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A KEYNOTE ADDRESS - OF SORTS

Address by

A. A. Sommer, Jr.

Commissioner

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A. A. Sommer, Jr.*

In preparing these remarks I re-read that masterful little book by James Willard Hurst, one of our speakers at this meeting, entitled, "The Legitimacy of the Business Corporation." Having done that it was tempting to simply summarize the superb insights of Professor Hurst, or better yet, it would have been well to have dispensed with a keynote address and simply have urged everyone to read or re-read this little masterpiece before coming here. Despite my desire to avoid parroting the thoughts of Professor Hurst, I am sure that the origins of much of what I express will be easily identified as originating in his work.

In assessing the extent to which federal and state law should establish standards of conduct for corporate management, we must, of course, have some notion of what the corporation is, what its role has been historically in our society, what society expects - and has expected - of the corporation, the

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manner in which the corporation as not only an economic entity but a social one as well relates to other facets of American life - political, economic, and social. And there must be some consideration of the overall goals that Americans seek, for a structure within which so much of the nation's wealth has developed and been gathered will not long be tolerated unless it has some discernible relationship to those goals. And certainly notice must be taken too of the fears which Americans have often expressed about "corporate power." It is impossible, of course, in this brief paper to elucidate all those considerations; at most I shall only suggest a few thoughts on these broader matters.

The source of the fear of corporations, of course, has not been the corporation as such, an impersonal Goliath bestriding the economy and the nation. As Bayless Manning has pointed out, the real name for what has been feared has been power: the power of certain people to do certain undesirable things to other people. From time immemorial "power" has been rooted in economic power; the ownership of lands once gave power, later the power of industrial ownership was the target of popular concern. Corporations as such have no power; the people who control them - whatever that means - have the power to decide whether a plant will be closed, thus impoverishing a

community; to decide to curtail production, thereby adding massively, in some instances, to the rolls of the unemployed, thus creating a problem for the political bodies; to blunder and thereby harm the interests of those depending upon the prosperity of the enterprise for jobs, dividends, security. Running through all this is an abiding misgiving in the American mind about any power, whatever its form or source. We carefully developed a system of political checks and balances to prevent undue accessions of power and, as recent history has shown, we react strongly when that balance is disturbed. This fear is real and hovers over every discussion of American corporations.

We all know the history of corporations, how they emerged initially as special grants from the sovereign, often to undertake a particular socially beneficial chore - the development of toll roads, waterways, and other parts of the infrastructure of the economy. Gradually, as men sought to gather capital for purposes of a manufacturing and commercial nature, without any special social purpose as a goal, and as egalitarian notions became more deeply rooted in American life, the general corporation laws emerged. There continued a good deal of confusion in thinking about what the corporation was designed for - was it to effectuate a special purpose or was it simply a useful instrument

for the fruitful use of capital?

As Professor Hurst has pointed out, the first legitimacy of the corporation stemmed from its utility. Professor Richard A. Posner has said,

> "The corporation is primarily a method of solving problems encountered in raising substantial amounts of capital for a venture."

This utility derived from a number of characteristics. Of outstanding importance, though in the view of some scholars of less importance than usually suggested, was the limitation of liability or commitment of those who invested. Other characteristics were, as Professor Berle has pointed out, the ability of the corporation to accumulate capital for expanding its activities and the increasingly perpetual nature of it. It did not suffer from the iron law of life that proprietorships did or the historic limitations that attended the partnership method of doing business.

Of increasing importance as the 19th century wore on, and as the demands for expansion of the American economy grew, was the ability of the corporate form of organization to centralize control of the corporation. The importance of this factor is

repeatedly mentioned by Professor Hurst:

> "Corporation law early favored business arrangements which centralized decision making, gave it considerable assurance of tenure, and armed it for vigorous maneuver."
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> "Law in effect reflected this eclipse as statutes and judge-made doctrine legitimated broad authority in top officers of corporate enterprises and protected this authority with the rule that shareholders might not interfere with regular business decisions of the officers and board of directors or obtain legal redress for alleged mismanagement save upon showing gross negligence or abuse of trust."
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> "For both small and large enterprises the corporation provided a defined, legally protected, and practically firm position of authority for those in central control."

