, "One of the most glaring deficiencies attributed to the corporate board . . . is its failure to monitor and evaluate the performance of the chief executive in a concrete way." To cite a specific example, decisions on executive compensation are made by the president—with perfunctory board approval in most situations. In the vast majority of corporations, Professor Mace found, the compensation committee, and the board which approves the recommendations of the compensation committee, "are not decision-making bodies."

Directors do not even ask discerning questions. It is considered "discourteous," a breach of "corporate manners" for directors to "challenge" the president or other corporate officers. This can be a very expensive form of decorum, as the Penn Central's shareholders painfully discovered. At the time of its collapse in June 1970, Penn Central was the largest railroad in the country and the sixth largest industrial corporation overall. Within a two-year period, shareholders witnessed the decline of their shares from $86.50 to $2.75.

Why? "The board was definitely responsible for the trouble," recounted outside director E. Clayton Gengras. "They took their fees and they didn't do anything. Over a period of years, people just sat there. That poor man from the University of Pennsylvania [University President Gaylord P. Harnwell], he never opened his mouth. They didn't know the factual picture and they didn't try to find out." As the Penn Central rushed towards its monumental crack-up, the board routinely approved every proposal forwarded by management. Although Penn Central was desperate for capital, the directors paid out nearly $100 million in dividends. The board never saw a capital expenditures budget. It never understood the inaccuracies published in Penn Central's annual reports. Just six hours before the corporation filed its bankruptcy petition, the board routinely approved new contracts for eight corporate executives, apparently unaware even then of the dimensions of the Penn Central's crisis. "All of this raises the serious question as to whether giant corporations affecting the everyday lives of our population . . . should continue to be governed in the traditional fashion or whether a new system of corporate directorships should be devised," concluded the House Banking and Currency Committee.

Yet boards will continue to be dysfunctional as long as they remain the creature of the corporate chief executive. For it is the chief executive who, like the family owner-manager in a small corporation, selects new members of the board. And it is the chief executive who de-selects existing board members when nominations for the board are necessary for annual shareholders' meetings.

Our own survey of the boards of the 200 largest industrial corporations found that the average board had a total of 14.49 directors, including 7.93 "outsiders" (that is, directors who were not employees of the corporation) and 6.56 insiders (or employee directors). Some 69 percent of the outside directors were fellow corporate executives; 6 percent were investment bankers; 7 percent were lawyers. Only 2 percent were women; a lesser percentage were black. Hence over 90 percent of the directors of our largest corporations either worked for the corporate chief executive or were fellow corporate executives, corporate bankers, or corporate lawyers.

Most "outside" directors appear to be chosen because of their status. "Presidents and chairmen of large and respected companies," one corporate president observed, "enjoy the prestige of serving on similar large and respected company boards. They are identified with their peers. They find the experience socially satisfying. Outside directorships provide a few more lines in their *Who's Who*, and it is a little bit like being knighted to say 'I'm a director of General Motors, or General Electric, or AT&T.' " Frequently, the chief executive chooses his friends, or individuals known to be "sympathetic" or "congenial," to be directors. "You certainly don't want anyone on your board who even slightly might be a challenge on a question of your tenure, so you pick personal friends with prestige titles and names," a corporate president explained. Another executive agreed: "What would you do if you were president? You control the company and you control the board. You want to perpetuate this control. . . . You sure as hell are not going to ask Ralph Nader. . . ."

At its worst, the outside director system degenerates into a private club, as the president of a west coast company explained:

You've got to remember that the outside directors of large national and regional companies are members of a sort of club. To be considered for admission you must have the title as president or chairman of a respectable and respected organization. This is what some young people call the Establishment. But these are the people you do business with, travel around with, serve on community projects with—and it has to be a group the members of which get along together. Regionally each area has its elite. Sometimes many will in fact be members of the same golf or social club. Here in Los Angeles you will find a great number of directors with membership in the Los Angeles Country Club; in Cleveland the same is true of the Union Club—each city has its hard core members of the club group.

Exceptions to this pattern become news events. In reporting on General Motor ' 1971 annual shareholders' meeting, the *Wall Street Journal* noted that, "The meeting's dramatic highlight was an impassioned and unprecedented speech by the Rev. Leon Sullivan, GM's recently appointed Negro director, supporting the Episcopal Church's efforts to get the company out of South Africa. It was the first time that a GM director had ever spoken against management at an annual meeting." Now Rev. Sullivan is an unusual outside director, being General Motors' first black director and only "public interest" director. But what makes Leon Sullivan most extraordinary is that he was the first director in *any* major American corporation to come out publicly against his own corporation when its operations tended to support apartheid.

Yet as lethargic as outside directors usually are, employee directors tend to be even less effective. The typical vice president/inside-director is in a very precarious position at a board meeting. Unwilling to say anything in disagreement with his boss, he usually sits quietly and waits until he is called upon to speak. Disagreements with other corporate executives are invariably resolved out of the board room. The effect is to present outsiders with a "united front": to make the corporate chief executive's decisions seem inevitable.

So staffed, board meetings in most large industrial corporations have become formalized into a monthly or bimonthly ritual, usually lasting about one to three hours. Much of this time is consumed by perhaps a 30-minute to an hour review of operations for the last period (month or quarter) by the president or vice president of finance. This is followed by board approvals of capital appropriations and of the actions of the executive committee taken since the last meeting. The meeting often concludes after senior executives have described a new research development or a major operations program. Usually the entire meeting—which is closed to shareholders—is choreographed by the corporate chief executive. He chooses which officers shall speak. He writes the agenda. When he wants to be asked about a particular issue, he plants the relevant question.

The impossibility of so infrequent or so circumscribed meetings of the board enabling directors to effectively "manage" their corporation was sardonically illustrated by the congressional testimony of H. O. Havemeyer, a corporate chieftain of an earlier day:

Q. As a member of that board, what else have you done?
A. *Oh, I have convened and talked.*
Q. You have convened and talked?
A. *And adjourned.*
Q. Well, you have convened and talked?
A. *And adjourned.*
Q. Well, what have you talked about?
A. *Statistics.*

This testimony was given in 1887 when outside directors were typically the "tools" or "dummies" of the controlling corporate president or bank. A popular gag on Wall Street was that the role of an outside director was to receive his five-dollar gold piece at the start of each meeting and then obediently fall asleep. Directorial lassitude is not so obvious today. Yet considering that the size and complexity of corporate enterprise has significantly increased since 1887 while the frequency and length of directors' meetings has not, it is a fair assumption that the outsiders who obediently nod through ceremonial board meetings today are little better informed than their brethren who slept before them.

Certainly directors' sources of information remain as much subject to management control today as they did 90 years ago. After resigning from TWA's board, former United States Supreme Court Justice Arthur Goldberg had this complaint: "What the typical board of directors gets is a recommendation which seems mono-

lithic. . . . It's not like a court, where a judge can order a brief from both sides." Recently the *quantity* of preparatory information available to outside directors has significantly increased. Yet the thickened reports and whirlwind plant tours are still only what the corporate chief executive wants outsiders to see. "In many corporations," found Professor Melvin Eisenberg, "the executives go so far as to wholly deny the board—supposedly entrusted with supreme power over the corporation—access to certain categories of information." For instance, a 1971 survey found that only 17 percent of 474 industrial firms sent manufacturing data to directors prior to board meetings, only 21 percent sent marketing data, and 11 percent sent no data at all.

