An Overview of the Laws of Corporations

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Alfred F. Conard

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AN OVERVIEW OF THE LAWS OF CORPORATIONS

Alfred F. Conard*

I. Introduction

At the end of the Middle Ages, there stood on the banks of the Thames a walled city comprising about a square mile of ground and 100,000 inhabitants, which was known as the City of London. During the following centuries, this aggregation of humanity spread beyond the walls, engulfing Westminster, Holbrook, Marylebone, Hampstead, and twenty-four other boroughs, until it embraced 700 square miles and 8 million inhabitants. This aggregate was known to geographers, travelers, newsmen, and merchants as the City of London. But the local residents, with British conservatism, continued to call “the City” only that original square mile whose inhabitants had now dwindled to less than 5,000.

In a somewhat similar way, there appeared in the middle of the nineteenth century bodies of legislation known as “corporation law.” During the twentieth century, legislatures found it necessary to enact great masses of additional legislation to deal with the special problems of corporations. People who worked with the entire group of relevant laws were known as “corporation lawyers.” But, like Londoners, they continued to regard as “corporation laws” only those few that covered the same points embraced by the laws of the Victorian era. The others carried distinct sobriquets.

This usage leads to a confusion in speaking about the “laws of corporations,” since they are so much broader than “corporation laws.” It would be hard, though, for a reader to remember that “laws of corporations” and “corporation laws” are not the same thing. In order to minimize this source of confusion, I shall avoid the term “corporation laws,” and speak rather of “corporation codes.”

With this understood, several separate bodies of the laws of corporations can be distinguished. These are (1) the corporation codes; (2) the judge-made law of corporations; (3) the securities laws; (4) the securities transfer laws; (5) the antitrust laws; (6) the tax laws; (7) the rules of the stock exchanges; and (8) accounting standards. With respect to each of these segments of law, this Article asks what it

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contributes to the corporation regime, how it relates to other segments of the regime, and how its functions are performed in other legal systems.

II. THE BUSINESS CORPORATION CODES

A. The Concept of a Corporation Code

Although every state has many laws dealing with business corporations, it is easy to distinguish the “corporation code” from the others. It is the one that takes the corporation from the cradle to the grave. It tells how corporations are formed, how their officers are elected, how they may issue and retire shares, and how they may dissolve and liquidate. It has an air of comprehensiveness, and it usually calls itself “General Corporation Law,” “The Business Corporation Act,” or the “Business Corporation Law,” with the definite article indicating that it is the only one on the subject. If Chief Justice Marshall should awaken—or Chief Justice Burger suffer amnesia—and read one of these laws, he would have every reason to think he had found a comprehensive statement of law on corporate affairs.

Codes of similar structure will be found in almost any foreign country, from Afghanistan to Zambia, including socialist states, except that most of them are more complete than the American codes in ways that I will explain later.

1. CAL. CORP. CODE § 100 (West 1954); DEL. CODE ANN. tit. 8, § 268 (1953).
4. The Model Business Corporation Act is the most typical illustration of all these codes, because it has been consciously copied in whole or in part by a majority of those now in effect. Its section headings suggest the general structure of such codes. They are “Introductory” (short title and definitions); “Substantive Provisions” (purposes, powers, name, securities, meetings, directors, dividends, and officers); “Formation” (contents and filing of articles); “Amendment” (procedures and reduction of capital); “Merger and Consolidation” (procedures and effects); “Sale of Assets” (procedures and rights of dissenters); “Dissolution” (conditions permitting or requiring and procedures); “Foreign Corporations” (admission, withdrawal, and penalties for unauthorized entry); “Annual Reports”; “Fees, Franchise Taxes, and Charges”; “Penalties”; and “Miscellaneous” (state supervision, exceptional procedures, applicability). ABA-ALI MODEL BUS. CORP. ACT (1969).
B. The Multiplicity of Corporation Codes

1. Territorial Multiplicity

Along with the most automobiles, television sets, and electric toothbrushes, the United States possesses by far the largest number of business corporation codes. Every state and the District of Columbia has its own, each a little different from the others.

This form of affluence seems not to be shared, nor even envied, by the other nations of the world. It will probably surprise no one that the Union of Soviet Socialist Republics, although it contains fifteen “Union Republics” (plus twenty “ Autonomous Republics” within the Union Republics), and at least twenty recognized national languages and cultures, governs corporations or “state enterprises” throughout all these republics with the same law. More significant, perhaps, is the case of India, which contains twenty-four states and territories and fourteen major languages. Its founders were familiar with the United States legal system, which in some respects they emulated, but they chose to have a single national legislation on corporations. In Mexico, which consists of twenty-nine states, each with its own civil code, there is a single body of federal legislation on commercial law, including corporations.

As might be expected, the closest parallels to the American position are found in other English-speaking nations. In the United Kingdom, which contains three differentiated legal systems (England, Scotland, and Northern Ireland), there are two corporation codes—one for England and Scotland, the other for Northern Ireland. Although the British Parliament has power to enact legislation for Northern Ireland, its members chose in the matter of the Companies Act to leave the North Irish Parliament free to choose its own law.

In Australia, there are six states that act independently in this area.

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8. But see Ziegel, Constitutional Aspects of Canadian Companies, in Studies in Canadian Company Law 193 (J. Ziegel ed. 1967), in which the author finds it “arguable whether the [Canadian] federal government needs a separate incorporation power” and notes that the United States “appears to have managed quite well” without it.


11. The constitution of 1883 made commercial law a subject of federal legislation; previously it had been a subject of state legislation. See R. Mantilla Molina, Derecho Mercantil 15 (10th ed. 1965).

of legislation, but they decided in 1959 to make their companies acts uniform and in 1962 substantially completed the task.\textsuperscript{13} South Africa, although divided into four provinces, has only one companies act.\textsuperscript{14}

Most similar to the United States' situation is that of Canada, where each of ten provinces has its own companies act. In one sense, Canada differs from the United States chiefly in having a smaller number of states to legislate. But there is a bigger difference in that the federal government has adopted a Canada Corporations Act,\textsuperscript{15} under which most large, nationwide companies have chosen to be incorporated.\textsuperscript{16}

2. Why Territorial Multiplicity?

The historical reasons for the extreme multiplicity of corporation codes in the United States are not difficult to discover. We may start with the United States Constitution, which says nothing about whether the states or the federation should hold the power of incorporation.\textsuperscript{17} This silence is easily attributable to the fact that incorporation was a very minor business of government in 1787, when the Constitution was drafted, and remained a minor business for many decades thereafter.\textsuperscript{18} If the Founding Fathers thought at all about incorporation, they must have assumed that both the states and the federation could continue to grant charters for purposes related to their respective powers, as they had done before.\textsuperscript{19} Whatever they thought, the effect of their saying nothing was to permit the states to continue granting corporate status under the doctrine of reserved powers.\textsuperscript{20} Thus the United States was destined, so long as no contrary steps were taken, to have at least as many corporation codes as there were states.

What is more remarkable is that the federal government did not

\textsuperscript{13} H. Mason & J. O'Hair, \textit{Australian Company Law} xi (1969). However, minor divergences in the acts remained and have been increased by subsequent amendments. G. Wallace & J. Young, \textit{Australian Company Law} v (1965).


\textsuperscript{16} See generally Ziegel, \textit{supra} note 8.

\textsuperscript{17} The exhaustive research by Professor Crosskey into the eighteenth century connotations of "commerce" seems to have turned up no specific references to the power of incorporation. See W. Crosskey, \textit{Politics and the Constitution in the History of the United States} (1955), esp. vol. 1, at 115-86.


\textsuperscript{19} In 1781, the Continental Congress had created the Bank of North America. This and numerous incorporations by the state and federal governments are listed in \textit{id.}, at 296-311.

take steps to adopt a pervasive national corporation code, which would override inconsistent state regulation related to interstate commerce, or perhaps "pre-empt" regulation affecting interstate commerce in the manner of the National Labor Relations Act.21 Here, the explanation does not appear to be constitutional. Although very restricted views have been held with regard to what activities constitute "commerce," there is no reason to doubt that the regulation of commerce, in the minds of the Founding Fathers, included regulation of the incorporation of commercial enterprises.22 If they had looked at the principal French commercial legislation extant in their time, they would have found that the Ordonnance du Commerce of 1676 included a chapter on business associations (sociétés).23 When the Napoleonic Code de Commerce was issued in 1807, it, too, contained a chapter on business associations, with express reference to stock corporations (sociétés anonymes).24

But, for a hundred years after the Constitution was written, Congress showed little interest in exercising its commerce power. Meanwhile, throughout the nineteenth century, the states built up their idiosyncratic patterns of legislation, their separate bureaucracies for dealing with corporation documents, and their addictions to tax revenues exacted for corporation privileges. Although federal intervention on the economic scene may be dated generally from 1887 and 1890 (the dates of the Interstate Commerce25 and the Sherman26 Acts), federal regulation of corporate organization was miraculously postponed until 1933.27 By this time state corporation bureaus were firmly established in the statehouse bureaucracies.28

Some valiant efforts were made to achieve a level of uniformity through separate state action. In 1928, the National Conference of Commissioners on Uniform State Laws promulgated a Uniform


22. See argument of counsel for Maryland in McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 331-33 (1819), where the argument is not that incorporation is generally outside the federal power but only that the particular incorporation of the Bank of the United States was neither necessary nor appropriate.