Corporation statutes reflected the utility of such centralized control. While today we blanch at the usual statutory statement that directors shall "manage" the corporation because of a concern that it suggests an unrealistic role for directors, it bears notice that this provision had its origins in a desire to make clear that the shareholders were not to manage the corporation. Accompanying these statutory limitations on the power of shareholders were court developed doctrines, sometimes reflected in statutory provisions, that limited the ability of shareholders to make various sorts of agreements that might impinge upon the centralization of management in the directors and the officers of the corporation.

Virtually contemporaneous with the development of strong tools for centralized control of the corporation was the disappearance in statutory law of virtually every vestige of social control over the conduct of corporations. In some measure this was the result of the disappearance of the special purpose charters which, as indicated, frequently elicited initiative and capital to do quasi-governmental chores and which were the beneficiaries of special economic benefits given by the state, thus justifying the regulation of their activities in order to serve the purpose for which the state granted the franchise. The elimination of a regulatory dimension was a response to the concept of the corporation as primarily defined in terms of its utility. Also during this time there was strong belief in the efficacy of the marketplace as a means of effective control over the conduct of the corporation; if the corporation adhered to its proper function of maximizing profit, then it would be rewarded or punished on the basis of its economic performance, and this would be an effective regulator of its conduct. Bayless Manning

summarized the results of this development in this manner:

> "...corporation law, as a field of intellectual effort, is dead in the United States. When American law ceased to take the 'corporation' seriously, the entire body of law that had been built upon that intellectual construct slowly perforated and rotted away. We have nothing left but our great empty corporation statutes - towering skyscrapers of rusted girders, internally welded together and containing nothing but wind."

The concentration of control in management necessarily widened the gap between management and the shareholders, a development noted and deplored by Berle and Means in 1932. The popular theme became "shareholder democracy", a reversal at least in part of the dominant strain in corporate law which had previously enhanced the utility of the corporate form as a means of economic development. Central to the development of federal securities law was the enhancement of the right and power of the shareholders of a corporation to participate in its affairs. In general the Securities and Exchange Commission, exercising its broad power under Section 14(a) of the Securities Exchange Act of 1934, sought to make more effective the rights which shareholders enjoyed under state corporation law, but which were difficult to exercise under that law, since it usually defined no effective procedures for their exercise. These mechanisms for the exercise of

shareholder power were accompanied by the requirement that the shareholder have the opportunity to exercise his power knowledgably. The extent to which the hopes underlying these reforms have been realized I will comment upon in a moment.

As Professor Schwartz will point out in the paper he proposes to deliver, "The task of reform may embrace two broad objectives: first, to constrain the power of corporations within the society; second, to contain the power of the corporate manager, or at least to render the exercise of the power more accountable."

Taking the second "task of reform" first, this relates essentially to the relations between the shareholders and the management. Professor Posner states in the chapter on corporations in his book, "Economic Analysis of the Law", that the "main concern of this chapter has been to explore ways in which the individuals who manage corporations are prevented from substituting personal goals for that of maximizing profits." He sees the problem of "accountability" as one involving essentially defeating the capacity of managers to place their own economic and general welfare ahead of the shareholders. In this endeavor he denigrates the influence of "shareholder democracy" and emphasizes instead mobility of control, the ability of the shareholders to oust management, the preservation of a market for control.

Thus, in his notion, the opportunity for shareholders to oust management by their own efforts and for management to be ousted by someone from outside the corporation should be relatively unimpeded, for only then will the corporation operate most efficiently for the benefit of shareholders. If this is sound economics, it is interesting to reflect on the extent to which mobility of control is realized in practice. Because of the enabling nature of corporate statutes, managements have been able to place very considerable impediments in the way of a "market" for corporate control. First, of course, there is the difficulty of organizing a sizeable body of shareholders in a proxy contest, one that begins obviously with the odds weighted heavily in favor of management because of their access to corporate funds to fight the contest as contrasted with the contingency of the anti-management group ever recovering its expenses. As for efforts to secure a shift of control from the outside, witness the proliferation of devices to impede the transfer of control: unusual majorities to effect mergers with holders of stipulated numbers of shares; staggered boards of directors; and other ingenious devices.

