

ARTICLES

Theses For A Corporate Reformation

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INTRODUCTION

Of all the institutions that shape U.S. society, none are more dominant than business corporations. They supply most of the food that is eaten, most of the clothes that are worn, most of the shelters that are inhabited, and most of the entertainments that are enjoyed. They are also the largest providers of the wages and the workplaces that determine the quality of a large sector of many people's lives. Corporations' criteria for advancement or demotion rule perceptions of personal success or failure. Corporate dividend and interest payments sustain insurance and annuities and motivate most of the savings that finance capital investment. Corporations deliver most of the revenue of state and federal governments, partly by paying their own taxes and partly by collecting and remitting most of the income, social security, and excise taxes levied against their employees and customers.¹

¹ Most of the statements in this paragraph are based on inference from statistical and other bases. An indication of corporations' role in the production of goods and services and payment of wages is their share of national business receipts, which in 1981 was \$7,026 billion out of a total of \$7,821 billion, or about 90%. UNITED STATES

Most of the nation's business corporations make these contributions to society with an efficiency that compares favorably with that of other human institutions. If they did not, the United States would not offer wages, careers, products, and homes that are equal to the best and better than most in the world today. But corporations are not faultless; some of them suffer from diseases that impair their efficiency and can spread insidiously if unchecked. Because of the central role of corporations in modern society, corporate diseases are of concern not only to shareholders, but to every citizen.

In the following pages I will identify some of the diseases that sap the efficiency of corporations as social instruments. By "efficiency" in

BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 1985, at 516 (105th ed. 1985) [hereafter STATISTICAL ABSTRACT].

The role of corporations as employers may be estimated more roughly by combining the corporate share of business receipts with statistics of employment by industry. Of the 102 million people employed in 1982, the number in employments that would not ordinarily be classified as "business" was only about 24 million (hospitals 3.0, medical 1.7, private education 1.9, households 1.6, government 15.8), leaving about 78 million, or 76% in "business." *Id.* at 405. About 90% of these, or 68% of all employed persons, might be assumed to be employed by business corporations.

The role of corporations in the remittance of federal taxes may be estimated by observing the fractions of internal revenue collections derived from various sources in 1983, *id.* at 315, and applying percentages that correspond to business corporations' shares of employment (68%) and of national business receipts (90%). On this basis, it would be reasonable to estimate that 31% of federal tax collections came from income tax withholding by corporations (0.68 x total 1983 withholding of 42.4%), 19% from employment taxes remitted by corporations (0.68 x total employment tax collections of 27.7%), 5% from corporate payments of excise taxes (0.9 x total excise tax collections of 5.7%), and 10% from corporate income tax, for a total of about 65% of internal revenue remitted by business corporations. In these estimates, I have attributed to corporations none of the remittances of estate and gift taxes (1% of the federal total), although corporate executors and administrators probably remit a substantial fraction of these taxes.

Available analyses of state tax collections are less detailed, but are sufficient to show that the largest reported elements in 1983 were general sales or gross receipts taxes (83.8 billion out of 171.4 billion, or 49% of all state collections), individual income taxes (49.8 billion, or 29%) and corporation income taxes (13.2 billion, or 8%). *Id.* at 279. The corporate share of excise tax remittances may be reasonably estimated at 90% (corresponding to the corporate share of national business receipts, described *supra*). The corporate share of individual income tax remittances may be reasonably estimated at 68%, based on the 76% of federal income tax that is withheld by employers, *id.* at 315, multiplied by the 90% of business receipts that come to corporations. The resulting estimates of corporate remittances would be \$75 billion of excise taxes (83.8 x 0.9), \$34 billion of individual income taxes (49.8 x 0.68), and \$13 billion of corporate income taxes (13.2 x 1.0) indicating corporate remittances of about \$122 billion, or 71% of state tax revenues, without counting corporate contributions to smaller sectors of state tax collections.

this context, I mean the extent to which corporations produce maximum social benefits, such as goods and services to consumers, incomes and careers to workers, and financial returns to investors, and impose minimum social costs, such as consumption of materials and labor, impairment of the health of employees and neighbors, and financial losses of investors and creditors. Among social benefits and costs, I include consequences that are sought or shunned by sensible people, even if they are not measured in monetary or material terms. In this sense, behavior that produces resentment and distrust may be inefficient, even if the measurable gain in product output is greater than the costs that are measurable in dollars.²

These corporate ills can be alleviated, I contend, by revising the rules that govern the structure, management, and status of business corporations, including not only rules that are found in "business corporation acts," but also rules that are found in uncodified judicial doctrine, securities laws, antitrust laws, and civil procedure codes.

I. FIVE CORPORATE DISEASES

Of the five diseases that I have chosen for attention, only one — the abuse of power by corporate managers — coincides with the predominant preoccupation of contemporary corporate critics.³ The other four are more appropriately ascribed to erroneous perceptions of reality by judges and legislators. The selection will probably surprise readers, for it includes problems that have attracted slight attention from commentators. I have made the choice in order to show that corporate reformation does not require merely, or even primarily, the restraint of aberrant executives; it requires a pervasive reorientation of corporation laws to respond to the realities of contemporary society.

If my choice of diseases is surprising, my omission of the derivative

² In accord with this conception of corporate functions, see White, *How Should We Talk About Corporations? The Languages of Economics and of Citizenship*, 94 *YALE L.J.* 1416, 1423 (1985).

³ Debate over the duties and liabilities of corporate directors has dominated American Law Institute discussions on principles of corporate governance and structure. It has entered not only the discussion of sections defining directors' duties, *Principles of Corp. Governance & Structure*, in 1982 *PROCEEDINGS* 498-528, but also of sections on structure. *Id.* at 438-40.

The conduct of directors was a major focus of attack in R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976), and C. STONE, *WHERE THE LAW ENDS* (1975). It is also a subject of affirmative and negative comment by a wide variety of other observers. See, e.g., *COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE* (D. Schwartz ed. 1979).

suit will probably be even more so. The omission is made partly because so little remains to be said after the deluge of commentaries on derivative suits, including that of Daniel Dykstra, to whom this symposium is dedicated.⁴ More fundamentally, they are omitted because they are not in themselves a major menace to corporate efficiency,⁵ and their abuses are best attacked by curing more basic problems. If shareholder supervision is activated, the need for derivative suits will be greatly diminished.⁶ If directors' liability is rationalized, the temptations for abuse of derivative suits will be significantly reduced.⁷ Derivative suits are not so much a disease as symptoms of diseases that should be attacked more directly.

⁴ Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74 (1967); see also Ballantine, *Abuses of Shareholders Derivative Suits: How Far Is California's New "Security for Expenses" Act Sound Regulation?*, 37 CALIF. L. REV. 399 (1949); Carson, *Current Phases of Derivative Actions Against Directors*, 40 MICH. L. REV. 1125 (1942); Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789 (1985); Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981); Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984); Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959; Hornstein, *The Future of Corporate Control*, 63 HARV. L. REV. 476 (1950); Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COLUM. L. REV. 1 (1947); Jones, *An Empirical Examination of the Incidence of Derivative and Class Action Lawsuits, 1971-1978*, 60 B.U.L. REV. 306 (1980) [hereafter *Class Action Incidence*]; Jones, *An Empirical Examination of the Resolution of Derivative and Class Action Lawsuits*, 60 B.U.L. REV. 542 (1980) [hereafter *Class Action Resolution*].

⁵ The argument that derivative suits, for all their faults, are more beneficial than detrimental is persuasively presented by Dykstra, Cox, Coffee and Schwartz, Hornstein, and Ballantine in the articles cited *supra* note 4. Moreover, Jones' statistical survey in *Class Action Incidence*, *supra* note 4, shows that the number of corporations subjected to suits in any year is extremely small.

⁶ Part II of this Article explores the advantages and potentialities of activating shareholder supervision. They have been the subject of earlier comment in Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459, 1480-83 (1984).

⁷ See discussion in part II of this Article, and earlier comments in Conard; *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895, 912-15; see also PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS, Tent. Draft No. 1 (1982) comments to 7.06 (c) and (d), at 394-99, and Reporter's Note, at 400 [hereafter T.D. 1, T.D. 2, or T.D. 3].

A. Abuses of Control

Since the majority of shareholders in publicly held corporations are generally passive,⁸ most corporate decisions are made with virtual finality by managers or minority shareholders whose financial interests may conflict with those of a majority of shareholders.⁹ In the largest corporations, the dominant decisionmakers are likely to be the executives; in smaller corporations they are likely to be a family group holding a large but minority block of shares, or another corporation in a related business, or (if the corporation is under financial stress) creditors.¹⁰ These decisionmakers are best known as “controlling persons” or, more briefly, “the control.”¹¹

⁸ The classical description of this phenomenon in the 200 largest corporations was presented in A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (rev. ed. 1967). For more recent observations, see R. GORDON, *BUSINESS LEADERSHIP IN THE LARGE CORPORATION* 156-88 (1961); E. HERMAN, *CORPORATE CONTROL, CORPORATE POWER* 9-14 (1981); R. LARNER, *MANAGEMENT CONTROL AND THE LARGE CORPORATION* 9-24 (1970). On reexamining the subject in 1976, Eisenberg found that most shareholders were still passive with respect to “routine” decisions, but less so in relation to “structural” decisions — especially those involving takeovers and mergers. M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 30-63 (1976). For the opinions of some famous Chief Executive Officers, see L. IACOCCA, *IACOCCA: AN AUTOBIOGRAPHY* 104, 131, 155 (1984); Geneen, *Why Directors Can't Protect the Shareholders*, *FORTUNE*, Sept. 17, 1984, at 28.

⁹ See Geneen, *supra* note 8, at 29. Classic illustrations of conflicts of interest between controlling persons and other shareholders are *Rogers v. Hill*, 289 U.S. 582 (1933) (involving executive compensation); *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947) (involving redemption of shares without prior notice to holders of conversion rights); *Irving Trust Co. v. Deutsch*, 73 F.2d 121 (2d Cir. 1934) (involving corporate investment opportunity); *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 121 N.E. 378 (1918) (involving power supply contract); see also Donaldson, *Financial Goals: Management vs. Stockholders*, 41 *HARV. BUS. REV.*, May-June 1963, at 116, 121 (dealing principally with conflicts between long-term goals that interest management and short-term goals that interest shareholders).

¹⁰ See generally A. BERLE & G. MEANS, *supra* note 8; R. GORDON, *supra* note 8; E. HERMAN, *supra* note 8, at 121-28; R. LARNER, *supra* note 8.

¹¹ See A. BERLE & G. MEANS, *supra* note 8, at 66-67; R. LARNER, *supra* note 8, at 2-5. It is important to recognize that these writers use “control” in the sense of practical ability to choose directors or guide directors’ decisions, not merely the theoretical ability that belongs to the majority of shareholders even when they are widely dispersed. E. HERMAN, *supra* note 8, at 17-26, makes illuminating distinctions among control, constraint, and latent power. Whether or not the SEC understands its definition in the practical or the theoretical sense is not clear from the definition in Rule 405 under the Securities Act of 1933, which defines “control” as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or other-

Abuses of control take many forms. Some executives obtain extravagant rewards through the operation of bonus or option schemes.¹² Some parent companies underpay subsidiaries for merchandise, or siphon off subsidiaries' assets.¹³ In the 1970's and 1980's the most conspicuous abuse has been the launching of costly takeover campaigns that gratify executives' appetites for power but add nothing to the productivity of their enterprises.¹⁴ When target executives see their own power threatened by takeover bids, they waste their companies' resources in takeover defenses, including the payment of greenmail.¹⁵ Often they adopt their own takeover campaigns as a means of making themselves less vulnerable to the takeover bids of others.¹⁶ The result is like an unending struggle of warlords, each of whom consumes the resources of his duchy in trying to capture the resources of other duchies rather than developing the resources of his own.