28. For further reflections on the neglected federal role in corporation law, see Jennings, The Role of the States in Corporate Regulation and Investor Protection, 23 LAW & CONTEMP. PROB. 193, esp. 194-96 (1958).
Business Corporations Act. Yet, it never won more than seven adop-
tions—some of them qualified—and was gradually demoted by the
Conference from a "uniform act" to a "model act," to an act "re-
ommended for consideration," and finally to an act "superseded" by
the Model Business Corporation Act of the American Bar Associa-
tion's Section on Corporation, Banking, and Business Law. As with
changes in the Soviet Presidium, these gentle degradations were
accomplished without a record of debate or a statement of considera-
tions. Even less productive was a brief dalliance by the American Law
Institute with the idea of a Restatement of the Law of Corporations
for Profit.

Such success as has been achieved in the direction of uniformity
is attributable to the ABA Model Act. But even that Act does not
aim at complete identity; at many points, it offers "optional" or "al-
ternative" sections, inviting legislatures to go in different direc-
tions. Its main thrust is not uniformity of substantive law, but
standardization of terminology. This is helpful in two ways. First, it
supplies legislatures with relatively lucid phrases that have been
honored by experts, and thus reduces the occasions for each provincial
draftsman to concoct his own distinctive brew of words. Second, it
increases the probability that a lawyer or judge interpreting a clause
can find a precise precedent in some other state, if not in his own.
But it relieves not at all the need for every corporation lawyer to
have a collection of statutes from fifty states and the opportunity for
businesses to attain special freedoms by incorporating in one state
instead of another.
3. The Multiplicity of Special-Purpose Corporation Codes

So far, I have spoken of territorial multiplicity, arising from the enactment of a separate code for each state. There is an additional multiplicity, resulting from the enactment of separate corporation codes within each state for specially regulated kinds of corporations. Michigan, for example, has separate "codes" for the formation and operation of banks, insurance companies, railroad companies, and many other named categories of enterprise. All modern states have some special provisions for the regulation of enterprises in finance and public service. Usually, enterprises of these kinds must not start or stop business without permission, and may need permission to increase or reduce their capital stock, reserved surplus, and other funds.

There are two ways of arranging such regulatory provisions. One method, which might be called "supplementary," is to provide a separate set of banking or insurance or railroad regulations containing arrangements for only those special matters on which the industry is to be actively supervised. Under the supplementary method, a banking corporation would be formed under the general corporation code, but would also be required to conform to the orders of the superintendent of banking on opening offices, maintenance of capital and surplus, and so on.

The other method, which might be called "substitutionary," is to exclude all application of the general business corporation code to banks, and to provide in the banking law a complete code of formation, operation, and dissolution for banks. The same procedure is followed for insurance companies, railroad companies, and other special subjects of regulation. When this method is followed—as it is very widely in the United States—there are not one, but several corporation codes in the same state with parallel structures but differing details on the entire cycle of corporate life.

In foreign industrialized countries, the "supplementary" method seems to be the one mainly used. In England, banks and insurance companies are formed under the general Companies Act, and the Act includes a number of special provisions in order to accommodate

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42. E.g., Mich. Comp. Laws Ann. § 450.3 (1967) (excluding from general corporation act, building and loan associations and companies formed as insurance, railroads, bridges, tunnels, and union depots companies).
them. In France, banks are sociétés anonymes, as are manufacturing companies and department stores, but the banks are subject to additional regulations and to orders of government ministries.

The supplementary method seems to be gaining favor in the United States. Although special railroad corporation acts still prevail widely, it is notable that electric generating companies (whose operations are now of much greater public necessity) are universally formed under general business corporation codes, with supplementary regulation of their service and finance operations. Moreover, there is an incipient movement to revise the special-purpose corporation codes by repealing their sections on general corporate routines and leaving in effect only the regulatory provisions that are peculiar to the industry. For example, the 1964 amendments of the New York Transportation Corporation Law, which replaced the old provision for formation of transportation companies dating from 1890, provide that transportation companies may be formed under the Business Corporation Law. A similar change has been made for the incorporation of banks. But insurance corporations remain under the old regime.

4. The Pains and Pleasures of Multiplicity

Considering not only the separate state corporation codes, but also the special-purpose corporation codes in the various states, there must be several hundred corporation codes of various degrees of completeness in the United States. It would probably be impractical to make one federal code do the whole job; most European countries have at least two general corporation codes (one for closely held and one for publicly held companies), as well as some special-purpose acts. But it would be imaginable to have only two or three corporation codes, rather than two or three hundred.

45. As an example of supplementary regulation, see N.Y. Pub. Serv. Law (McKinney 1955), as amended, (Supp. 1972) (separate articles on railroads, bus lines, motor transports, gas and electric companies, steam and water companies, and telephone and telegraph companies). It should be noted that the "systems" of electric generating companies are also subject to a special federal regime involving their acquisition and divestitures. Public Holding Company Act of 1935, 15 U.S.C. §§ 79a to 79z-6 (1970).
What difference would that make, and to whom? Law publishers would be the most directly affected, because they would have less books to sell. Lawyers would have fewer statute books to buy and fewer statutes to read. On the other hand, the publication of treatises might be stimulated because of the larger number of potential readers for a commentary on a single code. Law review articles would be more widely applicable, and lawyers could more readily find authoritative answers to their problems. For the same reasons, sophisticated clients could also find the answers more readily, and might become less dependent on their lawyers. Corporations and their officers could determine more quickly, and probably with less expense and more certainty, what rules are applicable to their organization and financial structure. State corporation bureaus would probably languish; they might be entirely abolished, or reduced to maintaining a local index of matters transacted in a national office or in a few regional offices.

If these were the only operative considerations, federal corporation laws would have been adopted long since. But these considerations are counterbalanced by another. A federal corporation code would certainly be much stricter than some, and perhaps stricter than all, of those now existing. Corporation officers can readily imagine a federal corporation regime as constraining as the federal securities, labor, and antitrust regimes. In contrast, the multiplicity of corporation laws has produced immense liberality. How this has come about is my next subject.

C. The Liberality of Corporation Laws

1. The "Race of Laxity"

In a colorful passage of his dissenting opinion in *Liggett Co. v. Lee*, Justice Brandeis recounted, "Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The states joined in advertising their wares. The race was one not of diligence but of laxity." 51

While enjoying the sparkle of Justice Brandeis' metaphor, we should guard ourselves against imagining that each state's legislature is conspiring each year to make its corporation code a little more alluringly permissive than any other. A very few states have been flaunting more fun at lower prices for traveling enterprises; the rest have been grudgingly granting the minimum concessions deemed necessary to keep most of their breadwinners at home. The perfor-

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50. 288 U.S. 517 (1933).
51. 288 U.S. at 558-59.
mance might better be called a "chase" than a "race," since it is characterized by one or two starting off in the lead, and the others striving only to stay within hailing distance. Most legislatures retain a few provisions that are stricter than Delaware's, but most of their companies will tolerate these rather than suffer the expense and inconvenience of a Delaware incorporation. The attitude of contemporary corporation law makers was expressed with unusual candor by the Law Reform Commission of New Jersey when it said,

> It is clear that the major protections to investors, creditors, employees, customers and the general public have come, and must continue to come, from Federal legislation and not from state corporation acts. . . . Any attempt to provide such regulations in the public interest through state incorporation acts and similar legislation would only drive corporations out of the state to more hospitable jurisdictions.

We should guard ourselves also against assuming that all of the liberality engendered by the "race of laxity" entails social or economic evils. One of the first relaxations that shocked public opinion was the grant of power to corporations to hold shares in other corporations. Nearly everyone will concede today that this power ought to exist, although they will also insist that there must be some limitations, such as those imposed by the Clayton Act and by the take-over regulations of the securities laws. When no-par shares were introduced, they appeared to some observers to be works of the devil, but hardly anyone can now be found who bewails this innovation.

Finally, we should not assume that the liberal trend of corporation codes is some kind of perversion of their original purpose. Corporation codes were introduced in the nineteenth century to permit people to organize themselves without the necessity of a special legislative act. Such general authorizations were first given for limited purposes, such as the operation of mills, bridges, and turnpikes, and were gradually extended to factories, commercial establishments,

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58. Arguments against no-par stock were not even noticed in 1970 in H. Henn, _Handbook of Law of Corporations_ § 159.
and eventually to nearly every kind of enterprise. The liberalizing phenomenon is often described in a less polemical way by saying that corporation codes are "enabling acts," to permit people to organize themselves in ways that would not be legally supportable without the codes.

2. The Exportation of Liberality

There is nothing very unusual about a race between states. One state's legislators may regulate consumer finance closely, while others leave it quite free from constraints, each group believing that its method is best "in the long run" for debtors and creditors. What is unusual about the race of laxity in corporation codes is that its effect will be felt almost entirely outside the state. When Delaware purported to give Western Airlines liberty to abolish cumulative voting, it granted a freedom that predominantly affected the California investors in Western Airlines and the travelers of California.