And outside directors have little personal incentive to doubt management. A 1973 survey of 378 manufacturing corporations with assets of $50 million or more showed that outside directors received median annual fees of approximately $5,900, while inside directors generally are not paid at all. On top of the $100,000+ incomes typically earned by outside directors, who are corporate chief executives or vice presidents, leading investment bankers, or law firm partners, such annual retainers or meeting fees seem like peanuts. The result is counterproductive. Outside directors rationalize not doing very much by the fact they are not paid very much.

How, then, can one reconcile the grand imperative, "The business and affairs of every corporation . . . shall be managed by or under the direction of . . . a board of directors" with the reality of this "non decision-making body"? The fashionable response is that the board is a legal fiction. Management control has overwhelmed the rule of law.

This widely held view is only half right. Management has deposed the board of directors—but it has done so under color of law. No rule within the modern corporation statutes prohibits management from nominating and serving as directors. Corporation law has abrogated directional independence by omission. Moreover, even if the statutes provided structural safeguards to maintain the independence of the board, these could not undo the effect of two provisions found in most state corporation laws.

The first provision is exemplified by a Delaware Corporation Law section which provides that a director shall "be fully protected in relying in good faith upon . . . reports made to the corporation by any of its officers." The meaning of this provision is very simple. Directors have no duty to know. "Unless something occurs to put them on suspicion that something is wrong, directors are entitled to rely on the honesty and integrity of [management]," held the leading case of *Graham v. Allis-Chalmers Manufacturing Company*. Directors are not required to "put into effect a system of watchfulness." They need not anticipate problems nor verify the accuracy of reports upon which they rely.

A second provision of the Delaware General Corporation Law accomplishes the same result by allowing the board to *formally* delegate responsibility for most corporate business to a committee dominated by inside directors. Our survey of the 200 largest industrial corporations indicates that approximately two-thirds of the corporations had withdrawn directorial powers from the full board—typically a majority of whose members were outsiders—to an executive committee at least half of whose members were insiders.

A much smaller number of corporations accomplish a comparable result by delegating authority to an insider-dominated finance committee. In our survey of the 200 largest industrial corporations, we found that 16 corporations had delegated authority to a finance committee, half or more of whose members were insiders.

Examples of the delegation of the board's authority to either an insider-dominated executive or finance committee have been well described by attorney John A. McMullen:

> At IBM—four directors, all top level officers of the corporation, control the all-important executive and finance committees; in addition, three of them are members of the powerful Corporate Office. At GM, four or five men, all inside directors of the company, dominate the executive and finance committees of the board as well as the administration committee comprised of key officers and directors. . . . DuPont's executive committee consists of the company's chairman of the board, president, and six senior vice presidents. Each of these men is entirely relieved of day-to-day functional responsibilities; each operates jointly with his fellow committee

members to set overall corporate policy, and acts only as an advisor to the operating department from which he originally derived his skills, training, and experience.

Yet, whether or not the board formally resolves to delegate operational authority to an executive committee between board meetings, the actuality is that employee directors or other senior executives invariably exercise the powers of initiation. It does not matter whether key corporate decisions are initiated by a single corporate autocrat or a board committee or a committee operating out of the office of the president. Senior executives call the shots. This is what Berle and Means meant by their insightful descriptions of "management control." This is why state corporation law is moribund. Not only is it written by corporate management's representatives, it is also hopelessly inaccurate. In appreciating the law of corporate governance, one rule above all others must be followed: *Concentrate on the omissions.* Where state law does not require directors to be, corporate executives inevitably are.

The Limitations of Shareholder Litigation

STATE LAW: THE NON-DUTY OF CARE

The erosion of shareholder authority within the corporation would be less serious if shareholders were able to oppose the abuses of corporate management in court. In theory, civil litigation remains the shareholder's ultimate check. The problem is that, except for certain limited claims under the federal securities laws, it rarely works. Long ago judicial doctrines reduced the state shareholder action to a trivial value.

Earliest was the judicial rejection of the principle of *ultra vires* action. In its classical form, the doctrine of *ultra vires* envisioned the corporate charter as a contract between the state, corporate management, and the shareholders. Corporations were prohibited from performing certain acts, not because they were illegal but because neither the state nor the shareholders had agreed to them. Shareholders could enjoin corporate officers and directors from engaging in actions "beyond their powers." Accordingly, in a leading 1867 case, a single shareholder blocked a railroad from extending its railway to a more distant point than that specified in the charter because that was not the enterprise he had bargained for.

With the rise of the corporate enabling acts, the principle of *ultra vires* declined. Shareholder limitations were overridden through court discoveries of "implied" or "auxiliary" powers. In the 1896 case of *Jacksonville M. P. Ry. & Nav. Co. v. Hopper*, for example, the United States Supreme Court held that the Florida railway company might engage in leasing and running a resort hotel, on the curious logic that "to maintain cheap hotels or eating houses . . . would not be so plainly an act outside the powers of a railway company as to compel a court to sustain the defense of ultra vires. . . ." By 1931, *Fletcher's Cyclopedia of Corporations* could proclaim, "the theory that a corporation can do no acts beyond its authority [has been] discarded by a majority of the courts in the country."

Paralleling the decline of *ultra vires* has been the universal refusal of state courts to hold corporate directors or officers liable for negligence. Because they are vested with great power over other people's property, the law has always nominally required, in the language of the present New York statute, that "Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like positions."

In practice, the typical judicial or statutory formulation of the duty of care is too vague to require much of anything. As Yale Law School's Professor Joseph Bishop concluded after an extensive review of the case law:

> The search for cases in which directors of industrial corporations have been held liable . . . for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack. Few are the cases in which the stockholders do not allege conflict of interest, still fewer those among them which achieve even such partial success as denial of the defendant's motion to dismiss the complaint.

In all, Professor Bishop was able to find only four recent cases in which a state court held that a shareholder had alleged a good cause of action for negligence uncomplicated by self-dealing. In only one

of these cases did a state court rule on the merits that a corporate officer was liable for negligence. And in that case, the word "negligence" had been used as a euphemism for dishonesty.

This result is primarily the fault of statutory draftsmen. They have refused to identify *how* a corporate officer meets his duty of care. They have never identified what specific actions he must perform; what specific responsibilities are his. In the absence of a clear standard from the legislature, state courts have refused to guess.

At most, state courts will hold corporate directors or executives liable for conduct involving obvious self-enrichment such as fraud, misapplication of funds, diversion of corporate business opportunities, or causing the corporation to make excessive payment for the purchase of their property. Yet even in these types of cases, where the actions of corporate officers amount to simple and obvious theft, the procedural rules of state corporation law have been skewed to discourage shareholder suits.

The most onerous bars to shareholder litigation are the so-called "security for expenses" provisions enacted by New York, New Jersey, Pennsylvania, Michigan, California, and 13 other states. These provisions require a complaining shareholder owning less than a stated amount of stock—typically 5 percent of the stock or shares worth less than $50,000—to "give security for the reasonable expenses, including attorney's fees, which may be incurred" by both the corporation and the parties defendant in a shareholder action. Since the cost of defendants' legal fees may amount to hundreds of thousands of dollars, the security for expense provision, when enforced, presents a formidable barrier to shareholder action.

The rules respecting attorneys' fees pose a second procedural pitfall for shareholder actions. Nearly every jurisdiction provides that only shareholders whose suits are successful may be reimbursed by the corporation for attorneys' fees. This rule seeks to discourage attorneys from bringing nonmeritorious suits. Several states, however, further provide that attorneys' fees may be awarded only if a substantial monetary benefit is conferred upon the corporation. As a practical matter, this standard precludes shareholder litigation in all cases except those of overreaching where a monetary benefit—the amount taken—is readily apparent. In all other cases it is normally cheaper to sell the stock than to compel the corporation to obey the law.