Apologists for unregulated business have often contended that these abuses by corporate masters are minor and adequately controlled by

wise." 17 C.F.R. § 230.405 (1984).

¹² For some recent reports of compensation that is disproportionate to enterprise success, see Loomis, *The Madness of Executive Compensation*, FORTUNE, July 12, 1982, at 42; Helyar, *Pay to Continental Illinois Ex-Officers is Fought by FDIC*, Wall St. J., Apr. 26, 1985, at 38, col. 1. For comment, see Goldberg, *Regulation of Hostile Tender Offers: A Dissenting View and Recommended Reforms*, 43 MD. L. REV. 225 (1984); Drucker, *Taming the Corporate Takeover*, Wall St. J., Oct. 30, 1984, at 20, col. 3-6; Drucker, *Reform Executive Compensation or Congress Will*, Wall St. J., Apr. 24, 1984, at 34, col. 3.

¹³ For a contemporary illustration, see Darlin, *State Officials Try to Unravel Baldwin Deals*, Wall St. J., May 20, 1985, at 33, col 3.

¹⁴ See R. HAYES & S. WHEELWRIGHT, RESTORING OUR COMPETITIVE EDGE 13-15 (1984); Lipton, *Takeover Abuses Mortgage the Future*, Wall St. J., Apr. 5, 1985, at 16, col. 4.

¹⁵ See Atkins, *Takeover Defense*, FIFTEENTH ANN. INST. ON SEC. REG. 193 (1984); Bialkin & Kramer, *Lock-ups, Proxy Contests, Counter-Tenders, and Other Acquisition Techniques*, FOURTEENTH ANN. INST. ON SEC. REG. 189 (1983); Fischel, McKinney & Goldschmid, *The Responsibilities of Directors in Connection with Unfriendly Tender Offers*, THIRTEENTH ANN. INST. ON SEC. REG. 131 (1982); Friedman, *The Tender Offer Advisory Committee Report*, FIFTEENTH ANN. INST. SEC. REG. 239 (1984); Goldberg, *supra* note 12, at 230-35; Noble, *Time is Money, Fear is Lots of Money*, N.Y. Times, Aug. 26, 1984, § 4, at D8, col. 1; Bleakley, *Surge in Company Takeovers Causes Widespread Concern*, N.Y. Times, July 3, 1984, at A1, col. 1. For a contention that many of the defensive tactics redound to the benefit of investors, see Jensen, *Takeovers, Folklore and Science*, 84 HARV. BUS. REV., Nov.-Dec. 1984, at 109.

¹⁶ See Hochman & Folger, *Deflecting Takeovers: Charter and By-Law Techniques*, 34 BUS. LAW. 537, 558 (1979).

market forces.¹⁷ But with the emergence of takeover defenses by poison pills, golden parachutes, and lockups,¹⁸ the most fervent advocates of nonregulation have been driven to join in a demand for restricting abuses of control in resisting takeovers.¹⁹ When executives whose positions are threatened are so quick to serve themselves at the expense of shareholders, a realistic observer will suspect that they have been serving themselves, although less conspicuously, all along.

The direct costs of the self-serving activities of control, other than those that occur in takeover battles, are usually small in relation to the total returns of an enterprise. Salaries and bonuses are usually a small fraction of a corporation's cashflow. But the indirect costs are likely to be much larger. If top executives are seen as ripping off the company, executives on lower levels feel justified in doing likewise. When automobile executives collected huge bonuses after obtaining give-backs from laborers, qualified observers believed that the bonuses would have uncounted costs in their effects on future demands of labor unions.²⁰ Beyond these visible costs, abuses of control undermine the faith of workers that their productivity contributes proportionately to their own rewards and destroy the perception of commonality in objectives and benefits that gives dignity to work.

B. *The Carousel of Directors' Liability for Negligence*

In accord with traditional principles of torts and trusts, the law declares directors liable for harm inflicted on corporations or their share-

¹⁷ See Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982).

¹⁸ "Poison Pill" is shorthand for a transaction that makes a target company less attractive to a bidder, typically by issuing rights that dilute the common stock. See *Summary and Analysis*, 54 LAW WEEK 1081 (1985); Hertzberg, *Takeover Targets Find Loading Up on Debt Can Fend Off Raiders*, Wall St. J., Sept. 10, 1985, at 1, col. 6. "Golden Parachutes" characterize generous pensions to executives of target companies. See Siegel, *Tender Offer Defense Tactics: A Proposal for Reform*, 36 HASTINGS L.J. 377, 378 (1984). "Lock-ups," sometimes adorned as "crown jewel lock-ups," involve granting to a third party options to buy the most valuable assets of a target company. See Note, *Controlling Imprudent Lockups: The Necessity for Federal Legislation*, 63 WASH. U.L.Q. 91 (1985); Note, *Lock-Up Option on "Crown Jewels" Enjoined*, FED. SEC. L. REP. (CCH) No. 1160, at 1 (Jan. 15, 1986).

¹⁹ See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

²⁰ Drucker, *Reform Executive Pay or Congress Will*, Wall St. J., Apr. 24, 1984, at 28, col. 3.

holders by the directors' negligent acts or omissions. In billion-dollar corporations, literal application of these principles would make directors liable for the tens or hundreds of millions of dollars that their mistakes may cost.

The probability that directors will actually be held liable, unless they have enriched themselves, is slight.²¹ Trial judges, whom higher courts recurrently find to have made erroneous rulings, are understandably reluctant to impose million-dollar liabilities on their counterparts in commerce whose decisions appear to have been in error. Courts find many ways, the foremost of which is the business judgment rule, to negate the application of the liability principle.²² This principle relieves courts of the duty to second-guess corporate directors in the way that they second-guess automobile drivers, surgeons, and asbestos product manufacturers. Even when a director's decision to repel a tender offer demonstrably deprives the shareholders of many millions of dollars, directors escape liability under an indulgent application of the rule.²³

Although a vigorous defense will usually save directors from an adverse final judgment, the theory of liability strikes directors' hearts with justified apprehensions. The price of escaping the theoretical liability is the expenditure of tens of thousands of dollars in attorneys' fees and hundreds of hours of their own time in responding to, or resisting, demands for discovery and in preparing their own evidence of due care.²⁴ Beyond these costs, there is always some vestigial risk of multimillion-dollar liability, which would outweigh the financial benefits of a thousand directorships.

In order to counter their directors' imminent risk of incurring large defense costs and their remote risk of eventual liability, corporations have developed the twin practices of indemnifying directors by payments from corporate treasuries and buying directors' insurance by

²¹ Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968); Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 932 (1983).

²² Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979); Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609 (1984); Sparks, *Recent Developments in Substantive Business Judgment Rule*, 61 N.C.L. REV. 534 (1983).

²³ See *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

²⁴ See *Joy v. North*, 692 F.2d 880, 892-93 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).

payments that come directly from corporate treasuries or indirectly by way of increased directors' fees.²⁵

Although insurance is rarely sufficient to cover directors' potential liability, it is usually adequate to pay for a settlement of claims, including fees for plaintiffs' counsel. Plaintiffs and their lawyers are usually glad to settle because they would have to invest more and more money in the suit as it dragged on and they might lose it altogether if they pursued it to final judgment. Similar considerations incline the directors toward settlement. Although the law imposes restrictions on indemnification and insurance coverage when directors are found guilty or found liable, a settlement before judgment preempts any such finding.²⁶ The concatenation of liability, indemnification, insurance, settlements, and awards of attorneys' fees accomplishes very little that is beneficial, and a great deal that is detrimental.

In more familiar areas of negligence law, such as automobile accidents, three kinds of benefits are commonly ascribed to negligence liability. First, it is supposed to deter negligent conduct.²⁷ The applicability of this factor to individual error has been questioned because negligence is by definition unintentional, and largely beyond individual control. Even if the threat of liability can deter negligent conduct when the liability is uninsured, the threat is blunted for directors, whose liability is covered by insurance and who can pass on their premium costs to the corporation.²⁸ Whatever deterrence occurs must result from the tiny share of costs that falls outside the insurance coverage.

The second benefit commonly ascribed to tort liability is the distribution of loss.²⁹ This benefit is most easily visualized in connection with personal injuries resulting from automobile accidents: liability insurance distributes the loss among the whole population of automobilists, instead of leaving it all on the unfortunate accident victim. The net effect is deemed beneficial even though more than half the costs are gobbled up in administrative expense, since the small costs of insurance premiums are so much more bearable than the big loss suffered by an uncompensated victim of severe injury.³⁰

²⁵ See Hinsey & DeLancey, *Directors and Officers Liability Insurance — An Approach to Its Evaluation and a Checklist*, 23 BUS. LAW. 869 (1968); Hinsey, DeLancey, Stahl & Kramer, *What Existing D & O Policies Cover*, 27 BUS. LAW. 147 (Special Issue, Feb. 1972).

²⁶ See DEL. GEN. CORP. L. § 145(b).

²⁷ P. ATIYAH, ACCIDENTS, COMPENSATION AND THE LAW 556-66 (1980).

²⁸ Cf. G. CALABRESI, THE COSTS OF ACCIDENTS 246-49 (1970).

²⁹ *Id.* at 39-67.

³⁰ *Id.* at 39.

The loss-distribution rationale is much less persuasive in the context of corporate losses. Very few of the corporate losses occasioned by directors' negligence result in any kind of distress of the corporate victim or its shareholders. Since most shareholders do their own risk-spreading by diversifying their investments, they would lose less by bearing the losses occasioned by directors' errors than they lose by paying premiums for insurance of which very little ever comes back to them in benefits.

A third benefit sometimes ascribed to the system of negligence liability linked with liability insurance is the diversion of resources from activities that have high social costs.³¹ Calabresi illustrated this concept by the hypothesis that imposing the costs of accidents on automobilists through liability insurance would reduce automobile use.³² Applied to corporate directorships, this principle presumably would result in corporations' minimizing the employment of directors, because of the increased cost of hiring them. On this analysis, negligence liability seems more likely to worsen than to better the quality of corporate governance.

While the benefits of directors' negligence liability range from slight to dubious, the costs of the system are demonstrable.³³ They consist most obviously of the fees of attorneys who prosecute and defend suits against directors. In addition, there are the costs of insurance administration, which contribute to making the inputs of the liability system much greater than its output. Least visible, but very important, are the costs of diverting directors' efforts from supervising the corporation's business to defending lawsuits.

In summary, the system of directors' liability for negligence is a great carousel that gobbles up large amounts of money, takes passengers on a noisy ride, and leaves them about where they got on, but with lighter pockets.

C. *The Creditor Trap*

The entity theory of corporateness, combined with a corporation law that omits any substantial requirements for the maintenance of capital, has provided resourceful entrepreneurs with a convenient device for evading the liabilities of an enterprise whenever the liabilities loom

³¹ *Id.* at 68-94. Calabresi calls this function "general deterrence."

³² *Id.* at 70-71.

³³ For a judicial appraisal of the costs of derivative suits against directors, see *Joy v. North*, 692 F.2d 880, 892-93 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

larger than prospective profits.³⁴ Although there are means by which creditors can sometimes avoid falling into the trap or can climb out of it after they have fallen in, the means are expensive at best and often unavailable.

