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The End of Corporate Law

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INTRODUCTION

Corporations are powerful entities, capable of harming the environment and modern society more broadly. Yet, as I argue in this Article, during the twentieth century the legal community has made corporate law, specifically the rules applicable to the allocation of power among directors, executives, and shareholders, ineffective as a means of regulating corporate power.[1] Put more bluntly, I argue that in the course of the past century corporate law has been used first to legitimate corporate power and then to exempt those exercising it from liability. Making corporations responsible for harmful conduct thus requires, first and foremost, putting an end to corporate law.[2]

The first part of this Article focuses on the early-twentieth century concerns about the growth of the publicly held corporation and the Progressives' response to it. I argue that reformers' dominant frame of reference during this era was the increasing power of the large public corporation. Amidst debates about the possibilities of effective federal or state regulation, corporate law scholars focused on the power that the control group (typically controlling shareholders and investment bankers) could exercise to manipulate stock prices and market transactions. Seeking to

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1. The Article does not examine the role of other corporate constituencies (for example, workers) because they remain outside the realm of state corporate law.

2. While the second part of this Article examines the shareholder proposal rule, enacted under the Securities Act of 1934, this Article does not make any claims with respect to the general effectiveness of securities regulation.

legitimate the public corporation and its power while eliminating such abuses by the control group, scholars turned their attention to corporate directors. After tinkering with ideas such as corporate self-government and shareholder organization, they settled on fiduciary duties as a means of taming corporate power. They put concerns about corporate power to rest by vesting corporate directors with public power and public trust (to be enforced by the courts). This understanding underlay many early New Deal programs.

As I argue in the second part of this Article, after the programs of the New Deal were put in place and the Great Depression wore down, concerns about corporate power indeed dissipated. Instead, reformers focused their attention on corporate internal hierarchies. As share ownership became more widely dispersed and professional management replaced bankers and controlling shareholders as the control group, corporate law scholars and reformers focused upon the relationship between management and individual shareholders. For one thing, in the early 1940s, the Securities and Exchange Commission ("SEC") adopted Rule 14a-8 to give shareholders the participatory role state law effectively denied them in managing the affairs of their corporations. It required the board to include certain shareholder proposals in its annual proxy solicitation. By protecting the rights of individual shareholders to participate in their corporation's annual meetings, the New Deal reformers and their successors hoped not only to constrain corporate management but also to legitimate its power to run the corporation. More broadly, they hoped to legitimate a democratic regime founded on professional management of collective property. Court cases embracing the description of directors as Platonic masters substantiated this idea in ways that, ironically, eclipsed any notion of shareholder participation.

Beginning in the 1960s, the focal point for analysis shifted to the market. As I explain in the third part of this Article, mainstream legal scholars and economists came to believe that the market was the most effective institution to constrain corporate activities. In addition to the fears of corporate power, which faded after influencing the early-twentieth century debates, the concerns about corporate hierarchies that dominated the mid-century discussions disappeared. Just as insider professional management became more powerful and the board of directors became ever less involved in managing the affairs of the corporation, scholars described directors as the (private) agents of the shareholders and emphasized the ability of individual shareholders freely to elect them (albeit in a corporate world dominated by institutional investors). Endorsing a strong separation between the roles of public shareholders and those in control, proponents of this vision argued that dissatisfied shareholders should use their voting power or sell their stock. The directors (and executives) were seen as the shareholders' agents but left to act with no constraints or liabilities.

I. POWER

The turn of the twentieth century witnessed a dramatic growth in the scale of private business organizations. Increasing consumer demand, rising numbers of skilled and unskilled workers, and an expanding pool of capital made the creation of large enterprises possible, while corporate lawyers created a variety of legal devices to help their clients increase the scope of their operations. Trusts, holding companies, and mergers became common, even if often contested in state courts.[3] The nineteenth-century corporation, which was subject to strict constraints on its powers and limitations on its capital structure, was replaced by larger and larger units. Between 1888 and 1893, New Jersey revised its general incorporation statute to eliminate restrictions on "capitalization and assets, mergers and consolidations, the issuance of voting stock, the purpose(s) of incorporation, and the duration and locale of business."[4] Other states followed suit, enacting more enabling incorporation statutes (including Delaware, which by the second decade of the twentieth century would become the revolution's leader).[5] And corporations were quick to use the powers that these enabling statutes granted them.[6]

The concentration of power in the trusts and large business corporations undermined nineteenth-century democratic ideals. Progressives feared that corporations were wearing away the function of the individual producer and, with it, nineteenth-century democratic and economic ideals. These ideals were the power of markets equally to "distribute the rewards of individual industry" and to help "conform individual liberty" to socially beneficial ends.[7] For some scholars, individual ownership of property and participation in the market economy were a means of cultivating social and political citizenship. They saw in the corporation's collective ownership a threat to the idea of "ordinary 'producers'" who "shape their world on equal footing."[8] For others, private

3. *See* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870–1960: THE CRISIS OF LEGAL ORTHODOXY 80–90 (1992) (examining these transformations).

4. SCOTT R. BOWMAN, THE MODERN CORPORATION AND AMERICAN POLITICAL THOUGHT: LAW, POWER, AND IDEOLOGY 60 (1996); *see also* ROLAND MARCHAND, CREATING THE CORPORATE SOUL: THE RISE OF PUBLIC RELATIONS AND CORPORATE IMAGERY IN AMERICAN BIG BUSINESS 7 (1998) (noting the proliferation of corporate mergers between 1895 and 1904).

5. *See, e.g.*, BOWMAN, *supra* note 4, at 60.

6. Melvin I. Urofsky, *Proposed Federal Incorporation in the Progressive Era*, 26 AM. J. LEGAL HIST. 160, 161 (1982).

7. L.S. Zacharias, *Repaving the Brandeis Way: The Decline of Developmental Property*, 82 NW. U. L. REV. 596, 618 (1988).

8. *Id.* at 619.

property was a means of constraining the exercise of public power. They saw in the concentration of power in a few corporations a threat to individual autonomy.[9]

Seeking to sustain the nineteenth-century ideals of civic engagement in the twentieth-century organizational society and to add organization, stability, and reason to what seemed to be the chaotic nature of industrial capitalism, Progressives focused their attention on the growing trusts. Some reformers viewed large business units (and an economy of scale) as inevitable and sought to subject them to national control. Others emphasized the need to control business units locally in order to encourage civic participation and constrain corporate power. While endorsing two presumably opposing positions—centralization and decentralization of power, respectively—Progressive reformers seemed to converge on mandatory disclosure as the ultimate means of regulating corporate power.[10]

The ideal of disclosure immensely influenced President Franklin Roosevelt's approach to federal regulation. While his advisers urged Roosevelt to create a federal body with powers to plan, stimulate, and stabilize economic activity, or even to consider a federal incorporation act, Roosevelt believed that when bankers' activities were exposed to public scrutiny, self-interest would be curbed.[11] Accordingly, the Securities Acts of 1933 and 1934 were not predicated upon the need for government planning but on the ideal of consumerism. They rested on the assumption that as long as individual shareholders were fully informed about the product, they would be able to make intelligent decisions about their securities purchases. Moreover, proponents of both Acts believed that as long as individual shareholders had access to internal corporate information, they would help free the market from fraud and manipulation.[12] The government could ensure "full and fair disclosure of the nature of the security being offered" but could not

9. *Id.* For a detailed analysis of these concerns and their impact on Progressive thought, see LAWRENCE E. MITCHELL, THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY 90–112 (2007).

10. Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503. 1516–19 (2006). On the positions of centralization and decentralization, see MICHAEL J. SANDEL, DEMOCRACY'S DISCONTENT: AMERICA IN SEARCH OF A PUBLIC PHILOSOPHY 211–21 (1996). On Progressive ideology more broadly, see, for example, RICHARD H. PELLS, RADICAL VISIONS AND AMERICAN DREAMS: CULTURE AND SOCIAL THOUGHT IN THE DEPRESSION YEARS (1998).

11. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 40–42 (1982). On the renewed interest in federal incorporation during the early New Deal, see generally Philip A. Loomis, Jr. & Beverly K. Rubman, *Corporate Governance in Historical Perspective*, 8 HOFSTRA L. REV. 141 (1980).

12. SELIGMAN, *supra* note 11, at 39–63.

"pass upon the investment quality of the security."[13]

Despite their limited scope, the business community did not welcome the 1933 and 1934 Acts. Of particular concern were the 1933 Act's liability clauses, which imposed civil liability on corporations and their officers for fraud and for misstatements in the registration statement, and the 1934 Act's limitations on the exchanges' powers.[14] Those advocating broader corporate reform were also not satisfied. In an article published several months after the 1933 Act was passed, Adolf A. Berle, Jr. cautioned that, while the Act sought to eliminate financial fraud, it did not resolve the crucial "problem of power arising from financial control exercised by investment bankers."[15]

Recognizing the limits of the new federal securities regulation, Progressive corporate law scholars like Berle wanted to use corporate law to constrain the power of the control group (investment bankers and controlling shareholders). These scholars described corporations as sovereign (or semi-sovereign) entities, accepted them as such, and aimed to rein in those who controlled them by arguing that corporate power should be exercised to benefit the community at large. *The Modern Corporation and Private Property*, which Berle coauthored with Gardiner C. Means, best articulated this argument.[16] While in the collective imagination of corporate law scholars the book is remembered for its exegesis of the separation of ownership from control in large public corporations, Berle and Means's interests focused on corporate power.

Berle and Means wrote that the separation of ownership from control allowed tremendous buildups of power and that, given corporations' economic power, it was meaningless to assume that corporations were private associations or that the state was the only center of coercive (public) power.[17] Corporate power, they explained, was "comparable to the concentration of religious power in the mediaeval church or of political power in the national state."[18] The modern corporation's political and economic powers were equivalent to the powers of the state.[19]

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13. *Id.* at 63 (quoting James Landis's recollection of the drafting of the Securities Act of 1933).

14. RALPH F. DE BEDTS, THE NEW DEAL'S SEC: THE FORMATIVE YEARS 49-50 (1964).

15. *Id. at* 51 (citing A.A. Berle, Jr., *High Finance: Master or Servant*, 23 YALE REV. 20, 40–42 (1933)).

16. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 352–57 (1932).

17. *Id.* at 352–53.

18. *Id.* at 352.

19. For a detailed description of Berle and Means's ideas, see Dalia Tsuk, *Corporations without Labor: The Politics of Progressive Corporate Law*, 151 U. PENN. L. REV. 1861 (2003) [hereinafter Tsuk, *Corporations without Labor*]; Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought*, 30 LAW & SOC. INQUIRY 179 (2005)

Having called attention to corporate power, as augmented by the separation of ownership from control, Berle and Means rejected the traditional common law rules of property and contract as means of restraining corporate power. They argued that the application of strict property rules to passive ownership would require the control group to exercise corporate power for the benefit of the shareholder and put "the bulk of American industry" in the service of "inactive and irresponsible security owners."[20] In turn, strict contractual rules would have vested the control group with uncurbed power. Instead, Berle and Means proclaimed that "by surrendering control and responsibility over the active property," shareholders had released the community from the obligation fully to protect their property rights and cleared the way for placing "the community in a position to demand that the modern corporation serve not [only] the owners or the control [group] but all society."[21] Corporate power was power in trust for the community.

Because they feared potential abuses of corporate power, Berle and Means rejected the idea of freeing corporations to act as if they were mere aggregates of individuals or natural entities distinct from their individual members.[22] Because they celebrated the contributions of corporate power to modern industrial society, Berle and Means also feared that an overuse of government regulation could eliminate the potential benefits of corporate power. They rejected both the early-twentieth century idea of self-governing associations and the alternative of allowing the state to regulate all corporate activities. Instead, Berle and Means wanted to subject large economic organizations to limits associated with checks on government power, specifically the requirement that corporations act to benefit the community.[23]

While the Securities Acts focused mostly on disclosure as a

[hereinafter Tsuk, *From Pluralism to Individualism*]. For a different interpretation of Berle's and his contemporaries' ideas, see William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99 (2008).

20. BERLE & MEANS, *supra* note 16, at 354.

21. *Id.* at 354–56.

22. On the natural entity theory and other visions of the corporation, see HORWITZ, *supra* note 3, at 100–05; Gregory A. Mark, Comment, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441 (1987); Mark M. Hager, *Bodies Politic: The Progressive History of Organizational "Real Entity" Theory*, 50 U. PITT. L. REV. 575 (1989); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201; Tsuk, *Corporations Without Labor*, *supra* note 19, at 1870–75.

23. Tsuk, *From Pluralism to Individualism*, *supra* note 19, at 195–96. Berle, Means, and their colleagues also believed that the courts could enforce these trust obligations. But the idea of imposing a unified conception of social trusteeship on directors (and corporations) became less feasible after the U.S. Supreme Court decision in *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938) put an end to the idea of federal common law. *Id.* at 204.

solution to the problems of corporate America, Berle and Means's conception of the corporation substantiated the early New Deal efforts to bring relief and recovery through government planning and coordination.[24] As Louis Jaffe put it, the different New Deal programs were grounded in the realization that "the most significant and powerful components of the social structure [were] economic groups, competing and complementary in varying degrees."[25] These programs' goal, as Means described it, was not to "make the market effective as a coordinator," which would have required "revers[ing] the trend of a century and break[ing] the large units into a multitude of smaller enterprises."[26] Rather, the thrust of the early New Deal was to keep the large units and increase "the element of administrative coordination of economic activity rather than its elimination."[27]

Still, as far as state corporate law goes, the idea that corporate power was power in trust for the community was insufficient as a regulatory tool, a fact that did not escape its main proponents. Fearing that such an abstraction could even help legitimate abuses of corporate power, Berle tried to make the idea of trusteeship concrete. In *Corporate Powers as Powers in Trust*, an article he published in 1931, "[d]uring the penultimate stage of *The Modern Corporation*'s creation,"[28] Berle assigned corporate directors the task of guaranteeing the appropriate exercise of corporate power.[29] Ironically, viewing directors as trustees helped ameliorate concerns about corporate power and thus legitimate it.

Berle's *Corporate Powers as Powers in Trust* was an argument designed to eliminate the potential for managerial abuse of its market powers. Berle wanted to protect those who were not in control of the corporate machinery from fraud and manipulative practices that were extremely harmful toward minority shareholders and that, in the early twentieth century, plagued the securities markets.[30] To that end, Berle surveyed corporate law

24. Joseph L. Weiner, *The New Deal and the Corporation*, 19 U. CHI. L. REV. 724, 724–25 (1952).

25. Louis L. Jaffe, *Law Making by Private Groups*, 51 HARV. L. REV. 201, 201 (1937).

26. Gardiner C. Means, *The Distribution of Control and Responsibility in a Modern Economy*, 50 POL. SCI. Q. 59, 63 (1935).

27. *Id.*

28. JORDAN A. SCHWARZ, LIBERAL: ADOLF A. BERLE AND THE VISION OF AN AMERICAN ERA 64 (1987).

29. *See* Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

30. At the turn of the twentieth century, investment bankers became promoters and directors of corporations and were able, through their economic power and the use of legal devices such as voting trusts and non-voting stock, to control even those boards on which they did not sit. As Berle wrote in 1926, because management stock would likely be controlled by the investment banking house that served as a promoter for the corporation, "it [was] possible,

doctrine with respect to a variety of managerial powers. He concluded, descriptively as well as normatively, that new stock issuance was allowed only when "the ratable interest of existing and prospective shareholders" was protected,[31] that dividends distribution had to benefit all shareholders,[32] that acquisition of stock in other corporations could not be used "to forward the enterprises of the managers as individuals or to subserve special interests within or without the corporation,"[33] that charter amendments had "to benefit the corporation as a whole, and . . . distribute equitably the benefit or the sacrifice . . . between all groups in the corporation as their interests may appear,"[34] and that the interests of all classes of shares had to be "respectively recognized and substantially protected" in merger and acquisition transactions.[35] To ensure that these goals were fulfilled, Berle wanted to make the powers to issue stock, to declare or withhold dividends, to acquire stock in other corporations, to amend the corporation's charter, and "to transfer the corporate enterprise to another enterprise by merger, exchange of stock, sale of assets or otherwise"[36]—each power previously considered a matter of contract law[37]—a matter of directors' trusteeship duties.