The strictly-for-export aspect of the Delaware corporation code was nicely illustrated by the first section of the General Corporation Law as it stood for several decades before the 1967 amendment. Public utility corporations could be formed under the General Corporation Law if they intended to operate outside the state, but if they intended to operate inside, they had to be formed under the much more rigorous chapters of Delaware law designed specifically for railroad, gas, water, oil, steam, telegraph, telephone, and electric power corporations. Whether the race be denominated one of liberality or laxity, Delaware has conspicuously won it. Of the twenty-five largest industrial corporations in the United States in 1971, thirteen were incorporated in Delaware. Only one of these

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60. See Katz, supra note 52, at 179.
63. The 25 largest industrial corporations, as listed by FORTUNE, May 1971, with their headquarters and states of incorporation, as listed by Moody's Investor's Serv., Inc., Moody's INDUSTRIALS MANUAL (1971) [hereinafter Moody's], are as follows:

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Main Office</th>
<th>Incorporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Motors</td>
<td>Michigan</td>
<td>Delaware</td>
</tr>
<tr>
<td>(Exxon)</td>
<td>New York</td>
<td>New York</td>
</tr>
<tr>
<td>Ford Motor</td>
<td>Michigan</td>
<td>Delaware</td>
</tr>
<tr>
<td>General Electric</td>
<td>New York</td>
<td>New York</td>
</tr>
<tr>
<td>International Business Machines</td>
<td>New York</td>
<td>New York</td>
</tr>
<tr>
<td>Mobil Oil</td>
<td>New York</td>
<td>New York</td>
</tr>
<tr>
<td>Chrysler</td>
<td>Michigan</td>
<td>Delaware</td>
</tr>
</tbody>
</table>
had its headquarters or any substantial fraction of its activities there. New Jersey, which had led the chase in the late nineteenth century, even lost to Delaware in 1966 one of its historic satrapies—the United States Steel Corporation.64

3. Which Law Governs?

The provision of legal regimes to be enjoyed in other jurisdictions is a uniquely American phenomenon. It should not be confused with the “tax haven” game, which is played by Liechtenstein, Luxembourg, the Bahamas, and, even to some extent, Switzerland. These countries serve as homes of investment companies or base companies that hold shares of operating companies elsewhere.65 But the operating companies are not incorporated in Liechtenstein, Luxembourg, or the Bahamas. In contrast, General Motors of Delaware is not a mere holding company, but an operating company that directly owns and operates its factories in Michigan, New York, and California.

The exportation of liberality within the United States depends on a principle of conflict of laws, according to which the law governing the internal affairs of a corporation is the law of the state of incorporation.66 In accordance with this principle, cumulative voting in General Motors Corporation is governed by the law of Delaware,

<table>
<thead>
<tr>
<th>Texaco</th>
<th>New York</th>
<th>Delaware</th>
</tr>
</thead>
<tbody>
<tr>
<td>International Tel. &amp; Tel.</td>
<td>New York</td>
<td>Delaware</td>
</tr>
<tr>
<td>Western Electric</td>
<td>New York</td>
<td>Delaware</td>
</tr>
<tr>
<td>Gulf Oil</td>
<td>Pennsylvania</td>
<td>Pennsylvania</td>
</tr>
<tr>
<td>Standard Oil (Cal.)</td>
<td>California</td>
<td>Delaware</td>
</tr>
<tr>
<td>U.S. Steel</td>
<td>New York</td>
<td>Delaware</td>
</tr>
<tr>
<td>Westinghouse Electric</td>
<td>Pennsylvania</td>
<td>Pennsylvania</td>
</tr>
<tr>
<td>Standard Oil (Ind.)</td>
<td>Illinois</td>
<td>Indiana</td>
</tr>
<tr>
<td>Shell Oil</td>
<td>Texas</td>
<td>Delaware</td>
</tr>
<tr>
<td>E.I. du Pont de Nemours</td>
<td>Delaware</td>
<td>Delaware</td>
</tr>
<tr>
<td>RCA</td>
<td>New York</td>
<td>Delaware</td>
</tr>
<tr>
<td>Goodyear Tire &amp; Rubber</td>
<td>Ohio</td>
<td>Ohio</td>
</tr>
<tr>
<td>Ling-Temco-Vought</td>
<td>Texas</td>
<td>Delaware</td>
</tr>
<tr>
<td>Procter &amp; Gamble</td>
<td>Ohio</td>
<td>Ohio</td>
</tr>
<tr>
<td>Atlantic Richfield</td>
<td>New York</td>
<td>Pennsylvania</td>
</tr>
<tr>
<td>Continental Oil</td>
<td>Connecticut</td>
<td>Delaware</td>
</tr>
<tr>
<td>Boeing</td>
<td>Washington</td>
<td>Delaware</td>
</tr>
<tr>
<td>Union Carbide</td>
<td>New York</td>
<td>New York</td>
</tr>
</tbody>
</table>

64. The United States Steel Corporation was formed in New Jersey in 1901 to acquire the shares of Carnegie Steel and other companies, mostly based in Pittsburgh and the Ohio Valley; presumably New Jersey was chosen because of its leadership in permitting acquisition of shares of other companies. In 1965 a corporation of the same name was incorporated in Delaware, and in 1966 the New Jersey corporation was merged into the Delaware corporation. See Moody’s, supra note 63, at 509-10.


rather than by the law of Michigan where the company is principally operated.\textsuperscript{67}

The conflict principle of most European countries is quite different: a corporation is governed by the law of the state in which its headquarters are located.\textsuperscript{68} To illustrate, a company with perpetual duration had incorporated in England and later moved its headquarters to Brussels, Belgium. According to English conflict rules, which are similar to those in the United States, the company continued to be governed by the law of England, but according to Belgian conflict rules, it became subject to Belgian corporation law, which causes a corporation to expire thirty years after it was formed, unless the charter is renewed.\textsuperscript{69}

States in which companies operate could, if they wished, change the normal conflict rules and impose their own laws on the Delaware corporations that operate principally in the host state. To a limited degree, New York has done this by imposing several of her own corporation code rules on foreign corporations that do most of their business in New York.\textsuperscript{70} In an exceptional case, California successfully imposed its own cumulative voting requirement on Western Airlines—a California-based company with a Delaware charter.\textsuperscript{71} But generally states have not done this—probably fearing that the offended company would blithely move its headquarters to some other state if the first host state proved inhospitable. The only states that have dared to impose their own rules on resisting foreign corporations have been New York and California, whose size and situation are likely to hold corporations there notwithstanding legal inconveniences. It is not surprising that a North Carolina draftsman's proposal to impose local standards on "pseudo-foreign" corporations was rejected by the legislature.\textsuperscript{72}

Theoretically, states could also frustrate the importation of lax

\textsuperscript{67} But see Western Air Lines, Inc. v. Sobieski, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961).


\textsuperscript{70} Rules imposed on certain foreign corporations relate to liabilities of officers and directors, disclosure of records, dividends and other distributions, reduction of capital, right of withdrawal, derivative suits, and indemnification of officers and directors. These provisions apply to foreign corporations that do 50 per cent or more of their business in New York and are not listed on a national securities exchange. N.Y. Bus. Corp. LAW §§ 1317-20 (McKinney 1963), as amended. (McKinney Supp. 1972).


\textsuperscript{72} Jennings, supra note 28, at 206.
foreign corporation laws by excluding foreign corporations from doing business in their jurisdiction unless they were governed by laws similar to the local ones or consented to be governed by local laws. Although natural persons have a constitutional right to migrate from state to state for business as well as pleasure, corporations are said to lack any such protection. However, states have not used their exclusive power for the purpose of requiring conformity of corporation codes. Some legislatures exercise their power of exclusion to the extent of providing that a corporation is admitted only for the exercise of powers that a similar domestic corporation could exercise, but this applies to the business they do, rather than to their rules of internal organization.

4. The Stigmata of Laxity

a. Comparisons over time. The laxity, or liberality, of state corporation codes in the United States can be detected by various kinds of clues. The simplest approach, perhaps, is to identify the points at which constrictions existed formerly, but have now been swept away. Justice Brandeis, in his famous dissent identifying the "race of laxity," cited limits on corporate life to periods such as thirty years, limits on total dollar capital, limits on corporate purposes (such as transportation, banking, insurance, and manufacturing), and exclusions of stockholding in other corporations as illustrations of former constrictions. He might well have added restrictions on holding real estate beyond that "actually occupied by such corporation[s] in the exercise of [their] franchise[s]." None of these departed restrictions seems to be mourned by contemporary commentators.

More recent relaxations in response to competitive pressures have dealt with matters that are still controversial. One of the most debated is the guaranteed option for cumulative voting, which has recently been eliminated from the Michigan law and from the

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74. E.g., N.Y. Bus. Corp. Law § 1306 (McKinney 1965).
75. 288 U.S. at 560-61.
76. Mich. Const. art. XII, § 5 (1908). This provision put a ten-year limit on such holdings; it was omitted in the constitution of 1963.
77. See, e.g., H. BALLANTINE, CORPORATIONS § 82 (rev. ed. 1946).
Illinois constitution. Distribution of profits when original capital is impaired is now permitted despite the regrets of commentators. Merger laws have been amended to permit deliberate squeeze-outs of unwanted minorities.

b. Comparisons between countries. Probably none of these clues reveals the full effects of the chase of laxity. The old restrictions, which have been eliminated in the interest of equal freedom, are less significant than the restrictions that might have been devised to meet new conditions if a different legislative atmosphere had prevailed. To stimulate one's imagination of what American corporation codes might have been in the absence of interstate competition for the favor of founders, it is useful to glance at the corporation laws of other nations that have nourished gigantic automobile and electrical manufacturers, metallurgists, and oil refiners. Examples may be found in England, France, Germany, and Sweden. One need only to match corresponding provisions on a few key subjects to find striking contrasts.

c. Regulation of stock-watering. An integral part of the corporation acts of other advanced countries is a provision governing the disclosures that must be made to new investors in a company—what they must be told, and what liabilities will be incurred for misleading them. The English Companies Act expressly commands that every prospectus—broadly defined as any invitation to invest—must contain many specified facts about the company, and particularly about any property that the company has recently bought or is about to buy for cash or for shares.