The usual first step of an enterpriser in laying the trap is to go through the motions of incorporation but provide the new corporation with negligible assets or with none at all.³⁵ Alternatively, enterprisers may acquire a corporation that has adequate assets and then impoverish it through transactions favorable to themselves but detrimental to the corporation.³⁶

The second step consists of borrowing money, buying goods on credit, hiring employees, or committing torts beyond the corporation's ability to pay for them. In order to keep up a facade of solvency so long as eventual profits are foreseen, the owners typically feed the corporation just enough money to pay the most emergent bills as they fall due. Occasionally owners pay the corporation's bills from their own pockets without ever passing the money through the corporation's treasury.

In the simplest form of the trap, the owners cause the corporation to issue them shares in exchange for whatever money they have advanced. More sophisticated owners take the corporation's promissory notes in exchange for most of their advances, or record themselves on the corporation's books as creditors on open account.

If the business produces a cash flow, the owners may drain off the cash as dividends or more likely as compensation for "management services." When the liabilities mount beyond the probable ability of the corporation to pay, the owners stop advancing funds, the enterprise stops paying its debts, the suppliers, lenders and employees quit, and operations halt. Usually the corporation goes voluntarily or involuntarily into bankruptcy, and its scanty assets are distributed among its creditors at the rate of a few cents on the dollar. If the owners have

³⁴ The problem was thrust upon professional consciousness and given its most popular sobriquet by Maurice Wormser in his seminal article. Wormser, *Piercing the Veil of Corporate Entity*, 12 COLUM. L. REV. 496 (1912). One aspect of the problem was the principal subject of E. LATTY, *SUBSIDIARY AND AFFILIATED CORPORATIONS* (1936); F. POWELL, *PARENT AND SUBSIDIARY CORPORATIONS* (1931); Douglas & Shanks, *Insulation from Liability through Subsidiary Corporations*, 39 YALE L.J. 193 (1929).

³⁵ Classic examples are *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344 (2d Cir. 1942); *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

³⁶ This seems to be the hypothesis on which the court acted in *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939), although the statement of facts casts some doubt upon the initial capitalization as well as upon the subsequent management.

made some of their advances in the form of loans, they will even lay claim to a portion of the corporate assets, concurrently with the outside creditors. If the outside creditors do not resist, the owners lose no more than they have advanced, although they have enjoyed a chance of making profits without discharging the liabilities foreseeably associated with the venture.

If the outside creditors are alert and are prepared to put some resources into investigation and litigation, they can probably subordinate claims that the owners file in the role of creditors,³⁷ or even make the owners contribute toward the corporation's obligations.³⁸ But their task is not easy. On the factual side, they must first discover who the owners are and what the owners have done that would justify denying their claims to be creditors and making them into debtors instead. On the doctrinal side, the creditors must penetrate the mists of metaphor³⁹ that enshroud the "piercing of the corporate veil." The difficulties are such that enterprisers often succeed in making outside creditors bear most of the risk of loss, while saving for shareholders the potentiality of profit.

Creditor traps impose various costs on society. Large and sophisticated creditors, often banks, consume manpower in investigating prospective borrowers and overseeing existing debtors to avoid getting caught in the trap. They then add the costs of investigation and oversight to the price of loans. Many merchandise creditors lack the financial means for investigation and oversight, take chances on their customers' solvency, and increase the prices they charge to all customers to cover the losses inflicted on them by the trappers. Unpaid employees and tort victims bear most of these losses but may pass on a part of them to merchants, landlords, hospitals and taxpayers by not paying their bills and by collecting public assistance. Thus, proprietors of inefficient enterprises escape the costs that their activities engender and pass them on to the entire community.

Apologists for the impenetrability of corporate entities may contend that the situation is harmless: vendors can protect themselves by investigating their customers' creditworthiness, and prospective tort victims can buy their own accident insurance.⁴⁰ But both of these solutions

³⁷ This is known as "subordination" of claims, and was enforced in *Taylor*, 306 U.S. 307, 322-24, and in *Pepper v. Litton*, 308 U.S. 295 (1939). It received statutory recognition in the Bankruptcy Act of 1978, § 510(c), 11 U.S.C. § 510(c) (1984).

³⁸ See *Weisser*, 127 F.2d at 344; *Minton*, 56 Cal. 2d at 576, 364 P.2d at 473, 15 Cal. Rptr. at 641.

³⁹ Justice Cardozo applied this phrase in *Berkey v. Third Ave. Ry.*, 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926).

⁴⁰ See Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 984-89 (1971); Com-

have the fault of externalizing the costs of inadequately capitalized enterprises. Moreover, enterprise owners can foresee their requirements of capital and insurance more clearly and cheaply than vendors can. Owners can also purchase insurance more economically than can their scattered accident victims. The use of the corporate entity as a creditor trap imposes needless costs on commerce and on human welfare.⁴¹

D. *The Anti-Foreign Anachronism*

When enterprisers in corporate form wish to transact business in a state other than the one in which they were incorporated, they find that they must obtain "admission" to the state, unless the desired transaction can be categorized as "interstate commerce" or falls within a few other exceptions.⁴² No such impediments can be imposed on sole proprietors or partners, because the citizens of one state who enter a second state are entitled under the Constitution to the same rights and privileges in the second state as that state grants to its own citizens.⁴³ But when enterprisers operate in corporate form, they abandon the rights and privileges of citizens.⁴⁴ This curiosity of constitutional law was conceived, as one might guess, by Chief Justice Taney, to whom corporations were a strange and unnatural phenomenon⁴⁵ and citizen-

ment, *Disregarding the Corporate Entity: Contract Claims*, 28 OHIO ST. L.J. 441 (1967).

⁴¹ See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 178 (1972).

⁴² For a typical statute, see REVISED MODEL BUSINESS CORP. ACT §§ 15.01, 15.02 (1984) [hereafter RMBCA]. Section 15.01(b) contains a list of activities in addition to interstate commerce that do not require admission. They include litigation, holding meetings, maintaining bank accounts, maintaining securities transfer offices, making sales through independent contractors, soliciting orders, acquiring or granting security interests, and isolated transactions.

⁴³ U.S. CONST. art. IV, § 2, cl. 1. The Supreme Court has applied the clause to invalidate a discriminatory state tax on out-of-state merchants, *Ward v. Maryland*, 79 U.S. (12 Wall.) 418 (1870), a discriminatory tax on nonresident fishermen, *Toomer v. Witsell*, 334 U.S. 385 (1948), a discriminatory income tax on nonresidents, *Austin v. New Hampshire*, 420 U.S. 656 (1975), and a discriminatory regulation on availability of abortions, *Doe v. Bolton*, 410 U.S. 179, 200 (1973). But the Court sustained a discriminatory hunting license fee, *Baldwin v. Fish & Game Comm'n*, 436 U.S. 371 (1978), presumably on the ground that hunting is not a fundamental right.

⁴⁴ *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1868); *Bank of Augusta v. Earle*, 38 U.S. (13 Pet.) 519, 586 (1839).

⁴⁵ Taney quoted with approval Marshall's characterization of a corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law." *Bank of Augusta*, 38 U.S. at 587 (citing *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819)).

ship a closely guarded status (not available, for instance, to blacks⁴⁶).

During the latter half of the nineteenth century, states often imposed discriminatory regulations and taxes on out-of-state corporations as conditions of admittance. Early in the twentieth century, the Supreme Court called a halt to these practices, partly on the ground that they burdened interstate commerce,⁴⁷ and partly because corporations were "persons" under the equal protection clause of the fourteenth amendment.⁴⁸ But the Court left untouched the requirement of admittance for intrastate business and the appendant denial of justice to corporations that have done intrastate business without being admitted.⁴⁹

When a corporation tries to enforce its legal rights in a state in which it has not been either incorporated or admitted, it is sure to face the contention that it has engaged in intrastate business without prior admittance, and therefore cannot maintain the action.⁵⁰ A Memphis cotton broker had to go through the Mississippi trial court, the Mississippi Supreme Court, and the United States Supreme Court to obtain a ruling on the interstate character of its business before it could pursue the merits of its claim of breach of contract by a Mississippi planter.⁵¹

In order to block an out-of-state corporation's suit, the debtor does not need to contend that the particular transaction sued on is intrastate. The creditor is disqualified if it has transacted intrastate business with anyone else without prior admittance.⁵² If it has transacted business of any kind with a resident, it is in for a long argument because of the uncertainty of the boundaries of "interstate" business.⁵³

The nonadmittance defense has a number of awkward consequences. It appears in its best light when the creditor corporation is found to have conducted intrastate business without prior admittance. In order

⁴⁶ See *Dred Scott v. Sandford*, 60 U.S. (19 How.) 393, 404-05 (1856).

⁴⁷ *Pullman Co. v. Kansas*, 216 U.S. 56 (1910); *Western Union Tel. Co. v. Kansas*, 216 U.S. 1 (1910).

⁴⁸ *Southern Ry. Co. v. Greene*, 216 U.S. 400 (1910).

⁴⁹ *Eli Lilly & Co. v. Sav-On-Drugs, Inc.*, 366 U.S. 276 (1961); *Hemphill v. Orloff*, 277 U.S. 537, 548 (1928); *Interstate Amusement Co. v. Albert*, 239 U.S. 560 (1916).

⁵⁰ Margolis, *Is the Plaintiff Doing Business in Illinois — A Perfect Defense?*, 71 ILL. B.J. 366 (1983). According to the author, an Illinois attorney asserted that he routinely files a motion to dismiss an out-of-state corporation's suit on the ground of nonadmittance and "always wins."

⁵¹ See *Allenberg Cotton Co. v. Pittman*, 419 U.S. 20 (1974).

⁵² See *Sar Mfg. v. Dumas Bros. Mfg.*, 526 F.2d 1283 (5th Cir. 1976); *McCullum Aviation v. Cim Assoc.*, 438 F. Supp. 245 (S.D. Fla. 1977); *Kar Prods. v. Acker*, 217 So. 2d 595 (1969).

⁵³ Margolis, *supra* note 50; Note, *A Proposed Minimum Threshold Analysis for the Imposition of State Door-Closing Statutes*, 51 FORDHAM L. REV. 1360 (1983).

to maintain its suit, the creditor must obtain belated admittance by paying the fees, taxes, and penalties for lateness that it should have paid earlier.⁵⁴ This result has some merit in helping the state collect the fees and taxes that are due it. But if the fees and taxes are as much as or more than the debtor owes, the creditor probably drops its suit; the values of the fees and taxes do not go to the state, but go, in effect, to the lucky debtor.

The defense is even more mischievous when the creditor wins. The creditor faces months or years of expensive litigation before it may argue the merits of its claim.⁵⁵ Even when final victory is certain, the costs of obtaining it may exceed its worth. In states that require the plaintiff to bear the burden of proving its nonengagement in intrastate business,⁵⁶ the creditor is put to the expense of making proof of a fact that is not even doubtful.

The contemporary basis for the rule barring suits by an unadmitted out-of-state corporation is a set of statutes that prevent out-of-state corporations from suing within the state before they are admitted.⁵⁷ These laws are said to have been enacted in order to induce out-of-state corporations that operate in the state to submit themselves to its jurisdiction so that local residents could sue them in local courts.⁵⁸ This justification was plausible in the middle of the nineteenth century, when an out-of-state corporation could generally not be sued in a state unless it had submitted itself to the state's jurisdiction by seeking admittance and naming an agent for service of process.⁵⁹ This practice was based on the notion that a "foreign" corporation has no existence in a state until it has been in some way officially recognized.⁶⁰

⁵⁴ *Salitan v. Carter, Ealey & Dinwiddie*, 332 S.W.2d 11, 80 A.L.R. 2d 455 (Mo. Ct. App. 1960) (applying a statute similar to the RMBCA section discussed *supra* note 42). Under an Arkansas statute, which seems to be unique, the lack of admission at the time of entering into a contract appears to be incurable. *See* 6 ARK. STAT. ANN. § 64-1202 (1980).