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if not probable, that there [would] be attractive opportunities for manipulation of securities, for negotiating favorable contracts with allied interests, or even for giving value to stock which represent[ed] no real investment." Adolf A. Berle, Jr., *Non-Voting Stock and "Bankers' Control*,*"* 39 HARV. L. REV. 673, 676 (1926). Given the "web of economic interests" which the investment banking house served and from which it made its profits, it was likely that management stock would be voted for transactions that benefited the investment banking house, or even the controlling groups, but not the controlled corporation. *Id.* William O. Douglas, sharing Berle's views, labeled the interests of investment banking houses "high finance," charging that they were "interested solely in the immediate profit." William O. Douglas, *The Forces of Disorder*, Address at the University of Chicago (Oct. 27, 1936) with additions from addresses at the Economic Club of Chicago (Feb. 1, 1938) and the Bond Club of New York (Mar. 24, 1937), *in* DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS 9 (James Allen ed., 1940). According to Douglas, the interests of high finance were different from those of small individual shareholders or even the corporation, but with the power of control, high finance was able to profit by siphoning money from other investors. *Id.* On the role of investment banking in the early decades of the twentieth century, see LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT 1–27 (1914); Gardiner C. Means, *The Separation of Ownership and Control in American Industry*, 46 Q. J. ECON. 68, 72–74 (1932); Miguel Cantillo Simon, *The Rise and Fall of Bank Control in the United States: 1890–1939*, 88 AM. ECON. REV. 1077 (1998).

31. Berle, *supra* note 29, at 1050. *See generally id.* at 1050–60.

32. *Id*. at 1060–63.

33. *Id*. at 1063. *See generally id.* at 1063–66.

34. *Id*. at 1066. *See generally id.* at 1066–69.

35. *Id*. at 1069. *See generally id.* at 1069–72.

36. *Id*. at 1069.

37. Rudolph E. Uhlman, *The Legal Status of Corporate Directors*, 19 B.U. L. REV. 12, 18 (1939).

For contemporary scholars, describing corporate directors as trustees for the shareholders, as Berle did in *Corporate Powers as Powers in Trust*, seems to be in direct contradiction to describing them as trustees for the community, as Berle and Means suggested in *The Modern Corporation and Private Property*. For Berle the two positions were complementary. In a follow-up article, he explained that those in control did not see themselves as fiduciaries.[38] Any weakening of their obligations toward the shareholders would thus make their power absolute. As Berle pointedly put it, "you can not abandon emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else."[39]

Berle's *Corporate Powers as Powers in Trust* was one of the first attempts to define a role for the board as distinguished from managers. Berle wanted the board to mediate the conflicting interests of those in control of the enterprise and the individual shareholders subject to their powers. A few years later, William O. Douglas offered a similar and more elaborate discussion of the function of the board.[40]

Douglas's *Directors Who Do Not Direct* was published in 1934, shortly after the enactment of the Securities Acts and three years before Douglas was to become Chairman of the SEC.[41] It began by reiterating the "many different abuses and malpractices" of the 1920s:

> secret loans to officers and directors, undisclosed profit-sharing plans, timely contracts unduly favorable to affiliated interests, dividend policies based on false estimates, manipulations of credit resources and capital structures to the detriment of minority interests, poor operations, and trading in securities of the company by virtue of inside information, to mention only a few.[42]

As Douglas saw it, all of these abuses indicated that businessmen had lost sight of their public role.[43]

Douglas believed that the newly enacted Securities Acts offered some protection to shareholders by requiring accurate disclosure in

38. Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note,* 45 HARV. L. REV. 1365, 1367 (1932).

39. *Id.*

40. *Cf.* Lawrence E. Mitchell, *The Trouble with Boards*, *in* THE NEW CORPORATE GOVERNANCE (Troy A. Paredes ed., forthcoming 2009) (examining the development of the modern monitoring board), *available at* http://ssrn.com/abstract=801308.

41. William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

42. *Id.* at 1306.

43. *Id.*

the proxy solicitation process but he did not think such disclosure was sufficient.[44] Seeking to encourage "the development of a social mindedness . . . among business men and their legal advisers,"[45] Douglas's attention focused on corporate law. He wanted to make the board independent of management. While Berle's analysis focused on the power of the control group to manipulate the market, Douglas's main concern was management's control of the board, which, he believed, was at the root of the problems of the 1920s.[46]

According to Douglas, the purpose of the board of directors was to protect shareholders from management.[47] To achieve this goal, directors had to be independent of management—they could not be "called in by the managers," drawn from the managers, or be subordinate to the managers in any way.[48] In fact, Douglas believed that the independent directors should be elected from among the shareholders.[49] Furthermore, the independent directors were to have a role distinct from the executives' role. While the executives were to manage the corporation, the independent board of directors was assigned the task of setting the corporation's policies and agenda and monitoring the executives lest they abuse their managerial power to benefit themselves or the control group.[50] As Douglas put it, independent directors, "[t]he representatives of the stockholders[,] would be there, not for the purpose of managing the enterprise, but with the object of supervising those who do and of formulating the general commercial and financial policies under which the business is to be conducted."[51]

In an address delivered five years after the publication of *Directors Who Do Not Direct*, Douglas went even further, suggesting that outside, independent directors should be "paid for their work in proportion to the actual contributions made by them."[52] Pay, he suggested, would go a long way toward the creation of a professional director.[53] It would allow outside, independent directors to protect the interests of the small stockholder as well as the community. "Since the beginning of corporate history—and particularly since corporations began to turn to the public for their funds," Douglas explained, "it has been recognized that the interests of the stockholders could not be adequately served by management alone. . . . The check of a board of vigilant, well-informed directors

44. *Id.* at 1323–25.
45. *Id.* at 1307.
46. Mitchell, *supra* note 40, at 17.
47. Douglas, *supra* note 41, at 1307.
48. *Id.* at 1313.
49. *Id.* at 1314–15.
50. *Id.* at 1314.
51. *Id.*
52. William O. Douglas, *Corporation Directors*, Address at Fort Worth, Tex. (Jan. 8, 1939), *in* DEMOCRACY AND FINANCE, *supra* note 30, at 47.
53. *Id.* at 52–53.

is needed to assure that management is always loyal, honest, and prudent."[54]

Lest he be misunderstood, Douglas emphasized that corporate powers were powers in trust. As he put it, "directors are trustees by virtue of business ethics as well as law; and . . . the powers which they exercise are powers in trust."[55] "[T]he paid director," he similarly pointed out in 1939, "would revive and strengthen the tradition of trusteeship. . . . In a larger sense, he would not be so much a paid director or a professional director as a *public* director, representing not only the present but the potential stockholder, and representing the general public as well."[56]

In short, while Douglas's focus was not corporate power but corporate internal hierarchies, he, like Berle, saw no contradiction between the directors' role as trustees for the community and their role as the shareholders' representatives. Douglas and Berle wanted to constrain those in control, whether investment bankers, minority owners, or management. Demanding corporations to act as trustees for the community and directors to represent the interests of the shareholders were thus complementary requirements.[57]

Berle's and Douglas's arguments did not stimulate a continuing scholarly debate about the role of the board of directors, but they helped alleviate concerns about corporate power. By the late 1930s, many believed that the policies of the New Deal sufficiently circumscribed the corporation's powers. The Securities Acts regulated the corporation's dealings with its shareholders as well as its creditors, new federal labor laws regulated the corporation's relations with its employees, and antitrust laws affected the corporation's behavior toward consumers and suppliers.[58] Even as corporations continued to gain tremendous power, concerns about the corporation's external powers rapidly dissipated. Instead, and seemingly following Berle's and Douglas's discussions of the relationship among directors, managers, and shareholders, scholars turned their attention to corporate internal hierarchies. Amidst fears about the possibility that European totalitarianism would

54. *Id.* at 50.