FEDERAL SECURITIES LAW: "TAKING OVER THE UNIVERSE GRADUALLY"?

To some extent, federal securities law—and federal court decisions—have compensated for the atrophy of state shareholder protection.

In 1968, the influential Second Circuit Court of Appeals handed down its celebrated *S.E.C. v. Texas Gulf Sulphur* decision which revolutionized the case law interpreting Rule 10b-5 under the 1934 Securities and Exchange Act. Rule 10b-5 provides that it is unlawful for any person to employ a fraudulent scheme, to make any untrue statement, or to fail to state a pertinent fact when purchasing or selling a security. *Texas Gulf* substantially broadened this antifraud rule by holding that corporate directors, officers, and employees violated 10b-5 when they purchased company stock knowing of a huge mineral strike before this fact was generally known or communicated to the public.

A federal district court, also in 1968, ruled in *Fratt v. Bar Chris*—a decision some commentators initially believed would have even greater effect on directorial behavior than *Texas Gulf*. In *Bar Chris* security holders asserted that a bowling alley construction company that had sold them convertible debentures had filed a registration statement prior to the sale of the bonds which contained false statements and omissions. After concluding that the registration statement did, indeed, contain numerous inaccuracies, the district court stunned Wall Street by holding all nine directors who signed the prospectus—including two new to the board—liable. In summing up their liability, the court seemed to move far toward creating a federal duty of care, at least with respect to registration statements:

> Section 11 imposes liability in the first instance upon a director, no matter how new he is. He is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property. In my opinion, a prudent man would *not* act in an important matter without any knowledge of the relevant facts, in sole

reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case. To say that such minimal conduct measures up to the statutory standard would, to all intents and purposes, absolve new directors from responsibility merely because they are new. This is not a sensible construction of section 11, when one bears in mind its fundamental purpose of requiring full and truthful disclosure for the protection of investors.

The cumulative result of these and other federal securities law decisions led the *Wall Street Journal* to exclaim in early 1973, "[D]irectors of corporations now face more perils than Pauline ever did!" In a similar vein, Harvard Law School's securities expert, Professor Louis Loss, observed in 1969 that "the great Rule 10b-5," which had emerged as the principal basis of liability under the federal securities laws, "seems to be taking over the universe gradually."

In retrospect, both views seem overstated. The basic reason the securities laws will neither "take over the universe" nor seriously "imperil outside directors" is that they are restricted to a discrete set of securities transactions. Although present securities laws do require corporate officers to file with the SEC accurate periodic financial reports and securities registration statements, not make false and misleading statements in proxies, nor defraud outsiders in connection with their own securities purchases or sales, the securities laws do not, emphasized the Supreme Court in 1971, reach transactions which otherwise involve "internal corporate mismanagement."

And in late 1973, the Second Circuit Court of Appeals held in *Lanza v. Drexel* that only corporate officers who recklessly or deliberately defrauded shareholders could be held liable for money damages under Rule 10b-5. In refusing to follow the reasoning of the district court in the *Escott v. Bar Chris* case, the appeals court made plain that an outside director who was "merely negligent" in his participation in a fraudulent securities transaction had little to fear.

The consequence of *Lanza* and similar recent decisions has been to leave federal securities law in a crazy quilt pattern. The federal securities laws, for example, will not reach a deliberate though not self-enriching decision of corporate executives to engage in an unprofitable line of business unless there has been an accompanying failure of disclosure. Nor will they reach decisions which *do* enrich corporate officers unless they involve security transactions. Liability seems so haphazard and fortuitous that former SEC Chairman William Cary was moved to complain:

> There is no justification for a *federal* law disciplining or holding a tippee liable for misusing inside information concerning management decisions but not monitoring the misconduct of management itself. . . . It is absurd that a corporate transaction, clearly unfair though perhaps not fraudulent, should be subject to attack in the federal courts only upon the ground that it has not been disclosed to shareholders rather than because of its inherent inequity.

NULLIFY THE JUDGMENT: INDEMNIFICATION INSURANCE

Not only is it difficult for shareholders to successfully sue their companies, but even successful judgments often can be nullified. Seventeen states today permit corporations to purchase indemnification insurance for their directors and officers against, in the words of a typical policy, any "wrongful act [committed] . . . in their capacities as directors or officers." A 1974 survey of the Fortune 500 list found that 80 percent of these companies carried indemnification insurance. A similar sample of corporations listed on the New York Stock Exchange found that 76.1 percent carried such insurance. Since indemnification insurance was virtually unknown as recently as a dozen years ago, and most insurance policies were purchased within the past five to seven years, it is a fair assumption that nearly every large industrial corporation permitted by state law will carry indemnification insurance within a short time.*

* One reason for the enormous leap in the number of corporations carrying indemnification insurance has been the scare tactics employed by the insurance companies. The general tenor of their approach is illustrated by an advertisement on page six of the *Wall Street Journal*, March 21, 1968, featuring a composite photograph of a board of directors presided over by a stuffed duck and the explanatory text, "As a corporate officer or director, you may be a sitting duck for a shareholder or third party liability suit." A similar ad appears on page nine of the same issue wherein a sullen looking stockholder announces that he "might just sue every company director reading this newspaper," and reminds the presumably panicking directors that he is just one of "24 million potential enemies."

There is, to be sure, a persuasive case for indemnifying corporate directors against the costs of nonmeritorious legal claims. If innocent directors had to settle such suits because they lacked the resources to hire competent attorneys, responsible men and women would be discouraged from becoming directors. But current indemnity statutes are not limited to the purpose of protecting innocent officers from the costs of nonmeritorious suits. They also protect guilty officers from accountability for their wrongs and reduce incentives for lawful conduct.

Delaware's statute exemplifies this overbreadth. It allows a corporation

> to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation . . . against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against any such liability under the provisions of this section.

As written, this provision permits the corporation to insulate its officers from *all* potential liabilities. Officers may be insured against any negligence, self-dealing, looting the corporation or embezzlement, all conflicts of interest, and deliberate statutory violations. They may be reimbursed for violations of federal safety, civil rights, environmental, tax, or antitrust laws. They may even be insured against the same judgments in derivative actions that an earlier provision of the same statute provided a corporation could not indemnify directly.

Delaware defends such insurance as a form of compensation, arguing that the corporation could make a larger compensation arrangement with the executive and let him pay for the insurance himself. But the question is not how much officers' compensation should be, but rather whether wrongful acts *should* be indemnified at all. Why should an executive of a drug company be indemnified for the costs of a criminal fine if he is convicted of allowing a harmful drug to injure several thousand people when the same act as a private individual would send him to jail? An untenable double standard has been created. The more powerful an executive becomes, the less likely he is to pay for an abuse of power.

Conflicts of Interests

In almost every primary economic relation of the industrial corporation—to competing corporations, to banks, to suppliers, to distributors, to investors—the law now permits (in many instances, encourages) the most blatant division of loyalties.

Most threatening is the anticompetitive practice of *interlocking directorates*. A philosophic cornerstone of American business is that vigorous competition will enable firms to have comparable access to capital, supplies, distributors, and markets, and thus an equal chance to succeed or fail on the merits. But if competing corporations place directors on each other's boards, there is opportunity to conspire on price or territory. If corporate officers sit on the boards of their banks or suppliers or distributors, there arises the obvious temptation to obtain preferential treatment based on favor and friendship. Then the race is not to the swift, but to the well-connected. Louis Brandeis saw the problem early in this century:

> The practice of interlocking directorates 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. In either event it leads 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.