⁵⁵ *See Allenberg Cotton Co. v. Pittman*, 419 U.S. 20 (1974); *Diversacon Indus. v. National Bank of Commerce*, 629 F.2d 1030 (5th Cir. 1980).

⁵⁶ *See supra* note 52.

⁵⁷ *E.g.*, RMBCA, *supra* note 42, at §§ 15.01, 15.02.

⁵⁸ Walker, *Foreign Corporation Laws: The Loss of Reason*, 47 N.C.L. REV. 1, 8-11 (1968).

⁵⁹ *Northern Ind. R.R. v. Michigan Cent. R.R.*, 18 F. Cas. 358 (C.C.D. Ind. 1853) (No. 10,321); G. HENDERSON, *THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW* 77-81 (1918); Fead, *Jurisdiction over Foreign Corporations*, 24 MICH. L. REV. 633 (1926).

⁶⁰ *See* Fead, *supra* note 59, at 634.

Whatever merit this justification had in earlier years⁶¹ perished when legislatures adopted long-arm statutes.⁶² These laws permit suits against corporations that have significant contacts with the state, whether or not they have been admitted. This development brought about, in the apt coinage of Laurens Walker, the “cessation of reason” for closing the courthouse door to unadmitted corporations.⁶³

A shadow of the original justification for closing the courtroom door persists in the fact that the admittance procedure provides a directory of some of the out-of-state corporations that local residents might want to sue. This is no more than a shadow because many corporations that residents would like to sue will not seek admittance and will not appear in the directory. If a corporation is less interested in suing local residents than in escaping suit itself, it will presumably neglect to be admitted.

Another shadowy justification for closing the courtroom door is the help that the admittance procedure gives to state tax collectors in discovering the identity of corporations that transact intrastate business. Some corporations that expect to sue within the state are induced to seek admittance and can be compelled in connection with admittance to disclose the extent of their in-state taxable activities. But the barrier offers little or no inducement to two classes of taxable corporations — those with no intention of maintaining suits within the state, and those whose in-state activities consist of interstate commerce.⁶⁴

As a tax-collection device, the barrier is comparable to a law that would bar civil suits by creditors who have not paid their income taxes. One can readily imagine the vigor — exceeding that of the most indomitable tax collector — with which defendants would argue for the taxability of a creditor when the creditor’s taxability would delay or defeat its suit to collect a debt.

⁶¹ The principal inconvenience of the doctrine was escaped as early as 1855 by holding that a foreign corporation consents to the jurisdiction of local courts by doing business in the state. *Lafayette Ins. Co. v. French*, 59 U.S. (18 How.) 404 (1855). However, difficult problems remained as to the validity of service of process on corporate agents who were not expressly authorized to receive service.

⁶² See generally Currie, *The Growth of the Long Arm: Eight Years of Extended Jurisdiction in Illinois*, 1963 U. ILL. L.F. 533; Homburger, *The Reach of New York’s Long-Arm Statute: Today and Tomorrow*, 15 BUFFALO L. REV. 61 (1965). Companion statutes generally authorize service of process outside the state by private persons. See, e.g., 110 ILL. ANN. STAT. ch. 110 § 2-208 (Smith-Hurd 1983).

⁶³ See generally Walker, *supra* note 58.

⁶⁴ See *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) (holding an out-of-state corporation subject to an apportioned income tax although its activities within the taxing state were exclusively interstate).

The rule that bars suits by unadmitted out-of-state corporations is an archaism that permits debtors to escape or delay paying their obligations and burdens the courts with litigation that is irrelevant to the substantive rights and duties of the litigating parties. Its benefits are slight and could surely be attained by more efficient means.⁶⁵

E. *The Profit Fixation*

According to conventional wisdom, the only legitimate primary motivation of corporate conduct is the enrichment of shareholders. The sharpest delineation of this fixation occurred in the Michigan Supreme Court's 1919 decision of *Dodge v. Ford Motor Co.*⁶⁶ The court reprimanded Henry Ford for contending that after the shareholders of his corporation had received profits of more than one thousand percent, the corporation could fairly share some of its profits with employees and consumers.⁶⁷

An echo of *Dodge v. Ford* reverberated in the American Law Institute's Corporate Governance drafts of 1982 and 1984, which announced as a general rule: "A business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain . . ."⁶⁸ There were exceptions requiring compliance with law and permitting consideration of ethical obligations and reasonable altruistic contributions,⁶⁹ but shareholder enrichment clearly retained primacy. Benefits to employees, consumers, creditors, or ambient communities might be conferred to the extent that they constituted ethical obligations⁷⁰ but could never be objectives, either primary or coequal with shareholder enrichment.

The primacy of shareholder enrichment, with minor concessions to legality, ethics, and altruism, probably represents the most widely

⁶⁵ See *infra* part II.

⁶⁶ 204 Mich. 459, 170 N.W. 668 (1919).

⁶⁷ *Id.* at 507, 170 N.W. at 684. The court declared, "A business corporation is organized and carried on primarily for the profit of shareholders. . . . The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or the nondistribution of profits among shareholders in order to devote them to other purposes."

⁶⁸ T.D. 1, *supra* note 7, § 2.01 (1982); T.D. 2, *supra* note 7, § 2.01 (1984).

⁶⁹ According to T.D. 2, *supra* note 7, a corporation "may take into account ethical considerations . . .," and "may devote a reasonable amount of resources . . ." to altruistic purposes, but ethical or altruistic considerations are impliedly excluded from "objectives."

⁷⁰ The ethical considerations that may be taken into account must be "reasonably regarded as appropriate," according to T.D. 2, *supra* note 7. Under T.D. 1, *supra* note 7, they had to be "generally recognized as relevant to the conduct of business."

shared aspiration of shareholders in publicly held corporations. But many other objectives motivate the formation and operation of some corporations.⁷¹ Small town merchants and farmers who organize banks are likely to be moved as much by the desire to provide themselves with local financial services as by the desire to receive gains on their investment. Manufacturers often form joint venture corporations primarily to provide themselves with foodstuffs or services that both of them need, rather than to generate investment returns. Employees who take over a failing enterprise act more to provide themselves with wages and salaries than to reap rewards as investors. Contractors organize real estate corporations as much for the opportunity to earn profits on construction contracts as to generate dividends from operation of the real estate. Many founders of corporations organize and operate them more to provide themselves and members of their families with careers of dignity than to maximize returns on their shares. Even publicly held corporations, if we can believe the protestations of their executives, mingle objectives of shareholder enrichment with objectives of worker welfare and consumer advantage.⁷² The traditional purpose clauses of corporate charters, which announced objectives like operating a railroad or a saw mill, were better descriptions of actual purposes than the Institute's formulation.

The doctrine that corporations must maximize shareholder gain works several kinds of mischief. It diminishes respect for law by erecting an exclusive value system in which few persons earnestly believe. It is invoked by executives and directors to relieve themselves of discussing the problems that society as a whole depends on them to solve. It provides dissident shareholders with a ground for harassing directors who serve the best interests of the corporation and of society. It discourages the adoption of policies which, like those of Henry Ford in 1916, advance the long-term prosperity of industry.

The Institute's affirmance of the primacy of profit-seeking is easily understood. The authors presumably sought to eliminate any basis for litigants to dispute, and for judges to decide, just how much weight

⁷¹ See White, *supra* note 2, at 1418-19; see also Anders, *Britain's Wellcome Drug House Decides Profits are Preferable to Founder's Victorian Idealism*, Wall St. J., June 20, 1985, at 32, col. 1 (reporting history of pharmaceutical company that passed up profit opportunities to pay larger dividends to charitable trust that owned all of its shares; company shifted to profit-maximization policy after finding it was being crowded out of its market by lack of research and development).

⁷² See BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE RESPONSIBILITY 12-13 (1981); BUSINESS ROUNDTABLE, THE ROLE AND COMPOSITION OF THE BOARD OF DIRECTORS OF THE PUBLICLY HELD CORPORATION 11-12 (1978).

directors should give to the competing interests of employees, consumers, bondholders, or the biosphere. But the draft falls into the converse error of preserving a foothold for dissident shareholders who, like the Dodge brothers in *Dodge v. Ford*, attack policies on the ground that they are too generous to employees or consumers.

The primacy of shareholder enrichment in judicial doctrine is reinforced by the provisions of most corporation codes, which provide for election of directors only by shareholders,⁷³ impliedly excluding employees, customers, consumers, creditors (with rare exceptions),⁷⁴ and government officials.⁷⁵

In contrast, several of the other industrialized nations of the world provide in various ways for balancing the interests of shareholders against those of employees. In Japan, respect for employee interests is a part of the corporate culture. An experienced observer has declared,

In Japan, economic enterprises are assumed to exist primarily for the benefit of those who work within them or otherwise depend upon them for their livelihood, as opposed to those who invest capital in them. . . . Instead of serving merely as a means through which various parties — including investors — make money, the enterprise has independent value as a constitutive system of relationships.⁷⁶

In Germany and the Netherlands, statutory provisions give employees formal roles in the selection of directors.⁷⁷ A proposed directive of

⁷³ My colleague G.J. Vining observes that shareholders' possession of voting power does not oblige them to seek only their financial advantage, any more than sole ownership of a farm obliges the owner to operate it only for profit. However, it gives plausibility to the argument of officers and directors that they should give primary emphasis to the objective that is most likely to be shared by all stockholders — financial returns.

⁷⁴ Delaware corporation law contains an unusual and little used provision authorizing the grant of voting rights to bondholders. DEL. CODE ANN. tit. 8 § 221 (1983).

⁷⁵ Directors have occasionally been appointed by governments because of particular legislative provisions. An account of experience with this kind of directorship in the Union Pacific Railroad is given in C. STONE, *supra* note 3, at 153-57.

⁷⁶ Reich, Book Review, 98 HARV. L. REV. 697, 705 (1985) (review of W. GOULD, *JAPAN'S RESHAPING OF AMERICAN LABOR LAW*). See also C.A. Anderson, in *Corporate Directors in Japan*, who observes that "there exists in Japan a degree of unity between management and labor not found in U.S. business. . . . Many senior Japanese managers have come up through the ranks and have been union leaders at one time or another. Thus, they seem to feel at least as obligated to the workers as to the owners of the corporation." HARV. BUS. REV., May-June 1984, at 30.

⁷⁷ Sanders, *Employee Participation in the Netherlands*, 1977 J. BUS. L. 209; Summers, *Worker Participation in the U.S. and West Germany: A Comparative Study from an American Perspective*, 28 AM. J. COMP. L. 367 (1980); cf. Summers, *Worker Participation in Sweden and the United States: Some Comparisons from an American Perspective*, 133 U. PA. L. REV. 175 (1984).

the European Community would require all twelve of its members to adopt measures with similar effect.⁷⁸ British company law affirms the duty of directors to act with regard to the interests of employees as well as of shareholders, although it bars employees from enforcing any such balancing of interests.⁷⁹ These developments, which give legal recognition to employee interests, are quite unlike the gracious gestures to worker concerns that are occasionally seen in the United States. When the president of the United Automobile Workers was named to the Chrysler board of directors, the votes cast for him were not the votes of employees, but the votes of shareholders, cast by the indulgence of the management's proxy committee.⁸⁰

Whether any United States investors would choose to experiment with codetermination if it were authorized by state corporation laws cannot be known. What is certain is that experimentation with structural representation of constituencies other than shareholders is barred in the United States by corporation statutes. The United States economy is protected from the perils of testing new ways of accommodating the conflicting interests of the diverse constituencies of business enterprises.