55. Douglas, *supra* note 41, at 1322.

56. Douglas, *supra* note 52, at 53.

57. Indeed, Douglas wanted to see the development of a professional managerial class, "skilled in the technique of business, the art of law, and the skill of government," that could monitor corporations so as to align the interests of the shareholders with the interests of the public—"so that the profit motive will be articulated with the public good" and investors guaranteed "more protection against the malpractices of management." Douglas, *supra* note 41, at 1328.

58. Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1688 (1988); *see also* E. Merrick Dodd, Jr., *The Modern Corporation, Private Property, and Recent Federal Legislation*, 54 HARV. L. REV. 917 (1941) (discussing the impact of the New Deal legislation on the relationship between management and security holders).

reach American shores, reformers turned corporations into bearers of the American democratic ideal. The SEC engaged in an overhaul of the proxy rules, presumably to give shareholders a more active voice in managing the affairs of their corporations, while legal scholars focused on the board's control of the proxy machinery and its fiduciary duties. Using democracy as a foundational concept, they ended up empowering the executives to run the corporation without constraints from either the directors or the shareholders. As the second part of this Article elaborates, just as the idea that corporate power was power in trust helped legitimate the large public corporation, the ideal of corporate democracy became an apology for executive power.

II. HIERARCHIES

The business community's relationship with the SEC is a good litmus test of the legitimacy of the public corporation and its power. The main actors in the SEC during the early 1930s believed that its role was to promote capitalism.[59] They thought government planning was required to guarantee the financial stability that was necessary to sustain capitalism. They presumed that the SEC would both "encourage rational organization within private groups and between private groups in order to achieve that stability," and eliminate those market practices that threatened it.[60] In short, the SEC "was both policeman and promoter; a vehicle for reform and a shield against more violent change."[61]

As already noted, the business community was initially troubled by the liability clauses of the 1933 Act.[62] But by the early 1940s it, too, came to believe that "the law, effectively enforced, assisted financial operations by policing marginal elements within the industry and by promoting minimum standards of disclosure."[63] Gradually, it became apparent that the SEC was not against corporations "or the profit motive."[64] In fact, it seemed that the commissioners and staff members saw "the SEC as an extension of business enterprise."[65] Corporate power was not (or no longer) their concern.

It was in this atmosphere that scholarly attention turned to the corporation's internal structure. In a world committed to the protection of business, scholars focused on the role of the individual

59. MICHAEL E. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 179 (1970).

60. *Id.* at 180.

61. *Id.*

62. DE BEDTS, *supra* note 14, at 50; *see also* discussion *supra* text accompanying notes 14–15.

63. PARRISH, *supra* note 59, at 229.

64. *Id.* at 231.

65. *Id.*

shareholder in the large public corporation and the duties that directors owed to her.[66] In the early 1940s such interest led the SEC's Office of General Counsel to undertake a study of the proxy regulations.[67] In 1942, following this study, the SEC suggested a number of changes, including the shareholder proposal rule.[68] Requiring the board of directors to include certain proposals from shareholders in its annual proxy solicitation, the rule was meant to encourage shareholder participation in corporate affairs (or shareholder democracy). As Milton Freeman, the draftsman of the rule, explained a decade later, the SEC envisioned as the principal beneficiary of the rule the small shareholder who treated her investment as a long-term investment.[69] SEC Chairman Ganson Purcell and his colleagues wanted to protect the individual shareholder against the corporation's management.[70] The directors, viewed as the shareholders' representatives (or fiduciaries), were entrusted with the task of mediating potential conflicts between management and shareholders.[71]

Business groups were opposed to the shareholder proposal rule and any other form of "further legitimizing shareholder activism."[72] In various disparaging comments about the knowledge, intentions, and ability of small shareholders, business groups proclaimed that the rule would "allow 'crack-pots' to make virtually meaningless

66. This shift in scholarly attention was substantiated in part by the assumption that the number of individual shareholders was rapidly growing. In 1934, the House Report on the Securities Exchange bill estimated that more than ten million individuals owned stocks or bonds, and that "over one fifth of all the corporate stock outstanding in the country [was] held by individuals with net incomes of less than $5,000 [$79,369.03 in 2009 dollars] a year." H.R. REP. NO. 73-1383, at 3–4 (1934). In addition, the House Report noted that more than fifteen million individuals held insurance policies, more than thirteen million had "savings accounts in mutual savings banks," and at least twenty-five million had "deposits in national and State banks and trust companies—which [were] in turn large holders of corporate stocks and bonds." *Id.* Whether or not these estimates were accurate, they supported reformers' growing interest in the role that individual shareholders could play in their corporations.

67. Philip A. Nicholas, Jr., The Securities and Exchange Commission and the Shareholder Proposal Rule: Agency Administration, Corporate Influence, and Shareholder Power, 1942–1988, at 111 (2002) (unpublished Ph.D. dissertation, State University of New York at Albany) (on file with author).

68. *Id.* at 111–12.

69. Milton V. Freeman, *An Estimate of the Practical Consequences of the Shareholder's Proposal Rule*, 34 U. DET. L.J. 549, 552 (1957).

70. *Securit[ies] and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the H. Comm. on Interstate and Foreign Commerce*, 78th Cong. 183 (1943) [hereinafter *Hearings*] (statement of Ganson Purcell, Chairman, Securities and Exchange Commission).

71. For a detailed discussion of the SEC's promulgation of Rule 14a-8, see Tsuk Mitchell, *supra* note 10, at 1547–53.

72. Nicholas, *supra* note 67, at 129.

statements";[73] that it "would put 'dangerous weapons in the hands of the professional troublemaker'";[74] that it "would open the door wide to libelous, malicious, scurrilous, or abusive matter supplied by notoriety-seeking persons who need buy only a single share of stock for the purpose";[75] and that it would increase the length of the proxy statement, burden corporations with increased cost (at a time of war), and burden shareholders with too much information.[76] Some went as far as to argue that "shareholder participation was not really necessary at all."[77]

Those businesses and business groups who were willing to support the rule wanted to limit the scope of shareholder participation. They suggested imposing restrictions that would permit only shareholders who owned a certain amount of stock to include their proposals and limit the number of proposals that any shareholder could submit.[78] They further suggested that shareholder proposals be limited to "proper subjects for shareholder action under state law, and not address the ordinary business activities under the purview of management."[79] The final rule, reflecting the New Dealers' own ambivalence about shareholder democracy, endorsed the suggested limitation. It required management to include shareholder proposals in its proxy solicitation only when these proposals were "proper subjects for action by the security holders."[80]

While the SEC was willing to limit the application of the rule, it was not willing to omit it. Proclaiming that it did not see how shareholder proposals would burden corporations (even in times of war), the SEC included the rule in its December 1942 release.[81] Chairman Purcell and his team were keen on expanding the rights of shareholders, especially the small individual shareholder or, as they described her, the owner. Purcell explained that:

> The rules are based on the fact that stockholders are the owners of their corporations and the stockholders' meetings are their meetings, and not the management's meetings. Anybody who approaches a stockholder and asks him for his proxy, must recognize that he is asking the stockholder to appoint him as the stockholder's agent. He should give the stockholder accurate information and must recognize his