With Brandeis as a major proponent, Congress in 1914 enacted the Clayton Act, section 8 of which expressly forbids any person from serving on the boards of two or more competing corporations. Until recently, however, section 8 had not been enforced. Through 1952, some 38 years after the enactment of the Clayton Act, the Department of Justice had not litigated a single case to a decision by a court. Through December 1975, the Department had instituted a total of 15 cases. The Federal Trade Commission, which has concurrent enforcement responsibilities, had filed only 13 complaints under section 8 of the Clayton Act through January 1965. Only one of these complaints resulted in a cease and desist order; the remainder were dismissed when the directors involved discon-

tinued the prohibited relationship. As Chairman Emanuel Celler's House Antitrust Subcommittee concluded in 1965 after a lengthy study of interlocks among competitors: enforcement had been neither "prompt nor vigorous."*

Shortly after Celler's study was released, economist Peter Dooley calculated that there were a total of 4,007 directorships held by the directors of the 200 largest nonfinancial corporations and the 50 largest financial corporations. "While most of these directors sat on a single board, 562 sat on two or more boards: Five men held six directorships each. In all, 1,404 directorships were held by multiple directors." Two hundred and thirty-three of the 250 corporations had at least one director who sat on the board of at least one other of the largest corporations. Most significantly, fully 297 interlocks involved companies which were competitors. "While illegal under the Clayton Act," observed Professor Dooley, "the law has not been effectively enforced, so that the institution of interlocking directorates continues to provide a vehicle for restricting competition. . . ."

Our own more recent survey of the boards of directors of the 50 largest industrial corporations identified eight apparent instances of illegal interlocks. John T. Connor, for example, is both a director of General Motors and Chairman of Allied Chemical, though Allied Chemical produces seat belts, shoulder harnesses, and airbags, all of which GM either presently manufactures or potentially could. Dean McGee is a director of General Electric and Chairman of Kerr-McGee, though both sell nuclear fuels. Henry S. Wingate is a director of both U.S. Steel and International Nickel Company of Canada, both of which mine nickel, iron ore, and other competing metals.

Even beyond inadequate enforcement of its provisions, section 8 only forbids interlocks among competitive corporations. Interlocks among corporations which provide services, supplies, funding, or distribution for each other equally violate the fundamental law that no man can serve two masters. They are also far more numerous. In 1974, the Center for Science in the Public Interest analyzed interlocking directorates and advisory committee connections of the eighteen largest United States oil corporations. They found 460 interlocking connections in all, including 132 interlocks with banks, 31 interlocks with insurance companies, 12 interlocks with utilities, 15 interlocks with transportation corporations, and 224 interlocks with manufacturing and distribution corporations. Oil company ties with banks (which supply capital), insurance companies (which provide an underwriting service), distribution companies (which distribute oil company products), and utilities, transportation, and manufacturing corporations (which purchase oil products) inevitably diminish the arm's length atmosphere in which effective competition thrives.

Such clubbishness, however, is typical of this nation's largest corporations. Our survey of the 50 largest industrial corporations and 10 largest commercial banks found that the 50 largest industrialists had 54 interlocks with the 10 leading commercial banks and 24 interlocks among themselves. Our survey also established that it has become a common practice for the leading commercial banks to bring together competitors on their boards of directors. For example, on its board Chase Manhattan unites directors from competing companies in four industries: industrial chemicals (Allied Chemical, Celanese, and Commercial Solvents Corporation); drugs (Pfizer and Squibb); paper goods (Celanese and International Paper); and oil (Exxon, Royal Dutch Petroleum, and Standard Oil of Indiana). Continental Illinois brings together leading agricultural equipment producers Caterpillar Tractor and International Harvester; food producers Esmark and Kraftco; and railroads Chicago-Milwaukee and Illinois Central.

When interlocks are viewed on a city-by-city basis, it becomes clear that there are substantial social costs as well—as in the case of Minneapolis-St. Paul. In January 1971, Richard Gibson, a methodical staff reporter for the *Minneapolis Star*, described the social structure of a major industrial city by examining the boards of the 20 or so leading Twin City industrial corporations and eight leading banks. What he found was a tight little net or what he

* In the past three years the Federal Trade Commission has begun to enforce the Act, bringing three major actions, the most important of which required seven directors common to the boards of 12 competing oil and gas corporations to resign. More recently the Justice Department awoke from its long slumber and brought an action in [illegible] against the Bank of America holding company and certain insurance companies which allegedly competed in providing designated services.

called swapping: Burlington Northern placed its executive on the board of General Mills, and General Mills reciprocated by placing an executive on the board of Burlington Northern. Honeywell, Pillsbury, 3M, and Dayton Hudson just placed executives everywhere, as did the leading banks.

But Gibson went beyond the statistics and examined the personalities involved. He found that the boards of the 30 leading corporations in a major metropolitan area of some two million people were dominated by 19 men. Eight served on three or more boards; five men served on four boards; six served on five boards or more. Crucially, these were the men that served as chairmen or led the key committees. All but one of these men, Professor Walter Heller, was a corporate executive. Fourteen of the 19 were corporate chief executives. Examined in social terms, the economy of Minneapolis looks like an oligarchy.

Certainly no one would argue that all interlocks, whether among competitors, in financing, supply, or distribution relations, direct or indirect, lead to collusive behavior. But it is unnecessary that any interlock occur. There are sufficient directors available so that each board may be staffed by disinterested persons. The costs of interlocks—favoritism, joint price or output actions, discouragement of entrepreneurs—must be weighed against what are at best negligible advantages.

Conflict of interests can also occur when large industrial corporations invite their investment banker or outside counsel to serve on their boards. For the investment banker, especially, this creates a stark division of loyalty. In addition to underwriting security offerings and related corporate financial services, he typically does investment counseling, employs brokers, and administers mutual funds. He is just as likely to perceive his primary obligation to run to his investment clients as to the shareholders of the corporation he directs. As one top executive explained, "As soon as you have an investment banker [on the board], you put yourself in a position where one group of shareholders might be favored at the expense of other shareholders."

A worse situation occurs when the investment banker is favored at the expense of *all* shareholders. J. M. Juran and J. Louden, authors of the American Management Association's study, *The Corporate Director*, cited instances where investment bankers have been guilty of guiding the company into a poor acquisition to create a need for selling securities. Investment banker-directors have insisted on being involved—for a fee—when the corporation seeks to borrow money from an insurance company or other lender. And when a corporation has an investment banker on its board, it becomes very difficult to transact business with other investment bankers. "Having a senior partner of an investment banking firm on our board is notice to the world that we are his captive client," said one corporate president. "Of course this is the main reason investment bankers want to be on so many boards. They think of board membership as a very good way of assuring that the business of the company goes only to them. It's a sort of Operation Stakeout. It tags the company as belonging to one particular firm."

A similar division of loyalties occurs when corporate counsel serves on the board. Attorneys have a financial interest to increase the corporation's law bills, rather than economize for its shareholders. This inability of lawyer-directors to give disinterested counsel has led some law firms to discourage partners from serving on clients' boards. For example, New York City's Debevoise, Plimpton, Lyons and Gates will not permit a partner to go on a board without the approval of the firm as a whole. Skadden, Arps, Slate, Meagher and Flom, also of New York, flatly prohibits partners from becoming directors "except in extenuating cases." Nonetheless, an exhaustive 1971–72 study of some 12,000 companies, which filed information statements with the SEC, found that approximately one in six employs an attorney from the company's outside counsel as a director.