II. THERAPEUTICS

The corporate diseases that have just been described are not the inescapable price of a system of private enterprise. They can be significantly reduced, without impairing the benefits of the private enterprise system, by changes in the substantive laws that govern corporate structure and operation. This section of the Article outlines some innova-

⁷⁸ Conard, *supra* note 6, at 1483-85; Hopt, *New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards*, 82 MICH. L. REV. 1338, 1344-48 (1984).

⁷⁹ Companies Act, 1985, § 309:

(1) The matters to which the directors of a company are to have regard in the performance of their functions shall include the interests of the company's employees in general as well as the interests of its members. (2) Accordingly the duty imposed by subsection (1) above on the directors of the company is owed by them to the company (and to the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its members.

The limitation of enforcement to the company presumably means that action can be brought only by those entitled to sue on behalf of the company, and relief can be granted only in favor of the company.

⁸⁰ See Fraser, *Worker Participation in Corporate Government: The U.A.W.-Chrysler Experience*, 58 CHI.-KENT L. REV. 949 (1982).

tions designed for this purpose. Their essential content is outlined here, without specifying the vehicles or the power sources that should be called upon to install them. The particular legal vehicles (whether statutes, regulations, or judicial decisions) and the power sources (whether federal or state) will be explored in a later section.

A. *Restraining Abuses of Control*

Restraining abuses of control should be approached from two directions. First, the legal environment of shareholding must be revised to liberate and stimulate shareholders to act in protection of their common interests. Second, courts must be emboldened to restrain the abuses of control when shareholders fail to do so.

1. *Activating Major Shareholders*

The capitalist conception of governance and its statutory articulation, involving the supervision of management by shareholders or by directors who represent them, is not obsolete. This model functions in many corporations, probably the great majority of those whose shares are not traded on public markets. When managers are actively supervised by shareholders or their chosen directors, judges or commissions seldom need to restrain managers from favoring themselves or a controlling minority. A primary objective of any significant corporate reform should be to induce major shareholders to exercise the powers of supervision entrusted to them by the corporate laws.

For many years, conventional wisdom has regarded any such supervision as an impossible dream. Skeptics have observed quite accurately that most individual shareholders would lose more if they spent their time and money investigating company affairs and rallying the support of fellow investors than they lose by allowing managers to abuse their offices, or by selling their shares at a loss and looking for a better managed company in which to invest the proceeds.

Recent developments, however, have shown that the dream of shareholder supervision is not only possible, but close to realization. In most of the largest corporations there are huge aggregations of shares in the hands of institutional investors such as investment companies, pension funds, endowments, and private trusts.⁸¹ These institutions can well afford to spend time and money evaluating the managements of present

⁸¹ See generally P. BLUMBERG, *CORPORATE RESPONSIBILITY IN A CHANGING SOCIETY* (1972); P. BLUMBERG, *THE MEGACORPORATION IN AMERICAN SOCIETY* (1975); E. HERMAN, *supra* note 8, at 137-46.

and prospective portfolio companies, and they do so continuously. Unlike most individual investors, they cannot sell their shares at a small loss on a whiff of bad news because their holdings are too massive to be dumped without depressing the market.

Although institutional investors normally avoid conflict with portfolio companies' managers, many of them have openly opposed management proposals for defenses against attractive tender offers. A primary objective of contemporary corporation law should be to induce institutions to go beyond intervention in the crises of takeover bids, and to elect directors who would nip abusive proposals in the bud. Investment managers could obviously protect investor interests more effectively by installing directors who would design responses in the interest of investors than they can by merely blocking abusive proposals that emanate from the executives and the deferential boards in target companies.

The first step in inducing active supervision by institutional investors is to remove their grounds for fearing that adverse legal or political consequences may flow from supervisory activity. Although active supervision invokes no express penalties, it does pose several potential perils. Since involvement in governmental investigations and private litigation is costly to institutions in time, money, and reputation, institutions wisely shun activities that invite the attention of the Securities Exchange Commission, the Antitrust Division of the Justice Department, or private suitors, even if they believe their activities are legal.

The most obvious risks of supervisory activism derive from burdens that are imposed on shareholders who "control" corporations. "Controlling shareholders" are liable *prima facie* for any violations of securities laws committed by the companies they control, and bear the burden of proving that they neither knew of nor participated in the violations.⁸² If they want to sell their shares in quantities that exceed normal market volume, they have to file registration statements and deliver prospectuses as if they were making a public offering of new securities.⁸³ If investment managers combined their forces to elect directors who would defend investor interests, they could plausibly be charged with being in control and subject to these liabilities and duties.

Another risk that institutional investors would incur if they combined

⁸² Securities Act § 15, 15 U.S.C. § 77o (1982); Securities Exchange Act § 20, 15 U.S.C. § 78r (1982).

⁸³ *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969). The ruling was derived from a broad interpretation of the definition of "underwriter" in Securities Act § 2(11), which was then applied to deny exemption under § 4(1), resulting in a duty to register under § 5 (1982).

to elect directors is the liability of "insiders" to surrender short-swing profits.⁸⁴ If courts regarded directors chosen by the institutions as "deputies" of the institutions, the institutions would have to surrender any gross gains that they might make on short-swing trades.⁸⁵ Alternatively, courts might "aggregate" the holdings of the institutions that combine to elect directors, thereby characterizing the institutions as ten percent shareholders,⁸⁶ who are likewise liable to surrender gross gains on short-swing trades. Since the duty to surrender applies to gross gains without regard to losses,⁸⁷ the institutions would not only disqualify themselves from making gains in short-swing trades but would probably sustain losses from any such transactions. Active supervision would become a very expensive business.

A third risk that institutional investors might incur by active supervision would arise under the Clayton Act provision forbidding the same person to hold directorships in competing companies.⁸⁸ If a group of institutions combined to elect directors in companies that compete with each other, the institutions might be held to violate the Clayton Act on the theory that the group was a de facto director of competing companies, for whom the nominal directors were merely deputies.⁸⁹ The ironical effect of Congress' efforts to restrain abuses of power by controlling investors has been to widen the path for abuses of power by managers.

If managers of large corporations are to be effectively supervised, institutional investors must be liberated from the risks imposed by possible interpretations of these securities and antitrust law commands. These laws were enacted to solve problems quite different from those presented by institutional investors' participation in the supervision of their portfolio companies.

⁸⁴ Securities Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1982).

⁸⁵ *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

⁸⁶ See *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971) (a group of investors who organized to seek control of a company should be regarded as a single shareholder for purposes of the requirement of filing a report by the holder of 10% or more of a registered issuer's shares pursuant to Securities Exchange Act § 13(d), 15 U.S.C. § 78m(d) (1982)).

⁸⁷ *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943), *cert. denied*, 320 U.S. 751 (1943).

⁸⁸ 15 U.S.C. § 19 (1984).

⁸⁹ When the appointment of Douglas Fraser to the Chrysler board was followed by a proposal to name a different UAW officer to the American Motors Board, the latter action was blocked by the refusal of the Department of Justice to give it clearance. Forst, *Labor Union Representation on Boards of Competitors: An Antitrust Analysis*, 7 J. CORP. L. 421, 424-28 (1982); Fraser, *supra* note 80, at 958.

In order to let investors participate actively in choosing directors, the first step would be to narrow the conception of "control" employed in securities regulation. Only those who give operating directions would be deemed to control the corporation; this definition would exclude investors who merely combine to elect directors. The latter type of investor should also be free from aggregation for the purposes of filing notices of share acquisition or surrendering short-swing profits. The Clayton Act prohibition of interlocking directorates should be limited to the holding of inconsistent positions by the same individual.

Another impediment, more political than legal, inhibits the activism of institutional investors. When Senators and Representatives investigate the management of corporations, they recurrently inveigh against the domination of companies by financial institutions.⁹⁰ These denunciations contain an implicit threat of legislative or administrative action against institutions that show too much initiative in supervising their portfolio companies.

The legitimate object of these denunciations is the domination of a corporation by one financial institution in its own interest and against the interests of other investors. But the problem is aggravated, rather than solved, by leaving corporate managers in unsupervised supremacy. A better approach is to promote participation by all of the financial institutions that hold shares, so that the broadest possible spectrum of shareholder interests is represented. Active participation of financial institutions in the supervision of corporate management should not be denounced but acclaimed as an objective of economic policy.

2. Judicial Evaluation of Conflict-of-Interest Transactions

Abuses of control will not be effectively restrained unless transactions that involve conflicts of interest are subject not only to the supervision of shareholders, but also to invalidation by court order.

Shareholder activism cannot be relied on to protect investor interests in conflict-of-interest transactions. Even in the largest corporations, where institutional investor activism is a future possibility, judicial intervention will be needed until legal impediments to institutional activism are removed. In smaller companies, including most of the three million whose shares are not publicly traded, few shareholders outside

⁹⁰ See 1 STAFF OF SUBCOMMITTEE ON DOMESTIC FINANCE, HOUSE COMMITTEE ON BANKING AND CURRENCY, *COMMERCIAL BANKS AND THEIR TRUST ACTIVITIES: EMERGING INFLUENCE ON THE AMERICAN ECONOMY* 1, 25. Although the evidence reviewed in the report related almost entirely to bank trust departments, the general comments included "institutional investors" generally.

of management combine the sophistication and the financial power necessary to supervise.

In 1984, the American Law Institute's reportorial group proposed to restrain abuses of control by the judgments of nonmanagement directors.⁹¹ This was a move in the right direction, but went less than half-way to the goal. Most nonmanagement directors are either friends of the executives or executives of other corporations. In either case, their personal allegiance is to the managers rather than to the shareholders.⁹² If they disapprove of the managers' behavior, they do not organize an insurrection; they resign.⁹³

In order to be willing and able to restrain abuses of control, directors must not be *disinterested*; they must be affirmatively *interested* in returns to shareholders or to other corporate constituencies. When directors are merely *disinterested*, judges should make their own determinations of the fairness of transactions that benefit controlling persons, without regard to the procedures followed or the conclusions reached by these directors. If the approval of directors who are merely "disinterested" dissuades judges from invalidating transactions in which managers are interested, shareholders would fare better without such directors.

Deference to the opinion of directors who are not personally involved in a conflict of interest is appropriate only when these directors are substantial stakeholders in the corporation, or the chosen representatives of substantial stakeholders. Substantial stakeholders include major groups of shareholders, major supplier or customer groups, and major employee organizations. When these directors have no interests of their own in the transaction in question, their decisions are likely to accom-

⁹¹ T.D. 3, *supra* note 7, §§ 5.08-5.16.

⁹² For a psychological analysis of the bases of directors' solidarity, see Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. & CONTEMP. PROB. 83 (1985).

⁹³ A striking example occurred in the Bendix Corporation during the presidency of Agee, in which a total of nine outside directors resigned between 1980 and 1983, only one of them announcing a reason, which was loss of confidence in the "top management." For a summary, see Conard, *supra* note 6, at 1472-73. For a different perspective, indicating that directors combined to confront Agee on the question of Mary Cunningham's position, although not on other issues, see M. CUNNINGHAM, *POWER PLAY*, 184-226 *passim* (1984).