73. *Id.*
74. *Id.*
75. *Hearings*, *supra* note 70, at 159.
76. Nicholas, *supra* note 67, at 128–30.
77. *Id.* at 130.
78. *Id.* at 129.
79. *Id.*
80. *Id.*
81. *Id.* at 128–32.

rights as the owner of the corporation.[82]

There was little public pressure to enact the rule, but the SEC staff persisted. Their interest in shareholder democracy mirrored what Morton Horwitz has labeled "the emergence of democracy as a basic concept in American constitutional law" during the early 1940s.[83] Horwitz traces this phenomenon to the personal and professional impact that the barbarities of totalitarianism in Europe had on American social scientists. Having devoted the early decades of the twentieth century to challenging absolutist theories in law, politics, and morals, these social scientists were left to wonder why America had been spared the ravages of European dictatorship. Political and legal theorists beginning in the late 1930s thus struggled to explain the contrast between democratic and non-democratic societies. As Horwitz notes, "This new obsession with democratic theory was designed to show how America had managed to avoid succumbing to European totalitarianism."[84] Whether deliberately or not, the SEC staff found a role for American corporations in this new collective narrative.[85]

The New Dealers wanted to recreate the traditional annual meeting, reminiscent of the democratic town meeting. They wanted to create a solid corporate foundation for the ideal of American democracy. Interestingly, when members of Congress raised questions about shareholder proposals supporting communism during the hearings concerning the rules, Purcell made clear that such proposals were outside the scope of the rule.[86] Frank Emerson and Franklin Latcham, avid 1950s advocates of shareholder democracy, beautifully captured the New Dealers' aspirations when they wrote:

> [S]hareholder democracy holds promise of rekindling on a broader basis the spirit of individual inquiry and free discussion through use of the SEC provisions for security holder

82. *Hearings*, *supra* note 70, at 183.

83. Morton Horwitz & Orlando do Campo, *When and How the Supreme Court Found Democracy—A Computer Study*, 14 QUINNIPIAC L. REV. 1, 28 (1994).

84. *Id.* On the emergence of democracy as a fundamental constitutional principle during the war years, see also EDWARD A. PURCELL, JR., THE CRISIS OF DEMOCRATIC THEORY: SCIENTIFIC NATURALISM & THE PROBLEM OF VALUE (1973); Morton J. Horwitz, *The Supreme Court, 1992 Term—Foreword: The Constitution of Change: Legal Fundamentality without Fundamentalism*, 107 HARV. L. REV. 30, 58–65 (1993).

85. For a judicial endorsement of the relationship between corporations and American democracy, see A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 586 (N.J. 1953) (noting the contributions of corporations to the national welfare and success during World War I, the Depression, and World War II, and stressing that corporations could help sustain American democracy during the Cold War by making contributions to academic institutions).

86. *Hearings*, *supra* note 70, at 163.

> communication and proposals for corporate action. This, too, is salut[a]ry in that it affords a haven for human growth in an awesome atomic age.[87]

The shareholder proposal rule became effective January 15, 1943.[88] In 1945, after recounting the mid-1920s attempts to empower shareholders, a commentator noted that with the enactment of the shareholder proposal rule, shareholder organization, while still theoretical, had become at least possible.[89]

Still, as much as the New Dealers wanted to enact the shareholder proposal rule, their ideal of shareholder democracy was also meant to substantiate the absolute power of management to run the corporation.[90] Subsequent developments brought that aspect to the fore. Beginning shortly after its adoption and continuing well into the 1980s, the shareholder proposal rule, especially the definition of proper subjects and the qualifications of the submitting shareholders, underwent cycles of interpretation and amendments by the SEC and the courts. These changes corresponded to, and helped shape, changing visions of the relationship among shareholders, executives, and directors in the large public corporation. Ultimately they destroyed any possibility of effective shareholder participation.

The first set of changes, adopted in 1947, simply formalized the role of the SEC's Division of Corporation Finance in reviewing shareholder proposals that corporations wanted to omit from their proxy statements.[91] A year later the SEC made additional changes, allowing corporations to omit proposals addressing proper subjects in three situations. First, corporations could omit proposals that were submitted primarily to enforce a personal claim or redress a personal grievance against the company or its management. Second, they could omit proposals if management had included a proposal from the security holder in a proxy solicitation related to the last two annual meetings and the security holder failed to attend the meeting or to present the proposal for action at the meeting. Finally, corporations could omit proposals if substantially the same proposal had been voted on at the last meeting and received less

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87. FRANK D. EMERSON & FRANKLIN C. LATCHAM, SHAREHOLDER DEMOCRACY: A BROADER OUTLOOK FOR CORPORATIONS 9–10 (1954).

88. George D. Hornstein, *A New Forum for Stockholders*, 45 COLUM. L. REV. 35, 48 (1945).

89. *Id.* On the shareholder proposal rule, see generally Daniel E. Lazaroff, *Promoting Corporate Democracy and Social Responsibility: The Need to Reform the Federal Proxy Rules on Shareholder Proposals*, 50 RUTGERS L. REV. 33 (1997).

90. Tsuk Mitchell, *supra* note 10, at 1512–13.

91. EMERSON & LATCHAM, *supra* note 87, at 94. Before these amendments were adopted, the Third Circuit established the SEC's authority to determine which shareholder proposals were "proper subjects." SEC v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947).

than three percent of the vote.[92] In 1952, the SEC went further, codifying its own practice of excluding from the scope of permissible shareholder proposals those "designed primarily to promote general economic, political, racial, religious, social or similar causes."[93] Two years later, the SEC excluded proposals referring to ordinary business from the appropriate scope of shareholders action.[94] Corporations could omit both those proposals having to do with too general (economic, political, racial, religious, social) a matter and those dealing with too narrow an issue, that is, ordinary business.[95]

The 1954 amendments left little of the original shareholder proposal rule. The only power that shareholders still had, other than selling their stock, was the typically impractical power to launch a proxy contest. Emerson went as far as to suggest that the 1954 amendments encouraged proxy contests.[96] (Proxy fights were so common in the 1950s, albeit typically unsuccessful, that an article in *Barron's National Business and Financial Weekly* proclaimed 1954 as "the year of battle by proxy."[97]) Instead of seeking to foster communication and cooperation between individual shareholders and managers, the 1954 amendments helped pave the way for a new vision of corporate democracy. Reflecting, in part, the growing dominance of institutional investors, this vision was predicated upon the individual shareholder's ability to self-protect by diversifying her portfolio. The idea that shareholders were merely investors, as distinguished from participants, prevailed.[98] By the 1990s, this market-centered vision would dominate corporate law. As I elaborate below, it was substantiated by developments in state corporate law which solidified the directors' role in supervising their corporations' affairs (and that of the executives in managing them).

The role and status of the board of directors have always been a contested issue. In the nineteenth century directors were described as both agents and trustees.[99] Yet courts and commentators agreed that while the directors' role was similar to that of agents and

92. EMERSON & LATCHAM, *supra* note 87, at 94–95. On these amendments, see also John G. Ledes, *A Review of* Proper Subject *Under the Proxy Rules*, 34 U. DET. L.J. 520, 522–23 (1957); Nicholas, *supra* note 67, at 170–73.

93. EMERSON & LATCHAM, *supra* note 87, at 96.

94. *Id.*

95. Med. Comm. for Human Rights v. SEC, 432 F.2d 659, 678–79 (D.C. Cir. 1970).

96. Frank D. Emerson, *Some Sociological and Legal Aspects of Institutional and Individual Participation Under the SEC's Shareholder Proposal Rule*, 34 U. DET. L.J. 528, 547 (1957).

97. John C. Perham, *Revolt of the Stockholder: Proxy Fights Are Breaking Out Everywhere These Days*, BARRON'S NAT'L BUS. & FIN. WKLY., Apr. 26, 1954, at 3.

98. On these two visions of the shareholders in the history of American corporate law, see Tsuk Mitchell, *supra* note 10.