Notwithstanding the limited increase of efforts to preserve mobility of control, the federal securities law has developed fruitfully to govern many aspects of the relationship between corporations and those who purchase their securities. In an effort to maximize the effectiveness of the scheme which has developed under the Securities Act of 1933 and the Securities Exchange Act of 1934, the courts, limited though they have felt themselves to be by the Birnbaum doctrine, now affirmed by the Supreme Court, have nonetheless effected imaginative extensions of the notion of who is a "purchaser" or "seller" of securities.

Of course it must be recognized that in many respects the federal law contains rules governing the relations of shareholders and management regardless of the presence of a purchaser or seller. The proxy rules, with their requirements for disclosure on a regular basis of transactions between the corporation and "insiders", have become a fairly effective regulator of the conduct of management. Even though rarely do shareholders, without the stimulus of an organized proxy contest for control, override the recommendations of management on proposals submitted for a shareholder vote and perhaps never do they refuse to elect the recommendations of management for directoral office, nonetheless the necessities of disclosure operate as a governor on the conduct of management. Management may not fear rebellion by shareholders, but they do fear the

pen of Forbes, The Wall Street Journal, Barrons and other commentators on the corporate scene if they expose to public view the manner in which they have utilized their positions for private gain. Not only may they suffer the opprobrium that follows from such disclosure, they may also become the targets of suits spawned by the disclosure.

As the courts have steadily expanded the situations in which the federal securities laws will intrude into corporate relationships, the line between mismanagement and conduct violative of the federal securities laws has become increasingly blurred, and management is less and less able to rely on the limitations once thought embedded in those laws.

In the eyes of Professor Cary this process is not sufficient to do what must be done. His proposal for a "Federal Corporate Minimum Standards Act", which must be credited with a large measure of responsibility for the theme of this conference, is, as Professor Schwartz suggests, mainly concerned with "Contain[ing] the power of the corporate manager." It appears to stem from several concerns. First, he is obviously disturbed with the strains placed upon a single, simple, limited rule in the development of policy which many consider desirable, and toward which the courts seem congenial. To some extent perhaps

this concern is esthetic: law should be cleaner, more defined, more predictable, more candidly stated than the restraints on management are in Rule 10b-5. Second, he is disturbed by the inherent conceptual limitations of the present federal basis of jurisdiction. As he states, "...there should be as much federal concern about the management of the public issue company and about its share owners as about the investor engaged in the purchase and sale of its stock." Third, he obviously despairs of state law forsaking its now firmly established bases, if for no other reason than the built-in competitive drive which stems from the multiplicity of jurisdictions concerned with incorporation and the total absence of any requirement of any economic relationship between the enterprise and the locus of its incorporation. In the face of this concern for the strains of expanding Rule 10b-5 and the proxy rules, and this despair of redemption through state law, plus the unlikelihood of any move toward a federal incorporation law, he opts for a cleaner, more explicit response to the deeply felt concern about relations between management and shareholders and seeks through federal standards limits on the conduct of management.

The first task of reform mentioned by Professor Schwartz, to "constrain the power of the corporations within society" reflects the fact that such constraints are no longer part of

the basic statutes governing corporations. To the extent that corporations have been regulated in relation to other social goals, it has been through special legislation that at least nominally is unconcerned with whether the prohibited conduct is through the medium of the corporations: antitrust laws; pollution and environment laws; legislation protective of employees.

It was thought by some that increased shareholder participation through the proxy machinery would be a means of controlling the corporation's relationships with the external world as well. These thought that the social sensibilities of shareholders might rise higher than those of management and thus through the exercise of their right to elect directors, and thus influence the selection of the managers, those sensibilities might impact the corporation's conduct.

It is at best doubtful whether events have justified these expectations. While there has developed the notion of the "ethical investor" whose universe of interests ranges more broadly than the narrow economic welfare of the corporation, still there is ample evidence that shareholders are animated for the most part by the desire for the economic profitability of the enterprise in the most conventional sense, although certainly many shareholders would probably rebel strongly if

their management flaunted grossly developing social concerns. In general it is doubtful if more effective participation of shareholders in the control of corporations' affairs will significantly better their performance or conduct in terms of meeting social requirements and responsibilities, although certainly strong vocal demands by segments of the shareholder population have influenced at least marginally the course which many managements have taken.