In France, investor protection takes quite a different form. When there is a public offering of securities, independent auditors must be appointed to determine the value of any property exchanged for shares, and to report on this matter (and on any other special favors obtained by the promoters) to a special shareholders' meeting of all the new subscribers. If they do not approve, their money, which has

80. Ill. Const. art. 11, § 3 (1870) (omitted from 1971 constitution).
81. Ballantine & Hills, Corporate Capital and Restrictions upon Dividends in Modern Corporation Laws, 28 Calif. L. Rev. 229, 261 (1935); Hills, Model Corporation Act, 48 Harv. L. Rev. 1334, 1338 (1935); Note, Dividends from Contributed Capital and Protection of Preferred Shareholders, 65 id. 1203 (1952).
83. Companies Act of 1948, 11 & 12 Geo. 6, c. 88, § 38 (prospectus must contain certain provisions), § 455 (definition of "prospectus"), sched. 4 (items to be included in prospectus).
been carefully held in escrow in the meantime, is refunded. Most of these safeguards are not applicable when there is no public offering of securities. German law also calls for an evaluation of property exchanged for shares or bought with share proceeds, either by one of the two boards (managing or supervisory), or by independent auditors in case of a conflict of interest. If the evaluation made by the board or the auditors differs from that of the incorporators, the Court of Commerce will decide. Swedish law is similar.

On the whole matter of protecting the investors against overvalued property, American corporation acts are conspicuously silent. The directors decide for what consideration the stock shall be issued, and tell the other investors—so far as the corporation acts are concerned—nothing about the decision. "In the absence of actual fraud in the transaction, the judgment of the directors . . . shall be conclusive."

The extreme permissiveness of the corporation acts is countered, however, by the extreme rigor of state and federal "securities acts." The company must fully disclose the price of any property recently acquired or soon to be acquired. The liability of the directors under these laws is not limited to actual fraud, but extends to any careless failure to avoid misleading partial disclosures. In a few states, an official may even intervene to forbid the sale if he thinks that a very poor bargain is being offered.

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85. Law of July 24, 1966, on Business Associations, art. 84, [1966] J.O. 6402, [1966] J.C.P. III. No. 32197. However, article 80 of the law requires an independent auditor even in a private offering. Also, in the event of later contributions in kind, article 193 requires similar procedures with no private-offering exemption.


87. AKTG § 35 (1965).


89. E.g., DEL. CODE ANN. tit. 8, § 152 (Supp. 1968), § 153 (Supp. 1971); ABA-ALI MODEL BUS. CORP. ACT §§ 18-19 (1960).

90. DEL. CODE ANN. tit. 8, § 152 (Supp. 1968). See also ABA-ALI MODEL BUS. CORP. ACT § 19 (1960).


The peculiarity of the American law of security flotations—taken in its entirety—is that investor protection is omitted from the “corporation acts” and inserted in a parallel series of “securities acts.” This arrangement has a number of odd consequences. One is that a layman—or even a lawyer who has not been well and recently educated—may easily rely on the soothing assurance of the corporation act (“the absence of actual fraud”), and find that his clients have incurred a heavy liability under the securities laws. Another consequence is that there are a number of interstitial situations in which investors tend to fall between the protective provisions. Delaware, for instance, has no securities act at all, so intrastate transactions there are entirely unprotected. A dozen other states have rather pallid securities laws that do not require any specified degree of disclosure and do not noticeably increase the vague fraud liability of the common law. A third consequence is that a lawyer (or layman) has to look into at least three sets of law books to discover the rules of liability to investors that impinge upon his incorporating or corporate client.

The peculiarity of the American corporation codes is illuminated by a review of the historical development of investor protection provisions in the different countries. We may start with the third quarter of the nineteenth century, from which most of the broad self-incorporation statutes date. Most legislators of this period seem to have entertained no suspicions that promoters would palm off overvalued property for shares in new companies. There were no protective provisions in the German General Commercial Code of 1861, nor in the English Companies Act of 1862, nor in the New York Business Corporation Act of 1875. The French were the most suspicious. Their share company law of 1867 provided that any proposal to issue shares for property must be submitted to an examination....
by an auditor, followed by consideration at a shareholders' meeting in which the contributors of property were not allowed to vote.\footnote{100} Moreover, each company had to appoint auditors, whose first duty was to audit the organization of the company.\footnote{101}

In all of the countries under consideration, stock-watering proved to be a real problem, forcing the legislatures to take action to control it. Even in France, which had started out with the tightest controls, additions were made. An 1893 provision required that subscribers who obtained stock in exchange for property retain their shares for two years—presumably to give the company a chance to sue these subscribers if fraud should appear.\footnote{102} Otherwise, the French provisions survived with little change until the shattering experiences of the 1930's. At this time, the French share company act was amended to require that the auditors who report on the property exchanged for shares be free of any entanglements with the shareholders in question; brothers, brothers-in-law, employees, and others likely to be subject to a conflict of interest were strictly excluded.\footnote{103} Finally, it was required that one of the auditors be the French equivalent of a certified public accountant.\footnote{104} The recodification of company law in 1966 preserved these provisions without essential alteration.\footnote{105}

By 1900, the German states had also made substantial changes in their company laws to control stock-watering. The articles of association were required to state what property had been exchanged for shares and to justify its valuation. If members of the executive or supervisory boards were promoters, independent auditors, appointed by either the local Chamber of Commerce or the Court of Commerce, were required. These amendments were codified in the Commercial Code of 1900,\footnote{106} and survived in the general revisions of the corporation code in 1937 and 1965.\footnote{107}

England dealt with the watered-stock problem in two stages. In 1890, directors were made liable for untruths in prospectuses, unless they could carry the burden of proving that they had used due diligence to ascertain and state the true facts.\footnote{108} But there was no require-

\footnote{100. Law of July 24, 1867, art. 4, [1867] D.P. IV. 205.}
\footnote{101. Law of July 24, 1867, arts. 5-6, [1867] D.P. IV. 205.}
\footnote{103. Decree of Aug. 8, 1935, art. 3, [1935] D.P. IV. 1588.}
\footnote{106. \textit{Handelsgesetzbuch} (HGB) §§ 186, 191-94 (1900).}
\footnote{107. AktG § 25 (1937); AktG § 33 (1955).}
\footnote{108. Act of Aug. 18, 1890, 53 & 54 Vict. c. 64, § 3(1).}
ment that a prospectus be issued, nor one prescribing its contents if issued. The general revision of the company law in 1908 remedied these deficiencies by defining any invitation to buy shares as a prospectus, and then requiring that every prospectus should tell about any property to be exchanged for shares.\textsuperscript{100} Perhaps the most significant difference from the French and German pattern was the absence of any explicit requirement of independent auditors for valuation of property contributions. The English pattern of 1908 has survived the general revisions of 1929\textsuperscript{110} and 1948.\textsuperscript{111}

During the same quarter century when European countries were beefing up their statutes to fight watered stock, the same abuses were rampant in the United States. Their footprints are preserved in the cases where courts struggled to provide remedies through the famed “trust fund,” “fraud,” and “statutory duty” theories.\textsuperscript{112} But the American legislators, unlike those of other nations, remained almost immobile. If they intervened at all, it was to nullify the judges’ efforts by decreeing that the judgment of the board of directors should be conclusive in the absence of fraud—without even excluding self-interested directors from this indulgence.\textsuperscript{113} It is small wonder that a future Supreme Court Justice found ample material for a scathing book on Other People’s Money.\textsuperscript{114} Whether or not promoters flourished more in the United States than in the old country has never been comparatively analyzed; it is certain that no other rich nation persisted so long in supplying promoters with a complaisant legislative ambiance.

When state legislatures—led by Kansas in 1911\textsuperscript{115}—screwed up their nerve to require substantial disclosures and to impose penalties for careless misrepresentation, they acted not by stiffening the body of their corporation acts, but by inventing a new kind of legislation called securities acts.\textsuperscript{116} The reasons for these choices were obvious enough. It would not have helped much to stiffen the Kansas corporation code so long as the codes of Arkansas, Delaware, and New Jersey remained unchanged; it was not practical, even if it were constitutionally possible, to regulate the organization of foreign corporations that might sell their securities to Kansas residents.

The same pattern was followed when the federal government

\textsuperscript{109} Act of Dec. 21, 1908, 8 Edw. 7, c. 69, §§ 80-82, 280.
\textsuperscript{110} Companies Act of 1929, 19 & 20 Geo. 5, c. 23, §§ 34-37, 380.
\textsuperscript{111} Companies Act of 1948, 11 & 12 Geo. 6, c. 38, §§ 37-43, 455.
\textsuperscript{112} See notes 87-89 infra and accompanying text.
\textsuperscript{113} See notes 89-90 supra and accompanying text.
\textsuperscript{114} L. BRANDIS, OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT (1914).
\textsuperscript{116} See generally L. LOSS & E. COMPT, supra note 94, at 5-10.
took up securities legislation in 1933. It had no direct power to alter the corporation codes of the various states; all it could do was erect a parallel and independent system of regulation.

By reason of these peculiarities of the federal system, the United States has come to have corporation acts that are uniquely permissive toward stock-watering, and an independent set of securities acts that are uniquely rigorous. The statement in the corporation acts—that the board of directors’ valuation of property is conclusive in the absence of actual fraud—is belied by the securities acts, which make the directors liable for saying less than enough, or for saying something untrue if by due diligence they could have learned of its falsity.

d. Conflict-of-interest provisions. The bashfulness of American legislators in the presence of promoters is almost equalled by their reticence in regard to corporation managers. In other advanced countries, the corporation acts deal explicitly and firmly with the possibility that corporation managers may have conflicts of interest in corporate transactions. They deal with this danger in two ways—one transactional, one structural. The transactional approach is to provide that the transactions in which the managers’ personal and official interests conflict are voidable, or that the company may adopt the transaction for its own benefit. The structural approach is to provide for some superboard, or parallel board, that keeps watch on the managers and reports to the shareholders.