Aggravating the costs to shareholders of these structural conflicts of interest is the tolerance by modern corporate law of self-enriching executive conduct. As early as an 1846 Supreme Court opinion, the rule was well established that any contract between an interested director and his corporation was voidable at the mere insistence of the corporation or any of its shareholders regardless of the fairness or unfairness of the transaction. Professor Harold Marsh explained why:

Under this rule it mattered not the slightest that there was a majority of so-called disinterested directors who approved the contract. The courts stated that the corporation was entitled to the unprejudiced judgment and advice of all of its directors and therefore it did no good to say that the interested director did not participate in the making of the contract on behalf of the corporation. . . .

By 1880, this principle "appeared to be impregnable. . . . It was stated in ringing terms by virtually every decided case, with arguments which seemed irrefutable, and it was sanctioned by age." One scholar termed this the "fundamental law of morals and of human nature" and identified its Biblical origin: "No man can serve two masters." "Fraud is too cunning and evasive," reasoned a New Jersey court, "for courts to establish a rule that invites its presence."

Today this principle is dead. The Delaware General Corporation Law not only tolerates interested conduct by corporate officers and directors; it has made self-dealing the norm.

Under current Delaware law, the chief executive of a corporation and other senior corporate executives may serve on the board of directors or compensation committee which: (1) sets executive salaries; (2) sells or purchases property from corporate executives; (3) loans money—on a secured or unsecured basis; with or without interest—to corporate executives; and (4) establishes pension plans, profit sharing plans, stock bonuses, retirement, benefit, incentive, and compensation plans (including "phantom stock"—a risk-free, cost-free stock option plan), trusts; health insurance; or deferred income plans for such corporate officers or their dependents.

Not only may corporate officers engage in such self-dealing but shareholders under Delaware law are nearly powerless to minimize the amount of corporate largess top executives pay themselves. Any contract or transaction between the corporation and an interested executive is permissible as long as it is "fair." But, in Delaware, fairness is presumed. Professor Ernest Folk, the leading commentator of Delaware's General Corporation Law, explains that "Given Delaware's presumption of sound business judgment with respect to board decisions, the courts will try to determine whether the decision can be attributed to any rational business purpose, and if so, there will be no judicial preemption of the decision."

There seem to be few practical limits to this doctrine. For example, if a corporate chief executive were so graceless as to embezzle $500,000, there is little question that even in Delaware he would be required to return the money and would be subject to criminal prosecution. Yet if that same corporate executive raised his salary $500,000 and received the approval of a board of directors he selected, there is equally little question that a Delaware court would term this "fair"—so long as the chief executive could point to similar salary increases in his industry or received the $500,000 through an "incentive bonus" or profit participation plan.

In the absence of judicial limitations, excessive remuneration has become the norm. In 1974 the executive compensation (salary, bonus, deferred income, and directors' fees) of the highest paid executive at the 50 largest industrial corporations was approximately $400,000—or about as much in one year as many of their employees earn in a lifetime and two and one-half times the average executive compensation of $145,000 earned by the highest paid executive at the 50 largest industrial corporations in 1963.

Contrary to the conventional wisdom, top executive salaries do not generally decrease in response to a decline in corporate sales or profits. In the recessionary years 1970–1973, Professor Wilbur Lewellen, a leading authority on executive compensation, found that the "mean" salary for the top executive at 50 large manufacturing corporations increased steadily from $251,867 in 1970, to $287,759 in 1971, $323,802 in 1972, and $389,277 in 1973.

But salary, bonus, and deferred income are only the most obvious benefits appropriated by corporate chieftains. Equally important is ownership income. Nearly every large industrial corporation offers its top executives stock options. These options allow executives to buy shares of stock in their corporation at a fixed price at any time or at specified times—often with the help of company-secured low interest loans or interest-free loans—and subsequently sell them.

From the shareholder's point of view, the result is a classic case of "heads we lose, tails you win." Over time, executives are

able to build up a substantial fortune in corporate stock without personal risk. The more they do so, the more they dilute the value of other stockholders' shares.

We examined the stock holdings of the highest paid executives at the 50 largest industrial corporations to get some indication of the extent of executive stock holdings. From the start, we eliminated from consideration the seven highest paid chief executives whose stock holdings were either largely inherited or largely "founder's shares": Henry Ford II (Ford Motors), Robert Sarnoff (RCA), Brooks McCormick (International Harvester), Willard Rockwell (Rockwell International), Armand Hammer (Occidental Petroleum), Sanford McDonnell (McDonnell Douglas) and J. P. Grace (W. P. Grace). The 43 remaining chief executives were "employee" executives. Yet each owned an average of $1,566,009 of his corporation's stock, according to the most recent proxy statements filed with the SEC and the closing stock prices of October 1, 1975.*

This crude figure illustrates three points. First, primarily at shareholder expense, the top executives of our largest corporations can, and often do, build up million-dollar fortunes in corporate stock on top of their substantial cash and deferred compensation. Second, the income of top executives is significantly increased each year by dividends from their corporate stock. Using our 43 top executives as an example again, each received an average of $60,382 in dividend income in 1974 above and beyond a $400,000 salary. Third, each top executive will further be enriched by increases in the price of the stock. Professor Lewellen has determined that a similar list of chief executives at the fifty largest industrial corporations (after deleting "extreme values" such as inherited or founder's stockholdings) averaged $220,087 per year in capital gains income for the four years 1960–63.

* This figure is admittedly a very crude approximation of ownership income. On the one hand, it does not distinguish the shares the executives purchase with their own money from those the company gave them through stock options, stock bonuses, or loan arrangements. On the other hand, it understates the amount of ownership income of these executives by making no allowance for the fact that corporate chief executives frequently sell stock they own in their own corporation and put their money in other investments.

Additionally, pension or retirement benefits have swollen. McKinsey and Company's 1975 Executive Compensation Survey found that all but one of 577 major U.S. corporations studied had a pension or profit-sharing retirement plan to pay former executives a fixed income each year after they retire. Almost half of the companies provide either a thrift or savings plan or a profit-sharing plan in addition to the pension plan. Our own survey found that the 21 chief executives of the 50 largest corporations who disclosed their estimated annual retirement benefits anticipated an income of $133,910 per year after they retire. And corporate executives also enjoy other benefits such as life and medical insurance; free medical service; educational grants for their children; indemnification insurance; company apartments; country club membership; luncheon or dinner club membership; chauffeur-driven cars; free legal and tax counseling; personal financial counseling; expense accounts; and other amenities. This myriad of stock bonus, insurance, and benefit programs increases the income of corporate chiefs by approximately 50–75 percent above their $400,000 direct remuneration to an actual income of approximately $600,000 to $700,000 per year.

Yet if excessive remuneration were a conflict of interest confined to the corporate chief executive, it would seem small once it was divided by the total number of shares in most large industrial corporations. What makes the executive compensation conflict truly expensive is that the corporate chief executive not only sets his own salary but also determines the remuneration of other executives all the way down the line. It is clearly in the corporate chief executive's personal interest to seek the greatest possible rewards for his subordinates as well as himself. For a corporate chief who can "deliver" high salaries increases the personal loyalty of his subordinates. And the higher his subordinates' income, the higher the chief executive's income must be.