Typical is a Wall Street Journal story reporting ITT's announcement without comment of the resignation of an outside director, and the statement of an anonymous source that the director was asked to resign after differing with the ITT chairman on the company's reorganization plan. Buyon, *ITT Corp. Says Outside Director A. Friedman Quit*, Wall St. J., June 26, 1985, at 17, col. 1.

moderate the common interests of all shareholders. But even in this situation, a judge must look to see whether the interests of those who have nominated these directors diverge from those of other investors. The judge should never be content with a determination that the directors are free from personal conflicts and have followed regular procedures.

B. Rationalizing Directors' Liability

The first step in rationalizing directors' liability is to distinguish sharply between inside directors, who are executives of the corporation, and outside directors, who are not. Inside directors are commanders; they observe operations, prepare reports, formulate policies, and exercise their personal discretion in most corporate transactions. Outside directors are supervisors; they depend on executives for information, for the presentation of alternative choices, and for the exercise of discretion in executing decisions made. Inside directors are strongly attracted to their jobs by salaries, which are usually their principal sources of income, by their chances of becoming multimillionaires through bonuses and options, and by the dignity of positions of command. These positions always attract plenty of applicants. Outside directors are weakly lured by fees that are seldom more than a minor source of their incomes; they can easily be dissuaded from serving if their positions are risky or arduous.⁹⁴

Because of the wide divergencies between their incentives to serve and their opportunity to control their own risks, inside and outside directors require very different legal treatments.

1. Outside Directors

Able and conscientious outside directors are essential to the efficient operation of corporations. Attracting them should be a major objective of contemporary corporate law.

In considering the attractions and the deterrents of outside directorships, thought should be given to the polar opposites that can be observed in the law's treatment of human error in other settings. People who err with their own hands or tongues, like automobile drivers, surgeons, and securities salesmen, are liable for the totality of harm that they negligently precipitate. People who are chosen or appointed to make decisions on the basis of facts presented to them by others, like

⁹⁴ See Dentzer & Wang, *Empty Seats on the Board*, NEWSWEEK, Aug. 5, 1985, at 46; Hertzberg, *Insurers Beginning to Refuse Coverage On Directors, Officers in Take-over Cases*, Wall St. J., Jan. 20, 1986, at 3, col. 2.

judges and legislators, are not liable for anything but specific malice. Although outside directors may stand between these poles, they are more like public decision-makers than like operators.

The optimal rule on the liability of outside directors would relieve them of all negligence liability, while leaving them liable for the value of preferential advantages that they obtain for themselves or their associates. This rule would comport with the distinction made between errors of operators (like policemen) and errors of decisionmakers (like judges and legislators). It would eliminate a deterrent to serving as an outside director. Most importantly, it would eliminate the necessity of insurance, the principal effect of which is to finance the settlement of shareholder suits. By eliminating insurance, it would sweep away the pots of gold that currently motivate many unproductive derivative suits.

Traditionalists will argue that liability must be retained in order to motivate directors to give some attention and care to their decisionmaking. Whether liability is a prophylactic for error is an insoluble enigma. Whatever prophylaxis it holds must relate to the uninsured portion of liability. The law could provide the prophylaxis without the carousel effect by forbidding insurance against directors' liability and limiting liability to an amount that directors can be forced to pay out of pocket without driving responsible persons out of directorships.

In light of these considerations, the earlier ALI proposal to set an upper limit on liability had merit.⁹⁵ This limit should be coupled with a prohibition of insurance against the liability that remains. If directors are still unwilling to serve without insurance, the limit should be reduced to the level at which uninsured liability is tolerable.⁹⁶

2. Inside Directors

The carousel of liability with indemnification and insurance is just as useless when applied to inside directors as it is when applied to outside directors. Liability should not exceed what executives can reasonably be required to pay from their own pockets, and insurance and indemnification should be prohibited. But the levels of uninsured liability should be higher for inside directors. Although inside directors, like their outside counterparts, make many decisions in reliance on the reports

⁹⁵ T.D. 1, *supra* note 7, § 7.06(e). This provision did not appear in the 1985 proposed revision. *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 7.16 (Discussion Draft 1, 1985).

⁹⁶ *Cf.* Geneen, *supra* note 8, at 31, favoring a requirement that directors pay damages out of their own pockets, but suggesting an upper limit of 10 times total compensation.

and recommendations of others, they are the ones who initiate corporate action and gather and present the facts to outside directors. While the law of negligence remains basic in the system of justice, executives are appropriate subjects of liability for their negligent errors.

On the other hand, holding corporate executives liable for the totality of harm caused by their errors is an absurdity that survives only because indemnification and insurance save the executives from paying more than a fraction of their theoretical liability. The carousel of liability and insurance is a wasteful way of making corporations insure themselves against risks that they would rather bear without insurance.

The ALI proposal to limit the liability of directors to a flat amount,⁹⁷ if coupled with a prohibition of indemnification and insurance, would be a plausible treatment of inside directors. Courts should retain discretion to set liability at an amount within this limit that is suitably admonitory in view of the particular executive's resources and the stakes for which the executive was playing at the time of the erroneous decision.

3. Litigation Expenses

Inside and outside directors should be either indemnified or insured against expenses of successfully defending themselves against charges of negligence and self-enrichment. The risks of having to defend themselves in litigation are far more pervasive than the risks of being found liable. If directors were denied this protection, they would have to be lured into service by remuneration that would cover their insurance premiums. Consequently, some indemnification and insurance would still burden corporate budgets even after the amounts of liability have been reduced and settlements on account of astronomical liability claims have been eliminated. But elimination of liability settlements would substantially reduce indemnification and insurance requirements. Elimination of these payments would reduce the incentives for attorneys to file suits on behalf of shareholders and would diminish correspondingly the costs of directors' expenses for defense.

4. Restitution of Benefits

Directors' liability for benefits that they receive in violation of their fiduciary duties would be unaffected by the foregoing proposals. Directors must never have any incentive to enrich themselves at the expense

⁹⁷ The proposal in T.D. 1, *supra* note 7, did not distinguish between inside and outside directors.

of other investors.

C. *Enforcing Corporations' Financial Responsibility*

A modern law of corporations should explicitly legitimate corporate proprietors' financial responsibility, which judges have courageously recognized in the face of legislative silence. The law should also provide functional guidelines to replace the vague and conflicting signals that judges have improvised to justify discarding the limited liability principle that is traditional in corporate law.

The principle that should guide the imposition of corporate debts upon corporate owners was articulated forty years ago by Henry Ballantine,⁹⁸ and given a judicial imprimatur by Roger Traynor.⁹⁹ Corporate owners should be liable for corporate debts when they have failed to provide the corporation with a reasonable margin of financial safety in the form of net assets or insurance.

Adopting this principle as a sole criterion, the law should dispense with the confusing tests of observance of corporate forms and separation of assets.¹⁰⁰ These tests were devised by judges who thought they had to find the corporate owners in violation of the corporation law in order to justify denying them the immunity that the corporation law seemed to promise them. But these tests have no functional correlation with the need to make corporate owners pay.

A harder problem is to find a workable test of an adequate margin. The requirement of a fixed amount of capital, which prevailed in earlier corporation codes, was impractical because the magnitude of an adequate margin varies infinitely with the scope of business operations. A fixed ratio of equity to debt, which is used in California as a criterion of distributions to shareholders,¹⁰¹ is preferable but still too rigid, because the reasonable requirements of enterprises vary widely among industries. The ultimate standard should be what is reasonable under the circumstances, as indicated by the practices of other enterprises in the same industry and by the opinions of qualified experts.

The complexities of proof could be alleviated by establishing presumptions. We may assume that competitive forces will establish reasonable average ratios in each industry, and that ratios far below the average signal reckless finance. An enterprise whose ratio of equity to

⁹⁸ H. BALLANTINE, *LAW OF CORPORATIONS* 302-03 (rev. ed. 1946).

⁹⁹ See *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

¹⁰⁰ See generally *Berkey v. Third Ave. Ry.*, 244 N.Y. 84, 155 N.E. 58 (1926).

¹⁰¹ CAL. CORP. CODE. § 500 (West Supp. 1985). Briefly summarized, the rule prohibits distributions unless assets equal 125% of liabilities.

debts, or of insurance to gross revenues, is less than half of the average should be presumed to have an inadequate margin of safety. Average equities for most industries can be readily determined from statistics published by the Internal Revenue Service.¹⁰² If no average is available, the twenty-five percent margin that California requires for dividends would be a valid presumptive level.¹⁰³ Average levels of insurance coverage could be obtained from insurance companies and their industry associations. If a company started with adequate ratios and later fell below them, owners should be held liable for the obligations incurred after the ratios became inadequate.

The law should give precision not only to the occasions for liability, but also to the persons to be held liable. These should be the persons who exercise control. To hold all the investors liable as partners by simply "disregarding the corporate entity" is too simplistic; it would implicate innocent and ignorant investors while missing the executives who know the facts and make the decisions. The liable persons should be those who participate actively in control as executives, as controlling shareholders, or even as controlling creditors.

Regardless of the margin of safety, controlling persons should be disqualified from claiming a share of corporate assets as secured or unsecured creditors before other creditors are fully paid, unless the other creditors were made aware, when they acquired their claims, of the controlling persons' claims. This disqualification is essential to give controlling persons an incentive to contain their liabilities within their reasonable expectations of ability to pay.

The concept of "controlling persons" should be limited for this purpose, as for purposes of securities regulation,¹⁰⁴ to executives, investors, or others who give orders to corporate operatives. It should exclude nonexecutive directors and the investors who nominate them, unless these directors or their nominators give operating instructions to executives.

¹⁰² INTERNAL REVENUE SERVICE, SOURCE BOOK: STATISTICS OF INCOME: ACTIVE CORPORATION INCOME TAX RETURNS (1982) [hereafter SOURCE BOOK]. The reports show aggregate balance sheet items for more than 200 industry groups and subgroups. For metal manufacturing corporations, for example, equity items for 1982 were about 40% of total assets. *Id.* at 35. For banks, equity items were about 8% of total assets. *Id.* at 30.

¹⁰³ For all reporting corporations, the aggregate equity items amounted to about 30% of aggregate assets. *Id.* at 8.

¹⁰⁴ See *supra* text of part II.

D. *Multistate Registration*

A nationwide corporate registry should be established; the bar to suits by out-of-state corporations should be simultaneously abolished. In-state claimants would be helped in finding out-of-state corporate debtors, while out-of-state corporate creditors would be relieved of the burden of the admittance requirements. Incidentally, state tax collectors would be helped in finding taxable corporations.

The registry should contain information filed in each state by the corporations of that state. The listing would contain facts about products made or sold by the corporation and about locations of corporate facilities. It should also contain the company's statement of the proportions of sales made, wages paid, and property owned in each state. A copy of the registry — presumably in computer form — should be made available in every state. Through it, anyone who wants to make a claim against a corporation of any state could find its name and relevant facts about it without having to inquire of the corporation bureaus of fifty states.

The registry could be administered by an interstate agency, which would specify the content and the form of the data to be submitted by corporations. The federal government would need to participate only by collecting data on corporations of foreign countries that do business in the United States and on corporations of states that do not participate in the consortium that prepares the registry.