. (1) Transactional restrictions. The transactional approach is pursued most vigorously in France. Under the law of 1966, conflicts between the personal and the official interests of an administrator must be reported to the whole board of administrators, which in turn informs the auditors and the shareholders; the latter may disapprove and hold the administrator responsible for any loss incurred. With respect to the ordinary fees or salaries of administrators, authorization can be given only by the shareholders.

The English law is curiously divided. The statute itself provides only that directors must disclose their conflicts of interest. But a standard bylaw—one of those automatically adopted unless expressly

120. Companies Act of 1967, c. 81, §§ 16(1)(e)-(d); Companies Act of 1948, 11 & 12 Geo. 6, c. 39, § 193.
rejected—excludes the director from voting on most matters in which he has a conflicting interest.\textsuperscript{121}

The German law contains the most sweeping provisions on contracts between board members and the corporation; these provisions depend for their efficacy on the distinctive German separation between an executive board and a supervisory council.\textsuperscript{122} Transactions between board members and the board are completely unauthorized—no matter how much disclosure and abstention from voting may have been performed; transactions with board members can be made only by the supervisory council.\textsuperscript{123} On the other hand, German law does not expressly condemn contracts between companies with interlocking directorates; in this area, it seems to rely on structural restrictions, designed to minimize the incidence of such conflicts.\textsuperscript{124}

Sweden simply forbids directors to act or vote on matters in which they are personally interested or in which they are involved through a “material interest” in another interested corporation.\textsuperscript{125}

In contrast, the principal American statutes do not breathe a word against directors acting under conflicts of interest. Where they speak at all, it is to approve actions in conflict situations that might otherwise fall afoul of some judge’s puritanical prejudices. Thus the Model Act takes pains to declare that the board of directors may fix directors’ compensation, if the articles of incorporation have not forbidden it to do so,\textsuperscript{126} and to provide that a contract tinged with conflict will nevertheless be valid if the affected directors disclose their interests and abstain from voting, or if shareholders ratify it after receiving an adequate disclosure, or if the arrangement is essentially fair.\textsuperscript{127} Even these provisions primly refrain from pronouncing any sanctions against conflicts, unless such sanctions can be negatively implied from their rejection under the stated circumstances.

In this area, the silence of the statutes is to some extent compensated by the vaunted rigor of the common-law fiduciary concept,\textsuperscript{128} which may have more drastic effects than the chiseled precepts of the

\textsuperscript{121} Companies Act of 1948, 11 & 12 Geo. 6, c. 38, sched. 1, table A, § 84.
\textsuperscript{123} AKTG § 112 (1965).
\textsuperscript{125} The Swedish Stock Corporation Act of 1944, § 86 (Eng. transl., Aktiebolaget Svenska Handelsbanken 1949).
\textsuperscript{126} ABA-ALI MODEL Bus. CORP. ACT § 35 (1969).
\textsuperscript{128} H. BALLANTINE, supra note 77, §§ 66-72a; H. HENN, supra note 58, §§ 235-41.
Old World statutes. Although most writers agree that the common-law doctrine is rigorous, they do not agree at all about where it starts and stops.\textsuperscript{129} In any state without a large collection of decisions, a judge has a wide area of choice; federal judges have a wide area in which to guess what a state judge would decide if he had the chance.\textsuperscript{131} Lawyers are assured of the opportunity to file voluminous briefs, with ample authority for any advantageous stance.

Securities legislation has had very little impact on conflict-of-interest transactions. The state blue sky laws and federal Securities Act of 1933\textsuperscript{132} seem completely inapplicable. The Securities Exchange Act of 1934\textsuperscript{133} touches the problem lightly. When shareholders' votes are sought on conflict-tainted transactions, proxy statements must reveal conflicts of interest.\textsuperscript{134} Under recent decisions, the shareholders' vote could probably be annulled if the necessary disclosure was omitted or made falsely.\textsuperscript{135} But the law says nothing about when shareholders must be consulted. If company charters are drawn to permit conflict-tainted transactions without consulting shareholders, the tangential impact of the Exchange Act can be sidestepped.

(2) \textit{Structural restrictions.} In the European corporation codes the structural devices for making conflicts of interest unlikely, and for ensuring that they will be discovered and evaluated if they exist, are fully as important as the devices for annulling the transactions themselves.

Here, the most remarkable device is the German division of managerial authority between an executive board and a supervisory council.\textsuperscript{136} The council members are elected by the shareholders and the employees. They appoint the board members, but the council members cannot manage the company, nor put themselves into executive positions.\textsuperscript{137} The executive board members wield the powers of management, but subject to the council that has chosen them.\textsuperscript{138}

\textsuperscript{129} Steefel \& von Faulkenhausen, \textit{supra} note 122, at 581 (German law). \textit{But see} Warren \& Willard, \textit{supra} note 117, who find no lack of rigor in French law on this subject.
\textsuperscript{130} See sources cited in note 128 \textit{supra}.
\textsuperscript{131} See Zahn \textit{v. Transamerica Corp.}, 162 F.2d 36, 45-46 (3d Cir. 1947).
\textsuperscript{136} See Vagts, \textit{supra} note 122, at 50-53.
\textsuperscript{137} AktG §§ 101, 119(1) (election), § 84 (appointment of executives), § 111(4) (managerial functions), § 105 (incompatibility with executive board membership) (1965).
\textsuperscript{138} AktG § 76(1), 111(1) (1955).
Moreover, the executives must not be executives or partners in any other enterprise without the council’s very specific consent. So their chances of having conflicting interests are cut down at the very beginning.

In France, the new law permits an arrangement similar to the German, with an executive board and a supervisory council. But the predominant regime today—as for the past century—is characterized by an administrative board, checked by a board of auditors. Although the auditors (unlike the German supervisory council) do not have any power over the administrators, they are elected by the same body, the shareholders, and are charged not only with verifying financial statements, but with reporting any irregularities of management that they discover. It is these auditors who receive reports of conflicts of interest, and are bound to prepare a report to the shareholders and to the state prosecutor.

The English structural safeguards against conflicts of interest are notably feebler than those of France and Germany, but are still substantial enough to merit contrast with the gaps in American laws. All publicly held companies are required to have auditors, who are chosen from an officially certified list (and thus comparable to American certified public accountants), elected by the shareholders, and obliged to report to the shareholders. Their report is confined to the accuracy of the financial statements; they are not invited to report on other irregularities (as are French auditors), nor are they empowered to appoint and remove executives (as is the German supervisory council).

Structural safeguards against conflicts of interest are completely absent from American corporation acts and are only sparingly supplied by other legislation, except in specialized situations.

139. AktG § 88 (1965).
144. Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 161.
145. Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 159.
146. Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 162.
147. Companies Act of 1967, c. 81, § 14, formerly Companies Act of 1948, 11 & 12 Geo. 6, c. 38, sched. 9.
tangling alliances of directors are inhibited by laws relating to banks, railroads, and registered public utility holding companies, but there are no comparable statutes for most other types of commercial and industrial companies. The antitrust rule against interlocking directorates among competitors is hardly relevant; it is companies that deal with each other, rather than companies that compete with each other, that present conflict-of-interest problems.

e. Auditing. One of the sharpest contrasts between corporation codes of the United States and other developed countries relates to the requirement of independent auditors. England, France, and Germany categorically require them. They are appointed by the shareholders and must be certified public accountants (or the European equivalent). They cannot serve if they are too closely tied to the management by business or family connections.

The principal corporation acts of the United States are politely silent on this delicate subject. This glaring gap is partly patched by stock exchange regulations, which apply to listed companies, and partly by Securities and Exchange Commission regulations, which also apply to "registered" companies (unlisted companies with over 1 million dollars in assets and 500 or more shareholders).

149. 12 U.S.C. § 78 (1970) (interlocks between investment banks and commercial banks that are members of federal reserve system); 15 U.S.C. § 19 (1970) (interlocks between banks that are members of federal reserve system); 15 U.S.C. § 78q(0) (1970) (interlocks between commercial banks or investment banks and registered public utility holding companies). There is also a provision of a more limited type in the Trust Indenture Act that forbids an indenture trustee (normally a bank and trust company) from having an interlocking director with the debtor company. 15 U.S.C. § 77jjj(b) (1970).


154. Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 161(2) (excluding officers and employees and their partners); Law of July 24, 1966, on Business Associations, art. 229, [1966] J.O. 6402, [1966] J.C.P. III. No. 32197 (excluding incorporators, officers, board members, employees of the company or its affiliates, and the close relatives by blood or marriage of these persons); AKTG § 164 (1965) (excluding members of the executive and supervisory boards and employees).

155. See NEW YORK STOCK EXCHANGE, INC., COMPANY MANUAL § A4, at A-67 (current ed. of updated looseleaf) [hereinafter NYSE COMPANY MANUAL]. Other exchanges do not publish their rules to the same extent as the New York Exchange, but are believed to make similar requirements in practice. See also pt. VIII infra.