The first issue we should confront, then, is whether indeed there is a need for strengthening the restraints on the prerogatives, the control, of management vis-a-vis the shareholders of the corporation. If, as Professor Hurst explains, the once expected restraint that shareholders might, because of their economic interests, place upon management, are not effective, and if "shareholder democracy" has not afforded an answer, and if the restraints of the market are not sufficient, then should the policy implicit in state corporation laws favoring largely unfettered management control be modified? Remember that the pattern existing in state laws derived from notions which related the legitimacy of the corporation to its utility. Have events ordained that the principle of utility be subordinated to other considerations of fairness, equity, economics, social concern? And if that is desirable, what is the most efficient, effective way of

doing that? Should we simply look to the courts to continue the task they have undertaken, not only under the securities laws, but through the application of general fiduciary principles and common law development? Or should we look to a federal enactment for relief, either a federal corporation law or the federal adoption of standards which would be minimums which would be effective if state law failed to reach them?

The second major question we must confront is how the affairs of corporations, these aggregations of economic power, should be related to the total social fabric, to what extent should the economic interests of management and shareholders alike be subordinated to larger considerations? These questions revive the classic Berle-Dodds debate about whom the corporation must answer to, a debate Professor Berle conceded Professor Dodd, who said it must be responsible to interests beyond those of the shareholders, had won, if judged by events: "Transition of the large corporation from a private enterprise to a social institution has now been accomplished and is generally recognized.

Professor Hurst has suggested there is a need to further

legitimize corporate power otherwise than through the utility of the corporate structure:

> "For all the brave talk of a new stockholder democracy and a new corporate statesmanship, it is unlikely that we would find satisfactory adjustment of the large corporation to the social context through new controls built into the corporation's own constitution; this aspect of legal development since 1890 would likely endure. But there would be insistent continuing demand to legitimize corporate power by its responsibility as well as its utility. To this end we would ultimately require a more comprehensive legislative response than any we had achieved by 1970."

The prime method proposed by those who seek to carry out Professor Hurst's suggestions for a "more comprehensive legislative response" is federal incorporation. The response they urge is not simply the substitution of a federal enabling statute, similar in many respects to those of the states, but with more stringent demands upon management in its allocation of the fruits of the enterprise between themselves and the shareholders, but rather a regulatory statute that might, as Professor Schwartz suggests, deal with the problem of "bigness", the participation in the governance of the corporation by constituencies beyond that of shareholders, the creation of a new regulatory function that would enforce the various mandates of the statute.

Almost universally hopes for reform of corporate control, whether those expressed by Professor Cary or the wider ranging ones entertained by Professor Schwartz and Ralph Nader, look to the federal government for realization. This, of course reflects a broad strain in American thought. As Professor Hurst has said, "The more important any legal theme is in United States history, the more likely it is that it has been significantly affected by the coexistence and interplay of the national and state governments." Any answers we derive must inevitably include recognition of this American phenomenon. In some measure this turning toward Washington reflects a philosophical conviction that these matters, being of national concern, should be dealt with through national means. And then there is the despair that state law can be molded to the pattern needed. It is not expectable that states will, confronted with the possibility that one state will not conform and thus become the favored haven of corporations, significantly harden their demands upon those controlling corporate enterprise, either in their relations with shareholders or with the social totality of the nation. This is recognized by many, perhaps most notably by Professor Folk who had the unique opportunity of observing the dynamics of state corporation law-making as Reporter for the amendments to the Delaware Corporation Law in the sixties.

The issues we confront at this conference are not newly indentified or newly arrived in the American consciousness. Concern with corporate power and corporate control has a long history. As the corporate mode of enterprise has become commonplace, as the size of corporations has expanded, as scholars reexamine the history of corporations and their theoretical foundations in our own and other societies, solutions satisfactory to other generations are called into question. Any conclusions of our time which may be expressed in statutes and court decisions will be questioned by the next generation, and theirs by the one after that. This is the stuff of which life is made.

Enough of the questions. Let us now seek answers.