99. Seymour D. Thompson, *Liability of Directors of Corporations*, 6 S. L. REV. 386, 387 (1880).

trustees, these labels were not entirely accurate when applied to directors.[100] In the early decades of the twentieth century, as my discussion above indicates, Progressive corporate law scholars converged on viewing corporate power as power in trust and directors as trustees for the corporation and the community.[101] But the trusteeship idea was never fully endorsed by the courts. Instead, courts preferred to view the directors' role as analogous to the position of elected officials in a representative democracy. Accordingly, "[s]tockholders are supposed to elect directors who are responsible for the general conduct of the enterprise," while "[t]he directors' task is to choose managers whose business is to execute the general policies laid down by the directors to whom they are primarily responsible for the general conduct of the enterprise."[102]

The idea that corporate democracy was a representative democracy became prominent beginning in the mid-1930s. By the early 1940s, as more shareholders attempted to use the derivative suit to challenge directors' actions and perhaps also as a backlash against the ideal of shareholder democracy, courts (with New York courts at the helm) drew on the ideal of representative democracy to limit the shareholders' ability to challenge directors' actions.[103] Their tool was an exemption from liability for honest mistakes, that is, mistakes that even a prudent person might make, from which directors benefited throughout the nineteenth century.[104]

100. Marcia M. McMurray, Note, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605, 605–06 & nn.3–4 (1987).

101. For a detailed discussion of these developments, see Dalia Tsuk Mitchell, *Status Bound: The Twentieth-Century Evolution of Directors' Liability*, 5 N.Y.U. J.L. & BUS. 63, 81–102 (2009).

102. Thomas F. Woodlock, *Careless Owners: How Shall the Supreme Inertia of the American Stockholder Be Overcome*, WALL ST. J., Apr. 22, 1931, at 1.

103. On the history of derivative suits (specifically in New York), see Lawrence E. Mitchell, *Gentleman's Agreement: The Antisemitic Origins of Restrictions on Stockholder Litigation* (George Washington Univ. Law Sch. Pub. Law & Legal Theory Research Paper Series, Paper No. 44, 2002), *available at* http://ssrn.com/abstract=321680.

104. Perhaps the earliest articulation of this exemption was found in *Percy v. Millaudon*, 8 MART. (n.s.) 68, 77–78 (La. 1829) ("[T]he adoption of a course from which loss ensues cannot make the [director] responsible, if the error was one into which a prudent man might have fallen. . . . The test of responsibility therefore should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by sh[o]wing that the error of the [director] is of so gross a kind, that a man of common sense, and ordinary attention, would not have fallen into it."). *See also* Godbold v. Branch Bank at Mobile, 11 Ala. 191, 199 (1847) (explaining that directors do not "undertake, that they possess such a perfect knowledge of the matters and subjects which may come under their cognizance, that they cannot err, or be mistaken, either in the wisdom or legality of the means employed by them"); Hodges v. New Eng. Screw Co., 3 R.I. 9, 18 (1853) (opining that "a Board of Directors acting in good faith and with reasonable care and diligence, who nevertheless fall into a mistake, either as to law or fact, are not liable for the consequences of such mistake"); S. Samuel

Expanding the scope of this exemption to encompass any and all directors' mistakes, courts created the modern business judgment rule as a rule of deference to directors' expert opinion. Directors were regarded as "a kind of group of Platonic guardians whose right to rule was a legislative mandate."[105] Shareholders were banned from giving "orders to the directors, or act[ing] for the corporation, unless by unanimous vote or agreement,"[106] and, for the most part, prevented from challenging directors' decisions that harmed the corporation.[107]

Specifically, in the absence of fraud, conflict of interest, or bad faith, courts refrained from evaluating directors' actions in matters entrusted to their discretion even when the directors' errors were gross. Take as one example *Everett v. Phillips,* a suit by a minority shareholder of Empire Power Corporation to compel directors sitting both on its board and on the board of Long Island Lighting Company to demand payment of indebtedness from the lighting company to the power company.[108] In determining that the directors did not violate their trust to the power company or its shareholders, the Court of Appeals of New York noted that not merely innocent (or honest) mistakes but also gross mistakes were protected from ex-post intervention by the courts.[109] As Chief Judge Lehman put it:

> [H]owever high may be the standard of fidelity to duty which the court may exact, errors of judgment by directors do not alone suffice to demonstrate lack of fidelity. That is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs.[110]

In the end, exemptions to directors' liability encroached upon the standard of care applicable to their actions.[111] As the following

Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 100 (1979) (noting that "the principal genesis of the business judgment rule [was] human fallibility").

105. Robert A. Kessler, *The Statutory Requirement of a Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696, 697 (1960).

106. *Id.* at 700.

107. For a detailed examination of the emergence of the modern business judgment rule, see Tsuk Mitchell, *supra* note 101, at 113–23.

108. Everett v. Phillips, 43 N.E.2d 18, 19 (N.Y. 1942).

109. *Id.* at 19–20.

110. *Id.* While *Everett* involved a duty of loyalty claim, the statement quoted above also applied to duty of care situations. *Id.*; *see also* Rous v. Carlisle, 26 N.Y.S.2d 197, 200 (App. Div. 1941) ("If a director exercises his business judgment in good faith on the information before him, he may not be called to account through the judicial process, even though he may have erred in his judgment. It is necessary, therefore, for the stockholder to allege facts showing more than error in business judgment.").

111. While my argument in this Article focuses on the duty of care, it is important to note that, at the same time, courts also substituted a concept of fairness for traditional notions of trust as the foundation of the duty of loyalty.

part explores, in the second half of the twentieth century, concerns about corporate power and hierarchies dissipated as new ideology came to dominate corporate law. Resting on the assumption that the corporation was a nexus of private, contractual relationships, this new ideology cleared the way for presumably egalitarian economic markets to become the relevant focal point for corporate law doctrine.[112] Directors and executives were not only empowered to manage the corporation without interference from the shareholders (or the community), they were also shielded from liability.

III. LEGITIMACY

One of the striking characteristics of early-twentieth century writings about corporate law was the absence of theoretical economics. Progressive thought was informed by a managerialist economic theory that justified "widespread, state-enforced wealth distribution and intervention in the market."[113] In turn, the mainstream of economic thought beginning in the 1910s was "increasingly skeptical, indifferent and eventually hostile toward concepts of social value—or to any concept of value that could not be defined strictly in terms of individual preference,"[114] and thus "increasingly strict and pessimistic about the science of measuring welfare."[115] The result was a sharp separation of law and economics in American thought from the 1930s through the 1960s. Mainstream economists developed "the neoclassical theory of competition" while legal scholars continued to rely on regulatory agencies to allocate resources.[116]

By the 1970s, however, neoclassical economists shifted their attention from markets to theorizing about the corporation's internal structures. Their new theory of the firm offered a picture of the corporation that fit the market-centered economic policies of the postwar years. Rather than putting management hierarchies and

Trust required directors and executives to work in their corporation's best interests and prohibited them from considering their interests while dealing with matters within the scope of their fiduciary obligations. In turn, fairness, a concept of balance and proportionality, allowed directors and managers to take their own interests into account in their examination of self-dealing transactions. Within a few decades, the courts' fairness test became fixated on process rather than substance. By the end of the twentieth century, the circumstances in which a fiduciary could be found to violate this fairness standard were relatively few. *See* Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425 (1993).

112. William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 416–20 (1989).

113. Herbert Hovenkamp, *Knowledge About Welfare: Legal Realism and the Separation of Law and Economics*, 84 MINN. L. REV. 805, 810 (2000).

114. *Id.* at 836.

115. *Id.* at 810.