156. 15 U.S.C. § 78l(g) (defining companies required to register); § 78m (requiring
These patches miss more than they cover: they cover about 7,000 listed and registered companies; they miss about 1.5 million unlisted and unregistered companies, of which at least 100,000 are million-dollar companies.\textsuperscript{157}

On the other side of the Atlantic, there are also some exemptions from the auditing rules, but they are much more carefully confined. While England no longer has any exemption,\textsuperscript{158} before 1967 exempt private companies were excused from hiring a certified public accountant, although they still had to have an independent audit.\textsuperscript{159}

In France, small close corporations are exempt;\textsuperscript{160} the principal substantive tests for this status are capital not exceeding approximately 60,000 dollars, shareholders not exceeding fifty, and restrictions that prevent share transfers to new members without consent of a supermajority of the existing members.\textsuperscript{161}

At this writing, the German law is perhaps even more permissive than the American on permitting companies to escape the audit requirement. Although all negotiable share companies are subject to this requirement—regardless of size—it can be escaped by taking the limited liability company form, which in Germany has no formal limit on amount of assets or number of shareholders.\textsuperscript{162}

But German law is destined to change very shortly. A law reform proposed by the government will subject companies to the auditing requirement when they have assets worth more than approximately 1 million dollars, whether or not they are listed or traded, and whether or not they issue negotiable shares.\textsuperscript{163} What is more important is that the reform, if adopted, will create a strong incentive for smaller companies to have their accounts audited; managers will be personally liable for losses resulting from accounting errors if they fail to hire public accountants to audit the statements.\textsuperscript{164}

\textsuperscript{157} These estimates are based on the analysis of distribution of corporations by size in Eisenberg, \textit{The Legal Role of Shareholders and Management in Modern Corporate Decisionmaking}, 57 Calif. L. Rev. 1, 35-36 (1969).

\textsuperscript{158} Companies Act of 1967, c. 81, § 2.

\textsuperscript{159} Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 161(1).


\textsuperscript{162} Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbH) (Law on Companies with Limited Liability), April 20, 1892, [1892] RGBl. 477.

\textsuperscript{163} Fleddermann, \textit{Der Referentenentwurf Eines GmbHG}, 1969 GMBH-RUNDSCHAU 97, 100, citing § 141 of the \textit{Referentenentwurf}.

\textsuperscript{164} Fleddermann, \textit{supra} note 163, citing §§ 138, 147 of the \textit{Referentenentwurf}.
Another great difference between the European and American systems flows from the fact that the European auditors are officers of the corporation, elected by the shareholders, and bear legal responsibility to assert their views in opposition to the management. In France, as already mentioned,165 the auditors are bound to reveal any irregularities that come to their attention to the shareholders and (if the irregularities are serious enough) to the state prosecutor. In Germany, if the auditors disagree with the management on how the accounts should be presented, they must take the matter to court for decision.166 In England, their report must be read at the shareholders' meeting.167

The position of American auditors is very different. If the original auditors refuse to certify the accounts, the management is free to seek other auditors who are more agreeable. The original auditors have no duty to complain to the shareholders.

f. Summation on laxity. One could cite additional subjects on which United States corporation codes are silent but foreign codes speak out. They would serve only to reinforce the pattern already observed.

The differences between the standards of management conduct in the United States and in Europe are not great when all sources of legislation and business custom are included, but there is a striking difference in the codification of these standards. In Europe, most of them are expressly stated at a logical point in the corporation code. In the United States, most are dealt with in securities legislation, or by regulations of the securities exchanges, or through customs imposed by the financial markets. Where the locus of the rule is federal securities regulation, the substantive requirement may be more rigorous than in Europe; the enforcement is almost certain to be. But the United States system leaves vastly more and wider gaps through which corporations escape the impingement of rules that enlightened modern opinion considers appropriate. Moreover, the United States system is more occult, and permits a high probability that corporation lawyers will proceed in blissful ignorance of some of the standards incumbent upon their clients.

III. THE JUDGE-MADE LAW OF CORPORATIONS

The law of corporations would be a sad rag if it were limited to the emissions of the legislatures. Despite the superficial inclu-

165. See text accompanying note 143 supra.
166. AKTG § 169 (1965).
167. Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 162(2).
siveness of the cradle-to-grave corporation codes, they have left most of the hard questions to be answered by the judges. Confronted with cases that had to be decided, the judges have resorted to freehand sketching, with results varying from the sublime to the ridiculous.

A. The Shareholder’s Complaint

Some time after incorporation was made easy, it became evident that some wielders of corporate power would brandish their weapons incompetently or dishonestly, and that the built-in controls, such as corporate expiration and annual elections, would be inadequate to correct the resulting evils. The laws of most other industrialized countries require some additional built-in controls—especially the independent board of auditors—but they have not stopped there. More than a hundred years ago, French legislation provided for a derivative action to be brought on behalf of the company by holders of five per cent of the shares, and recent legislation extends the right to a single shareholder. German and Swedish legislation permit an action on demand of ten per cent. English legislation permits a single shareholder to sue for an order “regulating the conduct of the company’s affairs in the future.”

In the United States, no legislature has expressed such distrust of corporation managers, and the minority shareholder has depended for his protection almost exclusively on judicial invention. Even before the Civil War, judges had shown themselves quite ready to respond to shareholders’ complaints. Although New York contributed the most celebrated cases, similar decisions were rendered in Mississippi, Ohio, Pennsylvania, and Wisconsin. In 1855, the United States Supreme Court extended the concept from suits against malfeasant corporate officials to suits against governmental officials who

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168. See text accompanying notes 136-50 supra.
171. AKTGB § 147(1) (1965) (§ 123(2) of the 1937 AktG was similar); THE SWEDISH STOCK CORPORATION ACT of 1944 §§ 128-29 (Eng. transl., Aktiebolaget Svenska Handelsbanken 1949).
172. COMPANIES ACT of 1948, 11 & 12 Geo. 6, c. 38, § 210. This provision was an innovation of the 1948 Act.
173. E.g., Bayless v. Orne, 1 Free. Ch. 161 (Miss. Ch. 1840); Robinson v. Smith, 5 Paige 222 (N.Y. Ch. 1852); Taylor v. Miami Exporting Co., 5 Ohio 162 (1831); Langolf v. Solberlitch, 2 Para. Eq. Cas. 64 (Pa. C.P. 1831); Putnam v. Sweet, 1 Chand. 286 (Wis. 1849). For these cases and their historical evaluation, I am indebted to Prunty, THE SHAREHOLDERS’ DERIVATIVE SUIT: NOTES ON ITS DERIVATION, 52 N.Y.U. L. REv. 980 (1957).
were making illegal claims against the corporation.\textsuperscript{174} Incidentally, the Court affirmed the propriety of federal courts' entertaining derivative suits under their diversity-of-citizenship jurisdiction.\textsuperscript{175}

In the 1940's, legislatures of a half-dozen states were persuaded by business interests to put brakes on derivative suits by requiring plaintiffs to deposit security to pay the defendants' legal fees if the plaintiffs should lose the suit.\textsuperscript{176} Probably the proponents thought they had, as Hornstein lamented, rung the "death knell of derivative suits."\textsuperscript{177} But the judges found ways around these provisions. Most statutes had an escape hatch for large shareholders,\textsuperscript{178} and New York judges permitted shareholders to aggregate their claims to reach the escape level; they even adjourned the suits to give plaintiffs time to assemble the required number of shares.\textsuperscript{179}

In the late 1950's, Congress set up an additional impediment to derivative suits by providing that a corporation should be deemed a resident of its principal place of business, as well as of the state in which it was incorporated.\textsuperscript{180} This provision considerably reduced the opportunities to establish "diversity of citizenship," and thereby cut down derivative cases in federal courts.\textsuperscript{181}

Despite legislative hostility and the absence of any express legislative encouragement, the derivative suit survives. According to latest reports, it is on the upswing.\textsuperscript{182} This should not be taken as a symptom of shareholder discontent, or of legal privateering. In a

\footnotesize{\textsuperscript{174} Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855).
\textsuperscript{175} 59 U.S. (18 How.) at 346-47.
\textsuperscript{176} The lead-off statute was New York's, now N.Y. Bus. Corp. Law \textsection\ 627 (McKinney Supp. 1972), which was based on F. Wood, Survey and Report Regarding Stockholders' Derivative Suits (1944). The report was commissioned by and prepared for the New York Chamber of Commerce.
Other statutes requiring shareholder plaintiffs to post security exist in Arkansas, California, Colorado, Florida, Maryland, Nebraska, New Jersey, North Dakota, Pennsylvania, Tennessee, Texas, and Wisconsin. Among important states without them are Delaware, Illinois, Michigan, and Ohio. See generally H. Henn, supra note 56, \textsection\ 372.
\textsuperscript{177} Hornstein, The Death Knell of Stockholders' Derivative Suits in New York, 32 Calif. L. Rev. 123 (1944).
\textsuperscript{178} See sources cited in H. Henn, supra note 58, \textsection\ 372, at 782 n.3. In New York, the requirement did not apply to holders of shares amounting to five per cent of the class or worth 50,000 dollars. See N.Y. Bus. Corp. Law \textsection\ 627 (McKinney Supp. 1972).
\textsuperscript{180} Act of July 25, 1958, Pub. L. No. 85-554, \textsection\ 2, 72 Stat. 415 (codified at 28 U.S.C. \textsection\ 1332(c) (1970)).
decade when shareholders are doubling,\(^{183}\) should the quantum of shareholders' suits remain static?

**B. The Errant Enterprise: The Theory of Ultra Vires**

Early corporation codes (and the officials who administered them) required articles of incorporation to be very specific about the business that the corporation proposed to follow. If the corporation was a railroad, the termini must be named without equivocation. But circumstances often made some change in the business plan imperative or desirable, and the practical businessmen who ran the corporation usually trimmed their sales to the wind. As long as all went well, no one was likely to complain. But when things went badly, someone was sure to remember that the corporation had strayed from its sworn objective.