A good illustration of this is General Electric, where in 1974 Reginald Jones, the chairman, received a compensation of $501,200. Walter Dance, Jack Parker, and Herman Weiss, the next three highest paid executives, received $400,750; $400,500; and $400,000, respectively. The next 107 highest paid officers averaged direct compensation of $121,240. Aggregate figures for "executive groups" at the other 50 largest industrial corporations were approx-

imately the same. In the average corporation, the 31 or so officers ranked immediately below the five highest paid executives received an average of $99,256 in direct remuneration, which would equal approximately $150,000 imputing the present value of stock bonus programs, retirement benefits, insurance, and other perquisites.

A compensation system is obviously askew when a private business corporation must pay a chief executive compensation and benefits of over $600,000 when this is 15 times the $40,000 or so the United States government must pay its highest ranking general, regulator, or Senator. Or when it must pay its next 20–100 senior executives an average of $150,000 each when the federal government expends a maximum of $38,000 per year to hire its highest ranking civil servants, and California, this nation's largest state, pays its governor $49,000.

This is not to deny that the entrepreneur or corporate founder who, at substantial risk, introduces a new or better good or service should not be given a substantial incentive to make an unusual personal contribution to society. But we are concerned here with the administrators of large industrial corporations who, at minimal personal risk, serve as the bureaucrats of private industry. These individuals receive their staggeringly large salaries and stock options by rising through executive ranks—in exactly the same way that government's civil servants rise through civil service ranks—and by then exploiting the laxity of state corporate laws that their predecessors helped write.

Remedies

REVAMPING THE BOARD

The modern corporation is akin to a political state in which all powers are held by a single clique. The senior executives of a large firm are essentially not accountable to any other officials within the firm. These are precisely the circumstances that, in a democratic political state, require a separation of powers into different branches of authority. As James Madison explained in the *Federalist No. 47*:

> The accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny. Were the federal constitution, therefore, really chargeable with this accumulation of power, or with a mixture of powers, having a dangerous tendency to such an accumulation, no further arguments would be necessary to inspire a universal reprobation of the system.

A similar concern over the unaccountability of business executives historically led to the elevation of a board of directors to review and check the actions of operating management. As a practical matter, if corporate governance is to be reformed, it must begin by returning the board to this historical role. The board should serve as an internal auditor of the corporation, responsible for constraining executive management from violations of law and breach of trust. Like a rival branch of government, the board's function must be defined as separate from operating management. Rather than pretending directors can "manage" the corporation, the board's role as disciplinarian should be clearly described. Specifically, the board of directors should:

- establish and monitor procedures that assure that operating executives are informed of and obey applicable federal, state, and local laws;
- approve or veto all important executive management business proposals such as corporate by-laws, mergers, or dividend decisions;
- hire and dismiss the chief executive officer and be able to disapprove the hiring and firing of the principal executives of the corporation; and
- report to the public and the shareholders how well the corporation has obeyed the law and protected the shareholders' investment.

It is not enough, however, to specify what the board should do. State corporations statutes have long provided that "the business and affairs of a corporation shall be managed by a board of directors," yet it has been over a century since the boards of the largest corporations have actually performed this role. To reform the corporation, a federal chartering law must also specify the manner in which the board performs its primary duties.

First, to insure that the corporation obeys federal and state laws, the board should designate executives responsible for compliance with these laws and require periodic signed reports describing the effectiveness of compliance procedures. Mechanisms to administer spot checks on compliance with the principal statutes should be created. Similar mechanisms can insure that corporate "whistle blowers" and nonemployee sources may communicate to the board—in private and without fear of retaliation—knowledge of violations of law.

Second, the board should actively review important executive business proposals to determine their full compliance with law, to preclude conflicts of interest, and to assure that executive decisions are rational and informed of all foreseeable risks and costs. But even though the board's responsibility here is limited to approval or veto of executive initiatives, it should proceed in as well-informed a manner as practicable. To demonstrate rational business judgment, the directorate should require management "to prove its case." It should review the studies upon which management relied to make a decision, require management to justify its decision in terms of costs or rebutting dissenting views, and, when necessary, request that outside experts provide an independent business analysis.

Only with respect to two types of business decisions should the board exceed this limited review role. The determination of salary, expense, and benefit schedules inherently possesses such obvious conflicts of interest for executives that only the board should make these decisions. And since the relocation of principal manufacturing facilities tends to have a greater effect on local communities than any other type of business decision, the board should require management to prepare a "community impact statement." This public report would be similar to the environmental impact statements presently required by the National Environmental Policy Act. It would require the corporation to state the purpose of a relocation decision; to compare feasible alternative means; to quantify the costs to the local community; and to consider methods to mitigate these costs. Although it would not prevent a corporation from making a profit-maximizing decision, it would require the corporation to minimize the costs of relocation decisions to local communities.

To accomplish this restructuring of the board requires the institutionalization of a new profession: the full-time "professional" director. Corporate scholar frequently identify William O. Douglas' 1940 proposal for "salaried, professional experts [who] would bring a new responsibility and authority to directorates and a new safety to stockholders" as the origin of the professional director idea. More recently, corporations including Westinghouse and Texas Instruments have established slots on their boards to be filled by full-time directors. Individuals such as Harvard Business School's Myles Mace and former Federal Reserve Board chairman William McChesney Martin consider their own thoroughgoing approach to boardroom responsibilities to be that of a "professional" director.

To succeed, professional directors must put in the substantial time necessary to get the job done. One cannot monitor the performance of Chrysler's or Gulf's management at a once-a-month meeting; those firms' activities are too sweeping and complicated for such ritual oversight. The obvious minimum here is an adequate salary to attract competent persons to work as full-time directors and to maintain the independence of the board from executive management.

The board must also be sufficiently staffed. A few board members alone cannot oversee the activities of thousands of executives. To be able to appraise operating management, the board needs a trim group of attorneys, economists, and labor and consumer advisors who can analyze complex business proposals, investigate complaints, spot-check accountability, and frame pertinent inquiries.

The board also needs timely access to relevant corporate data. To insure this, the board should be empowered to nominate the corporate financial auditor, select the corporation's counsel, compel the forwarding and preservation of corporate records, require all corporate executives or representatives to answer fully all board questions respecting corporate operations, and dismiss any executive or representative who fails to do so.

This proposed redesign for corporate democracy attempts to make executive management accountable to the law and shareholders without diminishing its operating efficiency. Like a judi-

ciary within the corporation, the board has ultimate powers to judge and sanction. Like a legislature, it oversees executive activity. Yet executive management substantially retains its powers to initiate and administer business operations. The chief executive officer retains control over the organization of the executive hierarchy and the allocation of the corporate budget. The directors are given ultimate control over a narrow jurisdiction: Does the corporation obey the law, avoid exploiting consumers or communities, and protect the shareholders' investment? The executive contingent retains general authority for all corporate operations.

No doubt there will be objections that this structure is too expensive or that it will disturb the "harmony" of executive management. But it is unclear that there would be any increased cost in adopting an effective board. The true cost to the corporation could only be determined by comparing the expense of a fully paid and staffed board with the savings resulting from the elimination of conflicts of interest and corporate waste. In addition, if this should result in a slightly increased corporate expense, the appropriateness must be assessed within a broader social context: should federal and state governments or the corporations themselves bear the primary expense of keeping corporations honest? In our view, this cost should be placed on the corporations as far as reasonably possible.