E. *Diversifying Objectives*

The law should recognize that business corporations may be legitimately operated for any of a wide variety of objectives.¹⁰⁶ It should not identify shareholder enrichment as the only permissible purpose of a business corporation. Survival of the firm may be a necessary prime objective, but when survival is secure, directors should be free in theory, as they are in practice, to exercise a wide discretion in favoring investors, employees, and consumers. The law should exclude only those purposes that conflict with imperative principles of law, or that favor directors, executives, and their associates at the expense of other constituencies.

In order to give substance to the diversity of purposes, corporation laws should allow charters to provide for election of directors by non-shareholder constituencies such as employees, creditors, and customers.

¹⁰⁶ An interesting formulation of corporate purposes is proposed by White, *supra* note 2, at 1424. White does not discuss legislators' receptivity to his formulation.

Investors would of course have to be fully informed of any deviation from the traditional model that limits voting to shareholders. Few organizers are likely to use such provisions in the near future, but openings for experimentation are as important in social organization as they are in technology.

III. JURIDICAL VEHICLES OF REFORM

The laws of corporations cannot be reformed merely by revising the statutes conventionally known as "corporation laws." The operative laws regulating corporate affairs are found in many other places, including judicial doctrine, securities laws, and bankruptcy laws. Effective reforms must be distributed at least as widely. This section offers observations on the roles of various juridical vehicles in effectuating the reforms that have been advocated in the preceding pages.

A. *The Role of State Legislation and Administration*

State laws should continue to be the principal repositories of corporate norms for large corporations as well as small, and state corporation bureaus should continue to be the repositories of corporate records. State laws need only be supplemented in a few key areas by a federal overlay, as they are now supplemented by the proxy and financial reporting requirements of federal securities laws. With this reinforcement of federal law, states would be emboldened to invigorate their own corporation laws without fearing the flight of corporations to other states.

1. Incorporation and Recordkeeping

States should retain the function of receiving and recording articles of incorporation, amendments, and annual reports. Corporate organizers should remain free to choose the state by whose law they will be governed in areas not controlled by the federal overlay. States already possess the facilities and the personnel for recordkeeping; these resources would be wasted if they were displaced by federal administration. A federal regime would not eliminate the need for coordination among different record-keeping centers, since records would probably be divided among regional centers, like the service centers of the Internal Revenue Service.

2. Multistate Registration

A multistate agency should compile a national registry of corporations out of data that each state would obtain from its own corpora-

tions. States should adopt a uniform law to ensure that all corporations file identical data. Federal law should encourage state participation in the national registry, but the registration could be most economically administered by the same state bureaus that now record companies' incorporations, amendments, and annual reports. The multistate registry should follow as models the Uniform Division of Income for Tax Purposes Act¹⁰⁶ and the organization for the multistate corporate tax bureau, the Multistate Tax Compact.¹⁰⁷

3. Governance of Localized Corporations

Regulation of internal governance, including the abuse of control and the carousel of directors' liability, requires a demarcation between local corporations within only one state's concern and corporations that are significantly multistate. New York and California have applied workable distinctions for years. These states apply some laws to "foreign" as well as "domestic" corporations that have a majority of their activities in the state.¹⁰⁸ The great majority of the nation's three million-odd corporations seem likely to fall within the localized category, although no statistics on localization are available.

With respect to multistate corporations, federal legislation should prescribe a few key norms of governance that would apply concurrently with state norms, so that investors could invoke federal norms whenever they found state norms insufficiently protective. But the federal law would not preempt states from enacting their own norms for corporations created under their own laws.

The federal government should not regulate localized corporations; states should be free to choose their own regimes of governance. When federal law imposes stricter requirements for multistate corporations, states will be likely to make matching reforms in their own laws because they will no longer fear that their localized corporations will flee

¹⁰⁶ 7A U.L.A. 331 (1985).

¹⁰⁷ PRENTICE-HALL, STATE AND LOCAL TAXES (All States Unit) ¶ 6310 *passim* (1985).

¹⁰⁸ In California, most of the basic sections of the Corporations Code apply to a corporation incorporated in any other state if the average of its California proportions of property, payroll, and sales is more than 50%, and the corporation's securities are not listed on a national stock exchange nor wholly owned by a corporation that falls outside these limits. CAL. CORP. CODE § 2115 (West Supp. 1985).

In New York, a more limited list of provisions applies to foreign corporations that derive one half or more of their business income from the state, and have no shares listed on a national securities exchange. N.Y. BUS. CORP. L. §§ 1317-20 (West Supp. 1986).

to less restrictive states. If a corporation moved just enough of its activities out of the state to destroy its localization, it would escape the state's regime only to fall under the federal.

States' freedom to choose their own norms for localized corporations cannot do much harm, and it may do some good. If states' choices are unwise, any harm to the national economy will be small because the aggregate volume of business done by localized corporations is a small fraction of the national economy. If the states' choices are wise, other states and the nation will learn from their success.

B. *A Federal Corporate Governance Act*

For several reasons, any reform that increases significantly the responsibilities of corporations and their managers must be initiated by federal legislation. The "race of laxity," as it was christened by Justice Brandeis,¹⁰⁹ may still be the most important reason, but it is not the only one. A second reason is the tendency of states to enact laws that reflect narrow conceptions of local interest, like the antitakeover acts, some of which have been invalidated by recent decisions.¹¹⁰ A third reason is the insolubility of the conflicts of laws that arise when states adopt divergent rules for interstate transactions. A fourth is the diversity in policy determinations and phrasing selections that are inevitable among fifty legislatures in a context so loaded with conflicting opinions as the affairs of corporations.

Although federal legislation must provide the impulsion for reform, it does not need to supply norms for all kinds of corporations, nor a complete set of norms for corporations of any kind. It can achieve some reforms by simply removing federal impediments to the operation of economic forces. It can achieve others by enacting norms that apply only when state norms are lacking. Finally, it should comprise a few imperative commands for those corporations that escape effective state regulation by distributing their activities among several states.

1. Extinguishing Federal Impediments

The most painless and basic step in revitalizing shareholder supervision of management is to remove the risks of liability and of political reprisal now threatening shareholders who participate actively in supervision. The risks of liability can be eliminated quite simply by

¹⁰⁹ *Liggett Co. v. Lee*, 288 U.S. 517, 558-59 (1933) (Brandeis, J., dissenting).

¹¹⁰ See *Edgar v. MITE Corp.*, 457 U.S. 624 (1982) (ruling negatively on an Illinois statute).

amending the language of the Securities Act, the Securities Exchange Act, and the Clayton Act to exclude their application to diversified investors.¹¹¹

The political threat should be resolved by a Congressional declaration that the exercise of responsible supervision is an objective of the regulation of securities, of investment companies and pension funds. Congress could achieve this by making simple additions to the purpose clauses of the relevant acts.¹¹²

If future experience discloses that institutional investors are still reluctant to exercise their shareholder rights, they should be relieved of some of the expenses involved in dissident proxy solicitation. Corporations could be required to reimburse the proxy solicitation expenses of groups of investors whose holdings aggregate twenty or thirty percent of the shares. Legislation might even require institutional investors to allocate a small fraction of fund income to the costs of determining policies of supervision and of combining with other institutional investors to elect directors. No proposals for legislation of this kind are advanced here because the need for them has not been shown. The possibilities are mentioned only to emphasize the variety of means of activating shareholders that should be explored before conceding the inevitability of unchecked managerialism.

2. A Federal Standard of Fairness

A major obstacle to clear thinking about standards of managerial integrity has been confusion between (a) elements of unfairness that

¹¹¹ The Securities Act and Securities Exchange Act could be modified by adding a definition of "control," which is now lacking, to comprise actual direction of policies, rather than merely election of directors who are permitted to exercise their own opinions. This would eliminate the danger of liability under Securities Act § 15 and Securities Exchange Act § 20, and of being obliged to register sales under Securities Act §§ 2(11), 4(1) and 5. Securities Exchange Act § 16 (b) could be amended to make clear that "directors" means the individuals who fill directorships, rather than the companies they work for, and that shareholdings should not be aggregated beyond holders that are themselves under common control. The Clayton Act should be restricted to directorships held by the same individual director.

¹¹² For example, the litany of objectives in the preamble of Exchange Act § 2 could be supplemented with a clause such as "effectuate the supervision of managers by individual and institutional investors"; this would provide justification for the original § 14, as well as expressing congressional support for active participation of institutional investors in governance.

In the Investment Company Act of 1940, the concluding clause of § 1 could be modified to add as a purpose, "to facilitate participation by institutional investors in corporate governance."

should lead to setting aside a transaction and (b) errors of judgment that should lead to individual liability of the directors who participated in the decision. The confusion was conspicuous in Tentative Draft No. 3 of the ALI Corporate Governance project, in which criteria of validity served simultaneously as criteria of individual liability.¹¹³ This confusion tends to paralyze judicial evaluation of transactions involving conflicts of interest. Judges are properly reluctant to hold multimillion dollar transactions voidable if their holding implies that the directors who approved it are liable for multimillion dollar damages. A federal corporate governance act should deal separately and very differently with the voidability of transactions and the liability of decisionmakers. In many instances a sale or purchase of assets or a modification of shareholders' rights should be set aside, but directors need not be held individually liable for their participation in the decision.

The criterion for setting aside a transaction in which directors have a conflicting interest should be whether, in the court's opinion, the same terms would have been likely to prevail in a transaction with complete outsiders. Judges should weigh the opinions of directors who are disinterested, along with the opinions of outside experts, and consider how far they may have been influenced by solidarity with the interested directors. If the directors have erred, the judges should correct their decisions.

The criterion of liability of disinterested directors should be quite different. In accordance with the established "business judgment rule," directors should be free of liability for damages when they have made decisions that other reasonable business people would be likely to make under similar circumstances.

3. A Federal Rule on Diversity of Objectives

Although the exclusivity of the goal of shareholder enrichment should be repudiated, a legislative declaration of policy is not a good way to achieve the result. Any attempt to legislate on the subject would produce fruitless debates on economic philosophy.

A more feasible objective of legislation is to confirm the liberty of directors to choose, without judicial intervention, among shareholder enrichment, employee welfare, consumer advantage, and other socially desirable goals, so long as shareholders receive rates of return on in-

¹¹³ T.D. 3, *supra* note 7. In § 5.08 (c), the remedies of rescission and damages are made available under exactly the same conditions. Moreover, the requirements of disclosure and votes by disinterested directors are stated as "duties" of the senior executives and directors, rather than as a condition of the validity of transactions.

vested capital comparable to others in the same industry. The self-interest of executives and powers of shareholders can be counted on to restrain excessive orgies of altruism.

4. A Federal Rule on Liability of Directors

A very different set of considerations apply to liability of officers and directors. First, a distinction should be drawn between directors' liability for benefits they or their associates receive and their liability for errors in approving other detrimental transactions. Benefits that officers, directors, and their associates receive from unfair transactions should be restored to their corporations without regard to the reasonableness of their errors. Errors that result in no benefits to directors or their associates should be governed by the classic business judgment rule. But the measure of liability should be radically changed. For nonexecutive directors, it should be reduced to zero or, at most, to the amount of each director's annual compensation. For executives, courts should be authorized to fix the liability at an amount that is not measured by the corporation's loss, but designed to admonish other executives without driving the best candidates away from directorships.

The liabilities that remain after this pruning should be inescapable; federal law should prohibit indemnification and insurance of payments made in settlement of claims of liability. Indemnification and insurance for the expenses of a successful defense should continue to be allowed in order to make directorships attractive.