116. *Id.* at 811.

the need to constrain corporate power at the center of the corporate paradigm, the new economic theory of the firm found a way around hierarchy and regulation by drawing on microeconomics to describe corporate entities as nexuses of private, contractual relationships and to paint a new picture of the firm and economic markets in which "hierarchy is irrelevant."[117] The corporation was merely a collection of "disaggregated . . . transactions" among individuals (or between them and the fictive entity, "as a matter of convenience").[118]

The new theory of the firm supported a shift of focus in scholarly debates from questions of power, influence, sanctions, and legitimacy to issues of cost reduction and profit maximization.[119] Its proponents reframed the problems of corporate power and hierarchies as the problem of the separation of ownership from control (or agency costs) and sought to demonstrate how capital markets could eliminate the concerns about efficiency associated with this separation.[120] The individual shareholder's ability freely to act in economic markets (that is, to sell her stock), supplemented only by her right to elect her directors, now described as her agents, was the cornerstone of their theory of corporate governance. Power and hierarchy disappeared, and the individual shareholder gained the ability to self-protect, mostly by selling her interest in the corporation. The market eclipsed both shareholder participation and fiduciary obligations as a means of taming corporate power or the control group.

For one thing, in 1983, the SEC changed the rule allowing omission of proposals that were not significantly related to the issuer's business.[121] It defined "not significantly related" as accounting for "less than 5 percent of the issuer's total assets . . . and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year."[122] In fact, the SEC was so obsessed with economic markets that in the course of preparing the amendments it went as far as to challenge the necessity of "a federal regulatory scheme protecting shareholder[] proposals."[123]

117. Bratton, *supra* note 112, at 417.

118. *Id.* at 416–20.

119. William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1498 (1989).

120. Tsuk, *From Pluralism to Individualism*, *supra* note 19, at 212–15.

121. Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 34-20091, 48 Fed. Reg. 38,218 (Aug. 23, 1983) (codified at 17 C.F.R. pt. 240).

122. *Id.* at 38,223.

123. Virginia J. Harnisch, Comment, *Rule 14a-8 After Reagan: Does It Protect Social Responsibility Shareholder Proposals?*, 6 J.L. & POL. 415, 433–34 (1990). The 1983 amendments also required a proponent of a shareholder proposal to own "at least one percent or $1,000, whichever is less, of securities eligible to be voted at the meeting." Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 115 (1988). The proponent had to "have owned those securities for at least one year prior to

No longer concerned about the role of the individual shareholder and her ability to influence her corporation's policies (including social policy), the SEC seemed to have embraced the idea that shareholders would prefer to sell their stock than to participate in corporate affairs. The vision of the shareholder as fixated on corporate profits, specifically short-term profits, became its motto.[124]

The structure of ownership in most large corporations substantiated this vision. By the 1980s, most U.S. firms had large shareholders, typically institutional investors or the initial owners (and their families).[125] Many scholars came to accept that the individual shareholder would remain rationally apathetic and passive[126] but trusted these large shareholders to take a more active role in monitoring corporate management. Institutional investors seemed more prone to communicate with managers, engage in proxy contests (or threaten them),[127] and submit shareholder proposals.[128]

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the meeting, and continue to own them through the day on which the meeting is held." *Id.* Moreover, the new amendments restricted all shareholders "to one 14a-8 proposal per meeting." *Id.* Finally, the new amendments made it sufficiently more difficult for the shareholder to gain access to the proxy machine by changing the "voting percentages for resubmission [of proposals] from three percent to five percent for the first resubmission, and from six to eight percent for the second." Harnisch*, supra*, at 439.

124. In the year following the 1983 amendments, "[f]orty-two percent fewer proposals were recorded." Harnisch*, supra* note 123, at 440. The numbers rebounded by 1987. Nicholas, *supra* note 67, at 387–88. Yet while social purpose proposals (addressing plant closing, environmental protection, apartheid, or employment discrimination) continued to be submitted, corporate governance issues captured the attention of shareholders, especially institutional investors. For analyses of trends in shareholder proposals, see Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 883–84 (1994); Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, Vanderbilt Law & Econ. Research Paper No. 05-30, *available at* http://ssrn.com/abstract=868652; Tsuk Mitchell, *supra* note 10, at 1569–73.

125. Gerald F. Davis & Tracy A. Thompson, *A Social Movement Perspective on Corporate Control*, 39 ADMIN. SCI. Q. 141, 154 (1994); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986). Shleifer and Vishny note that in "a sample of 456 of the Fortune 500 firms, 354 have at least one shareholder owning at least 5 percent of the firm. . . . The average holding of the largest shareholder among the 456 firms is 15.4 percent." *Id.* at 462. They further note that a large number of these shareholders are "families represented on boards of directors (149 cases) . . . pension and profit-sharing plans (90 cases) . . . financial firms such as banks, insurance companies, or investment funds (117 cases) . . . [and] firms and family holding companies with large stakes who do not have board seats (100 cases)." *Id.*

126. *See* J.A.C. Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 184–86 (1979).

127. *See generally* David A. Butz, *How Do Large Minority Shareholders Wield Control?*, 15 MANAGERIAL & DECISION ECON. 291 (1994).

128. *See, e.g.*, Anat R. Admati, Paul Pfleiderer & Joseph Zechner, *Large*

Although such expectations were not fulfilled—most institutional investors turned out to be less interested in spending money and effort on monitoring management[129]—institutional investors such as public pension funds and labor organizations helped shift the focus of debates from social issues to corporate governance, specifically management's anti-takeover tactics or compensation packages.[130]

In such an atmosphere, corporate democracy became strictly representative democracy; the rhetoric of shareholder democracy was rapidly associated not with shareholder participation but with the investors' twin rights of voice and exit.[131] But, as I conclude below, in the last decades of the twentieth century, the Delaware courts did their best to render even this limited set of rights ineffective, to solidify management's absolute power, and to shield it from liability.

First, as to the shareholders' right to exit, the Delaware courts refused to legitimate the market for control as a means of constraining directors and executives. In *Unocal Corp. v. Mesa Petroleum Co.*, the seminal takeover case, the Delaware Supreme Court drew upon the board's "fundamental duty and obligation to protect the corporate enterprise" to create the power of the board to adopt defensive tactics that would thwart hostile takeovers (and the market for control).[132] Shareholders' exit rights, in short, were

Shareholder Activism, Risk Sharing, and Financial Market Equilibrium, 102 J. POL. ECON. 1097, 1097–98 (1994) (arguing that institutional investors had become more active). *But see* John M. Bizjak & Christopher J. Marquette, *Are Shareholder Proposals All Bark and No Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills*, 33 J. FIN. & QUANTITATIVE ANALYSIS 499, 500 (1998) (concluding that, contrary to other studies of shareholder activism, their findings did not suggest that individual shareholder proposals received less support than proposals submitted by institutional investors).

129. *See, e.g.*, Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 629–30 (2006) (noting that although institutional investors could have had an active role in corporate governance, by the late 1990s most did not make efforts to monitor management, conduct proxy solicitations, put forward shareholder proposals, seek to elect representatives on the boards, or coordinate their activities).

130. Nicholas, *supra* note 67, at 429, 456. The most recent campaign to allow shareholders to nominate directors via company proxy materials, including a proposed rule by the SEC (Facilitating Shareholder Director Nominations, Securities Act Release No. 9046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765, 74 Fed. Reg. 29024 (proposed June 10, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274)), illustrates the prevalence of corporate governance issues as the focus of shareholder proposals, and shareholder democracy more broadly, at the turn of the twenty first century.

131. On the relevance of exit and voice to organizations and political governments, see generally ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINES IN FIRMS, ORGANIZATIONS, AND STATES (1970).

132. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985). The court enumerated several provisions of the Delaware General Corporations Law as sources for the board's power, but none of these provisions was explicitly

hollow.