It is true that an effective board will reduce the "harmony" of executive management in the sense that the power of the chief executive or senior executives will be subject to knowledgeable review. But a board which monitors rather than rubber-stamps management is exactly what is necessary to diminish the unfettered authority of the corporate chief executive or ruling clique. The autocratic power these individuals presently possess has proven unacceptably dangerous: it has led to recurring violations of law, conflicts of interest, productive inefficiency, and pervasive harm to consumers, workers, and the community environment. Under normal circumstances there should be a healthy friction between operating executives and the board to assure that the wisest possible use is made of corporate resources. When corporate executives are breaking the law, there should be no "harmony" whatsoever.

ELECTION OF THE BOARD

Restructuring the board is hardly likely to succeed if boards remain as homogeneously white, male, and narrowly oriented as they are today. Dissatisfaction with current selection of directors is so intense that analysts of corporate governance, including Harvard Law School's Abram Chayes, Yale political scientist Robert Dahl, and University of Southern California Law School Professor Christopher Stone, have each separately urged that the starting point of corporate reform should be to change the way in which the board is elected.

Professor Chayes, echoing John Locke's principle that no authority is legitimate except that granted "the consent of the governed," argues that employees and other groups substantially affected by corporate operations should have a say in its governance:

> Shareholder democracy, so-called, is misconceived because the shareholders are not the governed of the corporations whose consent must be sought. . . . Their interests are protected if financial information is made available, fraud and overreaching are prevented, and a market is maintained in which their shares may be sold. A priori, there is no reason for them to have any voice, direct or representational, in [corporate decision making]. They are no more affected than nonshareholding neighbors by these decisions. . . .
>
> A more spacious conception of 'membership,' and one closer to the facts of corporate life, would include all those having a relation of sufficient intimacy with the corporation or subject to its powers in a sufficiently specialized way. Their rightful share in decisions and the exercise of corporate power would be exercised through an institutional arrangement appropriately designed to represent the interests of a constituency of members having a significant common relation to the corporation and its power.

Professor Dahl holds a similar view: "[W]hy should people who own shares be given the privileges of citizenship in the government of the firm when citizenship is denied to other people who also make vital contributions to the firm?" he asks rhetorically. "The people I have in mind are, of course, employees and customers, without whom the firm could not exist, and the general

public, without whose support for (or acquiescence in) the myriad protections and services of the state the firm would instantly disappear. . . ." Yet Dahl finds proposals for interest group representation less desirable than those for worker self-management. He also suggests consideration of codetermination statutes such as those enacted by West Germany and ten other European and South American countries under which shareholders and employees separately elect designated portions of the board.

From a different perspective, Professor Stone has recommended that a federal agency appoint "general public directors" to serve on the boards of all the largest industrial and financial firms. In certain extreme cases such as where a corporation repeatedly violates the law, Stone recommends that the federal courts appoint "special public directors" to prevent further delinquency.

There are substantial problems with each of these proposals. It seems impossible to design a general "interest group" formula which will assure that all affected constituencies of large industrial corporations will be represented and that all constituencies will be given appropriate weight. Even if such a formula could be designed, however, there is the danger that consumer or community or minority or franchisee representatives would become only special pleaders for their constituents and otherwise lack the loyalty or interest to direct generally. This defect has emerged in West Germany under codetermination. Labor representatives apparently are indifferent to most problems of corporate management that do not directly affect labor. They seem as deferential to operating executive management as present American directors are. Alternatively, federally appointed public directors might be frozen out of critical decision-making by a majority of "privately" elected directors, or the appointing agency itself might be biased.

Nonetheless, the essence of the Chayes-Dahl-Stone argument is well taken. The boards of directors of most major corporations are, as CBS's Dan Rather criticized the original Nixon cabinet, too much like "twelve grey-haired guys named George." The quiescence of the board has resulted in important public and, for that matter, shareholder concerns being ignored.

An important answer is structural. The homogeneity of the board can only be ended by giving to each director, in addition to a general duty to see that the corporation is profitably administered, a separate oversight responsibility, a separate expertise, and a separate constituency so that each important public concern would be guaranteed at least one informed representative on the board. There might be nine corporate directors, each of whom is elected to a board position with one of the following oversight responsibilities:

1. Employee welfare
2. Consumer protection
3. Environmental protection and community relations
4. Shareholder rights
5. Compliance with law
6. Finances
7. Purchasing and marketing
8. Management efficiency
9. Planning and research

By requiring each director to balance responsibility for representing a particular social concern against responsibility for the overall health of the enterprise, the problem of isolated "public" directors would be avoided. No individual director is likely to be "frozen out" of collegial decision-making because all directors would be of the same character. Each director would spend the greater part of his or her time developing expertise in a different area; each director would have a motivation to insist that a different aspect of a business decision be considered. Yet each would simultaneously be responsible for participating in all board decisions, as directors now are. So the specialized area of each director would supplement but not supplant the director's general duties.

Although not a symmetrical analogy, the most successful precedent for dividing the representative responsibilities and constituencies is, of course, the Constitution of the United States. There, too, a basic question was one of motivation: How to design a political administration which would retain an equal respect for the rights of all of its citizens. Only by arranging "ambition . . . to counteract ambition" did the Federalists believe such respect would endure. By granting the President, the two houses of Congress, and the judiciary different geographic constituencies, different

terms, and different duties, the various factions of the nation's citizens were most likely to be insured some representation within the government. "Hence a double security arises to the rights of the people. The different governments will control each other, at the same time that each will be controlled by itself," explained Madison in *Federalist No. 51*.

In recent years, some business corporations have also perceived the advantages of creating constituent voices within the structure of the firm. Reverend Leon Sullivan, the only black director on General Motors' board, has made plain that he considers it his special responsibility to advance the interests of GM's black employees and dealers. His representation, among other things, has led to an increase in the number of blacks being trained to be GM executives. Gillette's Vice President for Product Integrity, Robert Giovacchini, is said to perform a similar role. Although not a member of the board, Mr. Giovacchini has been given the authority to recall any Gillette product, quash any advertising claim, or order any packaging change he feels is necessary to protect the company's consumers.

Only by institutionalizing the duties and power that individuals like Reverend Sullivan and Robert Giovacchini hold can responsible corporate government be brought to each large firm.

For in most giant corporations, no specific executive official or board member is responsible for protecting the interests of employees, consumers, the environment, or local communities. No one outside of senior management reviews the most important business decisions to assure their compliance with law, financial integrity, efficiency, or long-term corporate goals. Because these concerns become everybody's general interest, they become nobody's particular interest—and often go unattended.

To maintain the independence of the board from the operating management it reviews also requires that each federally chartered corporation shall be directed by a purely "outside" board. No executive, attorney, representative, or agent of a corporation should be allowed to serve simultaneously as a director of that same corporation. Directorial and executive loyalty should be furthered by an absolute prohibition of interlocks. No director, executive, general counsel, or company agent should be allowed to serve more than one corporation subject to the Federal Corporate Chartering Act.

Several objections may be raised. First, how can we be sure that completely outside boards will be competent? As elaborated subsequently, corporate campaign rules will be redesigned to emphasize qualifications. This will allow shareholder voters to make rational decisions based on information clearly presented to them. It is also a fair assumption that shareholders, given an actual choice and role in corporate governance, will want to elect the men and women most likely to safeguard their investments.