Legislatures had usually been quite positive about the essentiality of the incorporators' declaring their purpose, but almost never said anything about what would happen if the enterprise strayed from it. When judges were presented with this tangled skein, many found an easy way out by pretending that whatever was done wrong was not done at all; it was "ultra vires.\(^{184}\) Often the ridiculous consequence was to reward the transgressor by relieving it of paying for value received. This bit of judicial futility is still endured in England.\(^{185}\) In the United States, it was first mitigated by conflicting opinions of a more practical if less logical bent; but today, virtually

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\(^{183}\) The New York Stock Exchange reports the following total number of individual shareholders:

<table>
<thead>
<tr>
<th>Year</th>
<th>Number in Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1952</td>
<td>6.49</td>
</tr>
<tr>
<td>1956</td>
<td>8.63</td>
</tr>
<tr>
<td>1959</td>
<td>12.49</td>
</tr>
<tr>
<td>1962</td>
<td>17.01</td>
</tr>
<tr>
<td>1965</td>
<td>20.12</td>
</tr>
<tr>
<td>1970</td>
<td>30.85</td>
</tr>
</tbody>
</table>

NEW YORK STOCK EXCHANGE, INC., SHAREOWNERSHIP—1970, CENSUS OF SHAREHOLDERS 1 (undated).


all legislatures have provided more sensible solutions, and relieved the judges of groping in the dark.186

C. Watered Stock

Another glaring gap in the early corporation codes was the treatment of promoters and shareholders who participated in erecting corporations with stated capital far in excess of the real assets of the corporation—the problem of watered stock. With their accustomed negligence, legislatures had indicated clearly enough that stock should have a stated value, but omitted to provide for the unforeseen circumstance that the statement might not be true. When American judges were confronted with promoters' abuses and found themselves unarmed with any statutory weapons, they improvised a number of legal theories that still bedevil students in ivied halls. The United States Supreme Court in 1873 manipulated a “trust fund theory”—invented for quite different purposes—to impose liability on shareholders.187 Other courts, rejecting this farfetched rationale, embraced an equally farfetched conception of fraud to impose liability on a smaller group of shareholders.188 The New Jersey court supersensorily perceived, through the legislative silence, a legislative purpose to make innocent sharesubscribers liable to guilty creditors.189

One can hardly fail to admire the idealism, and to share the moral indignation, that inspired these judicial efforts. At the same time, one must recognize that these exertions had very little tendency to punish the guilty parties—the promoters—and a very strong tendency to catch bargain-hunting investors, who were just as innocently victimized as the creditors whose claims they were called on to satisfy. These judicial doctrines provided nothing like the prophylactic requirement of disclosure that inhered in the English prospectus requirement, or the focusing of liability on the promoters that characterized the German and French attacks.

Although the anti-watered stock doctrines are not quite dead, their objectives are now served more effectively in other ways. Their formal objective of compelling subscribers to pay full par value for

their shares is now achieved by statutory provisions. Their economic objective of repressing the fraudulent overvaluation of assets is accomplished by the securities laws—both state and federal—which permit administrative officials to enjoin fraudulent promotions before they start, and to punish their perpetrators after they have taken place.\footnote{E.g., Del. Code Ann. tit. 8, § 162 (Supp. 1968); ABA-ALI Model Bus. Corp. Act § 25 (1969).}

D. Fiduciary Duty and Conflicts of Interest

While some gaps have now been closed, other essential chapters in the canons of corporate conduct are still missing from the legislative script. A conspicuous instance is the fiduciary duty of directors, of which not a word is said in the influential Delaware and Model corporation codes. These documents specify liability only for specific oversights, such as paying dividends without a surplus.\footnote{Securities Act of 1933, §§ 17, 20, 24, 15 U.S.C. §§ 77q, 77t, 77x (1970); Uniform Securities Act §§ 101, 408-09.} A few legislatures in recent years have been brave enough to announce that a director of a corporation of that state ought to act in good faith and with the diligence, care, and skill of an ordinarily prudent man under similar circumstances. Pennsylvania seems to be alone in declaring openly that he should be deemed to stand in a fiduciary relationship,\footnote{Del. Code Ann. tit. 8, § 174 (Supp. 1968) (payment of dividends, repurchase of stock, or redemption of stock without proper funds); ABA-ALI Model Bus. Corp. Act § 48 (1969) (unlawful dividends, unlawful repurchase of shares, or unlawful distribution on liquidation). Prior to 1969, the Model Act also punished giving loans to directors and commencing business without paid-in capital, but these punishments were eliminated, presumably in pursuit of liberality equal to Delaware’s. ABA-ALI Model Bus. Corp. Act §§ 48(d)-(e) (1966).} although more than forty states have been willing to impose this rigorous standard upon a partner.\footnote{Pa. Stat. Ann. tit. 15, § 1408 (Pardon Supp. 1972).} They seem to prefer maintaining an embarrassed silence about whose interests the directors should serve. The judges, on the other hand, have rather unanimously proclaimed directors’ duties to act in the interests of their organizations, including the duty to bring into the common pot the profitable opportunities that emanate from the common endeavor.\footnote{Uniform Partnership Act § 21. For an adoption list, see 6 Uniform Laws Ann. 5 (West Supp. 1972).}

Closely allied to fiduciary duties are the effects of conflicts of interest on the part of officers and directors. In other advanced countries, the legislators have attacked this problem directly by pro-
viding that managers cannot negotiate agreements between themselves and their company. Such provisions are found not only in the continental countries, with their tradition of codification, but also in England, the mother of the common law.\footnote{196 See text accompanying notes 117-50 supra.}

In the United States, however, legislatures have left these thistles for judges to harvest. In general, the judges accepted the challenge, and imposed rigorous standards. In their early encounters, they tended to treat directors like family trustees, whose mere presence on opposite sides of a bargain rendered it voidable by either party.\footnote{197 \textit{E.g.}, Munson v. Syracuse, G. \& C.R.R., 103 N.Y. 58, 8 N.E. 355 (1886). \textit{See generally H. Henn, supra note 58, \S\ 238.}} In more recent decades, they softened their doctrine to a presumption of invalidity, or to a requirement that such contracts merely be "fair."\footnote{198 \textit{E.g.}, Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942). The story of the transition has been well told by Marsh, \textit{Are Directors Trustees?: Conflict of Interest and Corporate Morality}, 22 Bus. Law. 35 (1966).}

When the legislatures belatedly stepped into the picture, it was usually to restrain the zeal of the judges. The Delaware law, for instance, nowhere declares transactions void or voidable by reason of conflict of interest, but says they shall \textit{not} be invalid if they meet any of a number of tests involving disclosure, a majority of disinterested votes, and shareholder ratification.\footnote{199 \textit{Del. Code Ann. tit. 8, \S\ 144 (Supp. 1968).}} The Model Act is similar.\footnote{200 \textit{ABA-ALI Model Bus. Corp. Act} \S\ 41 (1969).} Judge-made law remains the motive force for invalidating transactions infected with conflict of interest. Moreover, judges have had to fight to save their conflict-of-interest principle from complete emasculation through shareholder ratifications. When shareholders ratified pure giveaways, the judges unsheathed the ancient saber of ultra vires and declared the ratification invalid.\footnote{201 \textit{E.g.}, Kerbs v. California E. Airways, 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952); Keenan v. Eshleman, 23 Del. Ch. 234, 2 A.2d 904, 120 A.L.R. 227 (Sup. Ct. 1938).}

\section{E. Insider Trading}

Of all unpleasant subjects that might repel an undecided incorporator, the one most superstitiously shunned by legislators is that of dealings between corporate officials and the shareholders of their corporations. From early days to late ones, the cases tell of corporate officials who have astutely bought up the shares of the company with knowledge of good news that had not yet been imparted to the other
shareholders.202 Professor Manne argues, rather persuasively, that the opportunity to do this is one of the main attractions of becoming a corporation official.203

Judicial indicators have fluctuated between extremes. In the earliest cases courts tended to think that such trading was permissible, or at least an ungovernable aspect of free securities markets.204 Shortly after the turn of the century, the courts of a few agricultural states swung to the view that insiders should tell everything before buying; doctrinally they declared that directors were trustees for the shareholders.205 But in all the major financial strongholds—Massachusetts, New York, Pennsylvania, and Illinois—the “no duty” rule persisted.206

A more tenable middle ground was sketched by the United States Supreme Court, with its famous “special facts doctrine”: An insider does not need to tell all, but if the good news is extraordinary, he may not use devious means to withhold the facts or to conceal his identity as buyer.207 This became “federal general common law,” applicable to all suits in federal courts.

In 1947, a classic instance of corporate officials’ overreaching was presented to a federal court in Pennsylvania.208 The officers and half-owners of a company operating in Michigan bought out the absentee owners of the other half, who lived in Pennsylvania, without telling them of a profitable opportunity to sell the whole company.209 At any time before 1938, the Pennsylvania owners would have had a plausible chance to win under the “special facts” doctrine. But in that year, the Supreme Court discovered that federal general common law, which it had been applying for at least a century, did not exist.210 So the suit, filed in a federal court in Pennsylvania, seemed destined for an inglorious end.


204. See cases cited in note 202 supra.


209. 73 F. Supp. at 800-01.

The district court, however, made a discovery that startled not only the defendants, but also the corporate bar. In the Securities Exchange Act of 1934 lay a seldom-cited section authorizing the SEC to regulate short sales, stop-loss orders, and any other "manipulative or deceptive device."211 Under the authority of this section, the Commission had issued an even less noticed rule that in effect declared any incompleteness of disclosure in connection with a securities purchase or sale to be a "deceptive device."212 The failure of the Michigan shareholders to tell the Pennsylvania shareholders all they knew was therefore unlawful. Finally, the unlawful conduct gave rise to a civil action on behalf of the persons injured—the Pennsylvania shareholders.213

Although cloaked as a bit of statutory interpretation, this decision was hardly less a judicial creation than the "special facts doctrine," whose empty chair it filled.214 How little it was foreseen by Congress is confirmed by the absence of any guides on judicial procedure such as those Congress had provided to accompany other remedial sections of the same act.215 The courts were obliged to create a whole system of remedies and procedures. State requirements of security for expenses were found not applicable,218 but state statutes of limitation common law." See also Friendly, In Praise of Erie—And of the New Federal Common Law, 19 RECORD OF N.Y.C. B.A. 64 (1964), 39 N.Y.U. L. REV. 384 (1964). In support of the contrasting view—that federal general common law was not just a flying saucer—see 1 W. Crosskey, supra note 17, at 626, 635; 2 id. at 865-987; Clark, State Law in the Federal Courts: The Brooding Omnipresence of Erie v. Tompkins, 55 YALE L.J. 267 (1946); Corbin, The Laws of the Several States, 50 YALE L.J. 762 (1941).