The right to vote did not fare better. While the Delaware courts stressed that directors could not impede the shareholders' vote, the shareholders' right to vote remained what it had been throughout the twentieth century—"a vestige or ritual of little practical importance."[133] Chancellor Allen's decision in *Blasius Industries, Inc. v. Atlas Corp.* illustrates this point. *Blasius* involved a conflict between Atlas's board and Atlas's largest shareholder, Blasius. In an attempt to prevent or at least delay Blasius from placing a majority of new directors on the board, Atlas's board increased its size by two and filled the newly created directorships.[134] Allen began by stressing that corporate law "does not create Platonic masters."[135] Rather, the shareholders, as principals, could view issues differently than did the board, and "[i]f they do, or did, they are entitled to employ the mechanisms provided by the corporation law and the . . . certificate of incorporation" to promote their views.[136] Moreover, the shareholders were entitled "to restrain their agents, the board, from acting for the principal purpose of thwarting that action."[137]

One would be mistaken to assume, however, that Allen (or the Delaware courts) fully embraced the idea that directors were agents of the shareholders. If such were the case, directors would not be able to act without the explicit or, at least, implied consent of their principals. But, while Allen would not allow directors to affect the shareholders' ability to elect their agents, he was fully content to permit directors to prevent shareholders from selling their stock to a hostile bidder.[138] Indeed, the issue was one of legitimacy. Allen used agency theory to legitimate the status of directors as, ironically, Platonic masters. As he put it, "The shareholder franchise is the ideological underpinning upon which the legitimacy

meant to address takeovers.

133. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

134. *Id.* at 652–53.

135. *Id.* at 663.

136. *Id.*

137. *Id.*

138. See, for example, Allen's decision in *Paramount Communications, Inc. v. Time, Inc.*, Nos. 10866, 10670, 10935, 1989 Del. Ch. LEXIS 77, at *89–90 (July 14, 1989) ("The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm. . . . That many, presumably most, shareholders would prefer the board to do otherwise than it has done does not, in the circumstances of a challenge to this type of transaction, in my opinion, afford a basis to interfere with the effectuation of the board's business judgment."). *See also* Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV. 999, 1011–14 (1999) (noting the apparent inconsistencies between the Delaware courts' disempowerment of shareholders in the hostile takeover cases and their approach in cases such as *Blasius*).

of directorial power rests."[139] No longer a means of shareholder participation (or empowerment), shareholders' voting rights became a means of legitimating management's exercise of power. As Allen noted, "whether the vote [was] seen functionally as an unimportant formalism, or as an important tool of discipline, it . . . legitimate[d] the exercise of power by some (directors and officers) over vast aggregations of property that they [did] not own."[140]

The Delaware courts did more than solidify and legitimate management's power. They also shielded directors and executives from liability. First, embracing the growing numbers of independent directors serving on boards (independence narrowly defined as lack of control or domination by an individual interested in the transaction),[141] the Delaware courts declared that if a majority of independent, disinterested directors approved the board's actions (including conflict of interest transactions and adoption of anti-takeover tactics), such actions would be shielded from further judicial inquiry.[142] Second, the Delaware courts collapsed the duty of care into the business judgment rule and proclaimed that to invoke the rule's protection, directors had a duty merely to inform themselves prior to making a business decision of all material information reasonably available to them.[143] Without

139. *Blasius*, 564 A.2d at 659.

140. *Id*.

141. Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988). For an insightful analysis of "independence" under Delaware law, see Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447 (2008). *See also* Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351 (1989) (advocating a director's separate duty of independence).

142. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (noting that when directors adopt a defensive tactic, their ability to fulfill their *Unocal* duties is "materially enhanced . . . where . . . a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards"); Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173, 176 n.3 (Del. 1986) (noting that "certain presumptions . . . generally attach to the decisions of a board whose majority consists of truly outside independent directors"); Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1990) (noting that the evidence supporting the conclusion that in making its decision the Time's board was not uninformed "is materially enhanced by the fact that twelve of Time's sixteen board members were outside independent directors."). On the liability shielding power of independent directors, see Mitchell, *supra* note 40, at 57–60; Tsuk Mitchell, *supra* note 101, at 138–40.

143. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 640–42 (2000). According to the traditional formulation of the business judgment rule, directors were presumed to act "in good faith, in the exercise of their best judgment, and for what they believed to be the advantage of the corporation and all its stockholders." Bodell v. Gen. Gas & Elec. Corp., 140 A. 264, 268 (Del. 1927). As Johnson argues, *Aronson* changed the rule into a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in

precedent to support its holding, the Delaware Supreme Court further announced that "under the business judgment rule director liability is predicated upon concepts of gross negligence."[144] Unless a plaintiff arguing a breach of the duty of care demonstrated that the directors were grossly negligent (that is, grossly negligent with respect to the requirement to be informed), the directors would have the presumption of the business judgment rule and the court would not second-guess their actions.[145] In short, as long as directors, insiders and outsiders alike, followed the scripts that the Delaware courts had provided them throughout the 1980s, the Delaware courts would not reevaluate their decisions. If up to the 1980s directors might have been held liable for breaches of their fiduciary obligations (although they seldom were),[146] by the end of the decade such possibility was nonexistent. In corporate law at the turn of the twenty-first century, managerial power is absolute power.

EPILOGUE

In re The Walt Disney Co. Derivative Litigation offered the Delaware courts a unique opportunity to reevaluate the twentieth-century legitimization of corporate power and erosion of directors' duties and liabilities.[147] The question in the case was whether Disney's board of directors breached their duties by hiring Michael Ovitz as president and firing him fourteen months later with a severance package of roughly $130 million.[148] Early in the litigation, the court dismissed the duty of loyalty claims. At the same time, Disney's charter exempted directors from liability for breaches of the

good faith and in the honest belief that the action taken was in the best interests of the company." Johnson, *supra*, at 640.

144. *Aronson*, 473 A.2d at 812; *see also* Johnson, *supra* note 143, at 643 n.81 (noting that this sentence captured "*Aronson*'s functional conflating of the duty of due care and the business judgment rule"). For a detailed analysis of these developments, see Tsuk Mitchell, *supra* note 101, at 140–49.

145. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985). Interestingly, what "gross negligence" meant remained an open question. Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 970 (Del. Ch. 1986). For the endorsement of similar language in other jurisdictions, see DENNIS J. BLOCK, NANCY E. BARTON & STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS 9–19 (2d ed. 1988).

146. Before the 1980s, only in "a handful of cases outside the context of financial institutions . . . directors of business corporations had been found liable for breach of their duty of care." Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 978 (1994). For the most part, commentators agree that "the business judgment rule has historically proved to be 'a very potent defense for corporate directors and officers against claims primarily asserted by shareholders for loss resulting from decisions that went awry.'" *Id.* at 980.

147. *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005), *aff'd* 906 A.2d 27 (Del. 2006) (references below are to the decision of the Court of Chancery).

148. *Id.* at 697.

duty of care (pursuant to section 102(b)(7) of the Delaware General Corporation Law).[149] The only means of imposing liability on Disney's board of directors was resurrecting a separate good faith standard. Chancellor Chandler was skillful in crafting such a standard, and the Delaware Supreme Court affirmed. According to *Disney*, a director might fail to act in good faith if he or she "intentionally acts with a purpose other than that of advancing the best interests of the corporation," "acts with the intent to violate applicable positive law," or "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[150] The latter possibility was particularly pertinent in *Disney*. Yet, following their own traditions, Chancellor Chandler and the Delaware Supreme Court determined that the Disney directors acted in good faith.[151] As Chandler apologetically explained, "This court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. But Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices . . . ."[152]

Having helped to eradicate any meaningful force out of corporate law, all that the Delaware courts have left to elaborate at the turn of the twenty-first century are ideals they are unwilling to enforce.

149. *Id.* at 751–53.

150. *Id.* at 755.

151. *Id.* at 760–79. It is important to add that developments past *Disney* have undermined the potential force of its good faith analysis. In *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006), the Delaware Supreme Court assessed "whether a violation of the duty to act in good faith is a basis for the direct imposition of liability." *Id.* at 369 n.29. The Court concluded that only the duty of care and duty of loyalty, "where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly." *Id.* at 370. Failure to act in good faith was subsumed under the duty of loyalty.

152. *In re Walt Disney*, 907 A.2d at 697.