A second objection is that once all interlocks are proscribed and a full-time outside board required, there will not be enough qualified directors to staff all major firms. This complaint springs from that corporate mentality which, accustomed to 60-year-old white male bankers and businessmen as directors, makes the norm a virtue. In fact, if we loosen the reins on our imagination, America has a large, rich, and diverse pool of possible directorial talent from academics and public administrators and community leaders to corporate and public interest lawyers.

But directors should be limited to four two-year terms so that boards do not become stale. And no director should be allowed to serve on more than one board at any one time. Although simultaneous service on two or three boards might allow key directors to "pollinize" directorates by comparing their different experiences, this would reduce their loyalty to any one board, jeopardize their ability to fully perform their new directorial responsibilities, and undermine the goal of opening up major boardrooms to as varied a new membership as is reasonable.

The shareholder electoral process should be made more democratic as well. Any shareholder or allied shareholder group which owns .1 percent of the common voting stock in the corporation or comprises 100 or more individuals and does not include a present executive of the corporation, nor act for a present executive, may nominate up to three persons to serve as directors. This will exclude executive management from the nomination process. It also increases the likelihood of a diverse board by preventing any one or

two sources from proposing all nominees. To prevent frivolous use of the nominating power, this proposal establishes a minimum shareownership condition.

Six weeks prior to the shareholders' meeting to elect directors, each shareholder should receive a ballot and a written statement on which each candidate for the board sets forth his or her qualifications to hold office and purposes for seeking office. All campaign costs would be borne by the corporation. These strict campaign and funding rules will assure that all nominees will have an equal opportunity to be judged by the shareholders. By preventing directorates from being bought, these provisions will require board elections to be conducted solely on the merit of the candidates.

Only the actual or "beneficial" owners of stock should be eligible to vote. Financial intermediaries shall be required to "pass through" voting rights in approximately the same manner that present New York and American Stock Exchange rules require broker-dealers to "pass through" proxies and corporate reports to shareholders owning stock in street name accounts. Already a number of major firms, including Sears, Roebuck, General Motors, McDonnell Douglas, and United States Steel, "pass through" voting rights to hundreds of thousands of employees holding stock in joint pension funds.

Finally, additional provisions will require cumulative voting and forbid "staggered" board elections. Thus any shareholder faction capable of jointly voting approximately 10 percent of the total number of shares cast may elect a director.

A NEW ROLE FOR SHAREHOLDERS

The difficulty with this proposal is the one that troubled Juvenal two millennia ago: *Quis custodiet ipsos custodes*, or, Who shall watch the watchmen? Without a full-time body to discipline the board, it would be so easy for the board of directors and executive management to become friends. Active vigilance could become routinized into an uncritical partnership. The same board theoretically elected to protect shareholder equity and internalize law might instead become management's lobbyist.

Relying on shareholders to discipline directors may strike many as a dubious approach. Historically, the record of shareholder participation in corporate governance has been an abysmal one. The monumental indifference of most shareholders is worse than that of sheep; sheep at least have some sense of what manner of man they follow. But taken together, the earlier proposals—an outside, full-time board, nominated by rival shareholder groups and voted on by beneficial owners—will increase involvement by shareholders. And cumulative voting insures that an aroused minority of shareholders—even one as small as 9 or 10 percent of all shareholders—shall have the opportunity to elect at least one member of the board.

But that alone is hardly sufficient. At a corporation the size of General Motors, an aggregation of 10 percent of all voting stock might require the allied action of over 200,000 invididuals—which probably could occur no more than once in a generation. To keep directors responsive to law and legitimate public concerns requires surer and more immediate mechanisms. In a word, it requires arming the victims of corporate abuses with the powers to swiftly respond to them. For only those employees, consumers, racial or sex minorities, and local communities harmed by corporate depradations can be depended upon to speedily complain. By allowing any victim to become a shareholder and by permitting any shareholder to have an effective voice, there will be the greatest likelihood of continuing scrutiny of the corporation's directorate. Shareholder involvement can be further enhanced by the disclosures discussed in the next chapter, by the opportunity to attend periodically scheduled directors' meetings to ask questions or present grievances, and by reform of the shareholder derivative action so that any investor who identifies a corporate violation of law may bring lawsuit without risk of financial loss.

For the purpose of motivating the board to perform its intended role, however, it is appropriate to inject shareholders further into corporate governance wherever they have a financial or other incentive to perform effectively.

Six weeks before a vote on any fundamental transaction—which can be defined as executive proposals involving the purchase, sale, lease, merger, consolidation, financing, refinancing, dissolution, or liquidation of assets equal to, say, 10 percent of the corporation's total assets or over $100 million, or the authorization

of corporate securities in any amount—the board should forward a written statement to the shareholders explaining the transaction, the vote by which the transaction was approved by the board, the reasons why members of the board approved the transaction, the reasons why other members opposed it, and the foreseeable costs and risks of implementing the proposal. This provision would provide for shareholder votes on all business decisions above a certain minimum size, however named. By requiring directors to publicly elaborate their reasoning—reasoning which may be judged not only during this vote but also during subsequent board elections or mismanagement suits—there would be a powerful incentive for directors to police themselves.

A complementary provision should allow any shareholder or allied shareholder group holding stock equal to a minimum of one percent of all outstanding stock to simultaneously publish a dissenting view or, at any time, to propose amendments to the corporate charter or bylaws.

AFFECTED COMMUNITIES

Shareholders are not the only ones with an incentive to review decisions of corporate management; nor, as Professors Chayes and Dahl argue, are shareholders the only persons who should be accorded corporate voting rights. The increasing use by American corporations of technologies and materials that pose direct and serious threats to the health of communities surrounding their plants requires the creation of a new form of corporate voting right. When a federally chartered corporation engages, for example, in production or distribution of nuclear fuels or the emission of toxic air, water, or solid waste pollutants, citizens whose health is endangered should not be left, at best, with receiving money damages after a time-consuming trial to compensate them for damaged property, impaired health, or even death.

Instead, upon finding of a public health hazard by three members of the board of directors or 3 percent of the shareholders, a corporate referendum should be held in the political jurisdiction affected by the health hazard. The referendum would be drafted by the unit triggering it—either the three board members or a designate of the shareholders. The affected citizens by majority vote will then decide whether the hazardous practice shall be allowed to continue. This form of direct democracy has obvious parallels to the initiative and referendum procedures familiar to many states—except that the election will be paid for by a business corporation and will not necessarily occur at a regular election.

What would happen to the local community if it voted to close a dangerous plant? Three answers seem reasonable. First, the board of directors should have the opportunity to modify the local plant to reduce the health hazard. If the board chooses to do so, it should be allowed to submit its modification plan as a subsequent referendum for community approval. Second, if the corporation chooses to leave after the vote, it should be required to immediately repay the local community for all damages to its health and property by the outlawed activity. This valuation proceeding should occur in federal district court. If the corporation chooses to leave before the referendum vote, it should additionally be required to pay its local employees salaries for a reasonable interim period. Third, the referendum voting procedure should be flexible. Local communities should be given the opportunity to vote upon an initiative calling for the corporation to remedy a specific health hazard by a designated date as an alternative to one calling for immediate closing of a plant. Similarly, the board should be given the opportunity to submit a plan of modification simultaneously with the initial referendum vote.

This type of election procedure is necessary to give enduring meaning to the democratic concept of "consent of the governed." To be sure, this proposal goes beyond the traditional assumption that the only affected or relevant constituents of the corporation are the shareholders. But no longer can we accept the Faustian bargain that the continued toleration of corporate destruction of local health and property is the cost to the public of doing business. In an equitable system of governance, the perpetrators should answer to their victims.