5. Jurisdiction of Disputes

Jurisdiction to decide disputes arising under the Federal Corporate Governance Act should be granted concurrently to state and federal courts; the jurisdiction of federal courts could be given a high monetary threshold in order to avoid unduly congesting the federal system. But federal courts should not be wholly spared from deciding these disputes, as Cary suggested.¹¹⁴ Federal judges can contribute uniquely to standards of corporate conduct because of their greater experience with the complicated financial transactions that arise out of securities, bankruptcy, and income tax disputes. Moreover, the smaller number of appellate courts in the federal system will accelerate the development of a coherent body of interpretation. Through creating a national case law of corporate governance, federal courts would contribute to justice no

¹¹⁴ Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 704-05 (1974).

less than through their rulings on other federal legislation.

6. Administration

A federal governance act will probably serve its purposes better if interpreted solely by courts and enforced solely by private actions than if administered by a government agency. Since the act would affect the rights of investors who have already committed their funds, it would not call for the complicated array of preventive disclosure that permeates the securities acts and justifies much of the administrative activity under those laws. The volume of rules and interpretations that the Securities and Exchange Commission can crank out¹¹⁵ would be more likely to impede than to promote compliance by the army of middle-sized corporations to which the proposed act would apply.

7. Statutory Setting

Two possibilities for the statutory setting of the Federal Corporate Governance Act merit consideration. The most cognate context in existing federal law consists of the provisions on proxies and financial reporting that are found in the Securities Exchange Act of 1934 and have been aptly called "federal corporation law."¹¹⁶ Framing the governance act as an amendment of the Exchange Act would enhance its attractiveness by making it seem an extension of established policies, rather than a heavy addition to the mass of federal legislation.

But equally cogent reasons justify separating the proposed Federal Corporate Governance Act from the Exchange Act. The Exchange Act is already overloaded; some of its "federal corporation law" provisions (especially the proxy rules and the ownership reporting rules) fit oddly with the regulation of brokers and dealers, which occupies most of the Act's volume. Moreover, the proposed coverage of the corporate governance act is radically different from that of the Exchange Act. The latter is concerned chiefly with about seven thousand companies whose securities are publicly traded, while the proposed governance act would cover a very much larger population, possibly some hundreds of thousands of corporations that are not localized within a single state.

¹¹⁵ In a decade in which "deregulation" was the slogan of both Democratic and Republican administrations, the pages of the Code of Federal Regulations devoted to securities grew from 566 to 1078 — an increase of about 90%. *Compare* 17 C.F.R. of Jan. 1, 1972 *with* the same title of Apr. 1, 1984.

¹¹⁶ See Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965).

The Exchange Act is administered by a Commission that has embroidered the commands of the Act with elaborate interpretations and "safe-harbor rules" even in areas that it has no statutory authority to regulate;¹¹⁷ the governance act should consist of standards that can be known without studying an unending series of agency releases. Consequently, the Federal Corporate Governance Act would operate more efficiently as a separate statute than as part of the Exchange Act.

C. *An Addition to the Bankruptcy Act*

The logical site for a law enforcing the financial responsibility of corporations is the federal Bankruptcy Act. This act already contains remedies for self-dealing transactions by which corporate owners pay themselves dividends when the corporation's assets are inadequate, or repay debts to themselves before repaying others.¹¹⁸ It also contains provisions for subordinating the debt claims of controlling persons.¹¹⁹ Liability of owners for incurring debts without having an adequate margin of safety would fit well in the same context.

Attaching the liability of owners to the Bankruptcy Act would also have administrative advantages. A trustee in bankruptcy could represent all the creditors at once. A uniform policy would prevail throughout the United States. Problems of choosing the applicable law in multistate transactions would disappear.

While adding some vigor to the enforcement of the liability of controlling persons, the bankruptcy connection would also protect controlling persons from premature assertions of liability. The primary debtor would first have to be adjudicated a bankrupt before the liability of the controlling persons could be asserted.

As a part of the Bankruptcy Act, the provision on controlling persons' liability would normally apply to corporations of all dimensions, whether localized or multistate. This is appropriate for the same reasons that led the founding fathers in 1787 to authorize Congress to enact "uniform laws on the subjects of bankruptcies."

¹¹⁷ See Conard, *Securities Regulation in the Burger Court*, 56 U. COLO. L. REV. 193, 222-23 (1985).

¹¹⁸ Bankruptcy Reform Act of 1978, 92 Stat. 2549, §§ 548(a)(2)(B)(ii) (fraudulent conveyances), 547 (preferences), 11 U.S.C. §§ 548(a)(2)(B)(ii), 547 (1984).

¹¹⁹ *Id.* § 510(c), 11 U.S.C. § 510(c) (1979).

D. A Federal Act to Simplify Multistate Corporate Litigation

Suits by and against out-of-state corporations should be facilitated and relieved of archaic encumbrances by a federal statute containing three main features. First, the Act should promote the creation of a national registry of corporations, so that complainants could discover corporations' identities and the means of suing them. Second, it should specify means of serving process on out-of-state corporations that are reasonably convenient for both parties. Third, the Act should prohibit states from barring suits by out-of-state corporations on the ground of nonadmittance. The registry and the process rules would provide means of suing out-of-state corporations that would be more comprehensive and more fair than those provided by the cumbrous admittance procedures. The prohibition on barring unadmitted corporations would facilitate the enforcement of obligations and relieve the courts of a volume of unproductive litigation. The Act would be helpful not only to private suitors, but also to state tax collectors.

1. Coverage

The coverage of the Multistate Corporate Litigation Act would differ radically from that of the Federal Corporate Governance Act. First, it would apply to corporations of all dimensions, however localized. All should have access to courts, and all should be suable on local causes of action. Second, it would be designed primarily to bring about changes in procedural law, rather than to impinge directly on corporate behavior.

2. The National Registry

The registration section should authorize states to organize a national registry of corporations by forming a multistate consortium that would collate data filed by corporations in each of their home states. The data would include the names of corporations, their lines of business, and the addresses of offices at which they can be served with process. The Act should require filing in a federal office only by those corporations whose home states do not participate in the coordinated multistate registry. States would be induced to join the consortium in order to spare their corporations from the nuisance and expense of federal registration.

Administration of the Act should be entrusted to the Department of Commerce so that it could be coordinated with the statistical activities of the Bureau of the Census. The Department would be authorized to

determine whether each state's participation in the multistate national registry is sufficient to exempt its corporations from federal registration.

3. Service of Process on Out-of-State Corporations

The Act's provisions on service of process would authorize service upon a properly registered corporation only at an office designated for that purpose in or outside the state of the forum. If no such office is designated, service upon the secretary of state would suffice.

4. Extinguishing the Nonadmittance Defense

With these provisions in force, the exclusion of unadmitted out-of-state corporations from in-state courts would lose not only its original justification, but all of the other improvised rationalizations that have been advanced for it. In the interest of interstate commerce and of relieving courts from dilatory defenses, the barring of unadmitted corporations should be prohibited by federal law.

IV. POLITICAL REALITIES

The reforms proposed in these pages are designed to benefit nearly every sector of society by increasing the efficiency of the engines — the business corporations — that produce most of the goods, careers, and living conditions that people enjoy or endure. The only classes that would be *prima facie* losers are (1) corporate executives — who would lose some of their autonomy, (2) lawyers — who would lose fees for litigation and defensive tactics, and (3) insurance underwriters — who would lose profits on officers' and directors' liability policies.

On a deeper analysis, most executives would gain more than they would lose. If those executives who launch ambitious takeover campaigns were more effectively restrained by directors representing investors, executives who are minding their business would be safer from attack. If target executives were restrained by their directors from paying greenmail, the incentive for purely predatory raids would be undercut. If the excessive rewards collected by a few executives were restrained, most executives would benefit from more favorable public perceptions of corporate management.

The adoption of these or of other fundamental reforms will be delayed not so much by the threats that they entail as by inertia. When major reforms in the laws of corporations have come about, it is usually because corporate executives and their lawyers fear something worse.

In West Germany, reforms have come about as a means of forestalling the demands of Communists. In England, Tory governments have enacted reforms in order to fend off Labour demands for nationalization of major enterprises. In the United States, the revisions of corporation law contained in the Securities Acts of 1933 and 1934 were produced by the collapse of financial markets following the stock market debacle of 1929. At that time, the financial industry was ready to submit to a regulatory regime in order to regain the confidence of the investing public.

Since 1934, the greatest showing of interest in corporate reform was precipitated by the protest movements of the Vietnam era, reflected in Nader's *Taming the Giant Corporation*¹²⁰ and in congressional proposals for a federal corporation act.¹²¹ The momentum carried over into the ALI-ABA conferences on *Corporate Structure and Governance*¹²² and the ALI project on the same subject. But the sense of urgency was gone, and the ALI dawdled with proposals that would let courts revise the wisdom of disinterested directors only if the directors neglected rituals of disclosure and consideration.¹²³

Reform will come about only when a major wave of dissatisfaction with the performance of United States business prepares executives to accept reform in lieu of something worse. In 1984, there was a flurry of proposals to restrain the self-serving conduct of controlling persons in takeover targets.¹²⁴ If Senators and Representatives are wary enough to pass up the temptation for a band-aid fix, concern about tender-offer abuses could lead to a significant reaffirmance of judicial control over abuses of control. If not, reform will await deeper future crises.

The principal utility of reform proposals like those contained in this Article is to provide an agenda from which items may be used by legislators and judges in future years when opportunities for progress arise.

¹²⁰ R. NADER, M. GREEN & J. SELIGMAN, *supra* note 3.

¹²¹ See S. 2567, 96th Cong., 2d Sess. (1980), entitled "Protection of Shareholders' Rights Act of 1980"; H.R. 7010, 96th Cong., 2d Sess. (1980), entitled "Corporate Democracy Act of 1980"; H.R. 7481, 94th Cong., 1st Sess. (1975) (establishing a Federal Corporate Chartering Commission).

¹²² See COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE, *supra* note 3.

¹²³ See T.D. 1, *supra* note 7, § 7.03 (1983); T.D. 3, *supra* note 7, § 5.08.

¹²⁴ S. 2782, S. 2779, S. 2784 and H.R. 5972, all 98th Cong., 2d Sess., 1984.

CONCLUSION

Corporations, like individuals, suffer diseases that impair their efficiency as contributors to the welfare and prosperity of the population. These diseases thrive in part because of deficiencies in the laws that govern corporations. This is no wonder, since many features of corporation law have survived unchanged from the middle of the nineteenth century, when the future role of business corporations in the twentieth century could hardly have been imagined either by legislators or by judges. Some of the laws designed to combat these diseases have led to exaggerated applications that in turn have caused other ills.

The laws that need to be changed are not found merely, or even primarily, in the codes that bear names like "business corporations act." They include parts of the federal securities laws, principles of tort and insurance law (mostly judge-made), and the federal Bankruptcy Act. The revisions require a new conception of what business corporations do and what they are.

Although the prospects of substantial reform are remote, thinking about fundamental reformation is not entirely futile. Law could be incrementally changed in many ways. Judges have opportunities to qualify or even to repudiate outworn doctrines. Bits and pieces of legislation can at least move in the right direction.

Substantial reform will require federal legislation; the states are impotent to act separately. But reform does not require federal incorporation, nor a general replacement of state by federal corporation law. A relatively small number of federal commands could bring about substantial changes in the conduct of corporate affairs without destroying the existing system of state incorporation, recordkeeping, and procedural regulation. Improvements in the laws of corporations can contribute significantly to the productivity — both economic and social — of business enterprise.