213. 73 F. Supp. at 800.
214. For the shocked surprise of a professor, see Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 NW. U. L. REV. 627 (1963). In the year before this decision, Ganson Purcell, who had resigned in the same year from the chairmanship of the Commission, and two members of the SEC legal staff wrote at length concerning SEC enforcement of the accountability of corporation officers. On the last four pages of their fifty-odd page article, they wrote briefly of the impact of rule 10b-5, and predicted increased use of the Commission's "administrative machinery" to investigate and seek injunctive relief. There was not a word about a private shareholder's remedy. Purcell, Foster & Hill, Enforcing the Accountability of Corporate Management and Related Activities of the S.E.C., 32 VA. L. REV. 497, 551-54 (1946).
215. In section 9, which expressly forbade specific forms of market-rigging and authorized the Commission to regulate dealing in options, Congress expressly authorized private suits in state or federal courts, allowed court orders requiring security for expenses, and imposed a one-year time limitation. Likewise, section 16(b) authorized private suits on stated conditions in state or federal courts with a two-year time limitation. 15 U.S.C. §§ 78i, 78p(b) (1970).
were. Derivative and class actions were admissible. Counsel fees could be awarded by the court. Relief was granted in the form of rescission, damages, and accounting for profits. In the notorious Texas Gulf Sulphur cases, where the SEC was the complainant, the defendants were required to deposit their profits in court for distribution to claimants who might appear. Taken together, these rulings constitute one of the major waves of recent judicial lawmaking in the civil and commercial area. Their effect was to restore to the federal courts power over insider trading, with or without diversity of citizenship. What is more remarkable is that in this area American courts were not grappling with problems that had already been attacked or conquered by European legislators, but with ones that European legislators had not yet faced. Only in the late 1960's and 1970's, after the American law of insider trading had unfolded, did European legislators and commentators begin to give their attention to this problem.

IV. THE SECURITIES LAWS

A. An American First?

Of all the features of laws of corporation in the United States, those that usually awaken the greatest curiosity in foreign observers are the “securities laws.” This in turn leads to speculation about why the United States has had such an unusual development in this area. Are United States enterprisers more unscrupulous than those of other nations, calling forth a unique governmental effort at repres-
sion? Or did the wide dispersion of wealth—enabling very unsophisticated people to buy securities—create the need for an unusual degree of regulation? Or did the dramatic quality of the 1929 market crash trigger this extraordinary efflorescence of administrative power?

The answers are much more complex than the questions, and require a separation of various aspects of the securities laws, some of which are rather distinctive and others of which are belated followers of reforms adopted much earlier in other countries.

B. Informing New Investors

The aspect of securities legislation that has the heaviest impact on corporate organization is the requirement that new investors be offered information about what they are invited to buy. This is the heart of the Securities Act of 1933\(^\text{225}\) —the first of the federal acts—and a principal focus of most state “blue sky” laws.\(^\text{226}\)

There was nothing new about this kind of regulation when Congress adopted it in 1933. The Act of 1933 was preceded by forty-seven state blue sky laws,\(^\text{227}\) starting with the Kansas Act of 1911.\(^\text{228}\) Probably a majority of these contained registration provisions.\(^\text{229}\)

Nor was it a new idea when Kansas adopted it in 1911.\(^\text{230}\) As early as 1867, the British Companies Act required that prospectuses should disclose contracts made or to be made between the company and the promoters.\(^\text{231}\) This direction was backed up in 1890 by the Directors’ Liability Act,\(^\text{232}\) whose language was to be virtually copied forty-three years later in section 11 of the Securities Act of 1933.\(^\text{233}\)


\(^{227}\) Id. at 17.


\(^{229}\) L. Loss & E. Cowett, supra note 94, at 34, report that 37 of the securities acts extant in 1958 contained provisions for registration of securities. Other securities acts generally contained provisions requiring the registration of dealers and provisions enhancing civil and criminal penalties for fraud.

\(^{230}\) The principal novelty in the Kansas act was the wide discretion given the Commissioner to determine which offerings were sound and which were fraudulent. Id. at 5-8.

\(^{231}\) 50 & 51 Vict. c. 131, § 38. This and other acts from 1862 to 1900 are conveniently collected in A. Glynne-Jones, The Companies Acts 1862 to 1900 (3d ed. 1905).

\(^{232}\) 53 & 54 Vict. c. 64.


3. (1) Where after the passing of this Act a prospectus or notice invites persons to subscribe for shares in or debentures or debenture stock of a company, every person who is a director of the company at the time of the issue of the prospectus or notice, and every person who having authorised such naming of him is named in the prospectus or notice as a director of the company or as hav-
Directors' Liability Act imposed personal liability on directors for false statements unless they proved that they reasonably believed the false statements, having relied on the reports of experts or on other plausible bases. In 1900 the British prospectus requirements were fleshed out with a whole list of questions specifically to be answered by the prospectus, and these requirements were further elaborated in 1908. Likewise, before the turn of the century, the French and German statutes contained provisions to assure that share subscribers were informed about the promoters' dealings, and France required appointment of a special auditing committee to review the company's organization.

The most distinctive aspect of the securities offering laws in the United States was not their originality, but their lateness in arriving. Another distinction was their separation from the corporation codes

(A) With respect to every such untrue statement not purporting to be made on the authority of an expert, or of a public official document or statement, that he had reasonable ground to believe, and did up to the time of the allotment of the shares, debentures, or debenture stock, as the case may be, believe, that the statement was true; and

(B) With respect to every such untrue statement purporting to be a statement by or contained in what purports to be a copy of or extract from a report or valuation of an engineer, valuer, accountant, or other expert, that it fairly represented the statement made by such engineer, valuer, accountant, or other expert, or was a correct and fair copy of or extract from the report or valuation. Provided always that notwithstanding that such untrue statement fairly represented the statement made by such engineer, valuer, accountant, or other expert, or was a correct and fair copy of an extract from the report or valuation, such director, person named, promoter, or other person who authorised the issue of the prospectus or notice as aforesaid, shall be liable to pay compensation as aforesaid if it be proved that he had no reasonable ground to believe that the person making the statement, report, or valuation was competent to make it; and

(C) With respect to every such untrue statement purporting to be a statement made by an official person or contained in what purports to be a copy or extract from a public official document, that it was a correct and fair representation of such statement or copy of or extract from such document, or unless it is proved that having consented to become a director of the company he withdrew his consent before the issue of the prospectus or notice and that the prospectus or notice was issued without his authority or consent, or that the prospectus or notice was issued without his knowledge or consent, and that on becoming aware of its issue he forthwith gave reasonable public notice that it was so issued without his knowledge or consent, or that after the issue of such prospectus or notice and before allotment thereunder, he, on becoming aware of any untrue statement therein, withdrew his consent thereto, and caused reasonable public notice of such withdrawal and of the reason therefor, to be given.

234. The Companies Act of 1900, 63 & 64 Vict. c. 48, § 10.
235. The Companies (Consolidation) Act of 1908, 8 Edw. 7, c. 69, § 81. In the same Act, section 84 incorporated the director's liability provisions of 1890.
236. See laws cited in notes 100-01 & 106 supra.
into which the corresponding provisions of European laws were inserted. Both features are attributable, in part, to the lack of a federal corporation code, which could have effectively governed the offerings of all corporations. Yet, there is an additional reason why American securities laws were so late in coming and so separated from the corporation codes. Regulation of prospectuses in the state corporation codes would have been futile, because it would have had no effect on corporations of the other forty-seven states. Worse, it would probably have driven some domestic enterprises to incorporate elsewhere. To regulate securities effectively, legislators had to invent a new pattern of commands that would apply to in-state operations of out-of-state corporations.

When the legislation came, it descended with pent-up force that far surpassed that of its European predecessors. The state blue sky laws frequently empowered the state commissioner not only to require information, but to forbid the issuance of securities that appeared to be unsound. The federal law was fortified with a powerful commission authorized to investigate, issue stop orders, and promulgate rules that substantially sharpened the corners of the original enactment.

C. Publication of Financial Results

A second concern of securities regulation is the publication of financial results. Most state corporation codes require no spontaneous report of the company’s financial status or of its periodic achievements. State securities laws are equally silent on financial reporting after securities have once been sold to the public. In the few

239. Under the ABA-ALI MoDEL Bus. CORP. Act (1969), a corporation must let a qualified shareholder inspect its books at the company offices and must supply financial statements on written request (section 52). The annual report filed with the state reveals only gross assets and stated capital, without liabilities (sections 125(g)-(h)); even the asset statement is unnecessary if the corporation elects to pay a franchise tax on its entire capital (section 125(h))—the normal procedure for an intrastate company. Delaware law is even less demanding. DEL. CODE ANN. tit. 8, §§ 230-21, 224, 502 (Supp. 1971).

states that do require annual financial statements, the content of the statements is so unspecified that the statements are of little value.\footnote{See note 239 supra. The statement to be circulated under the 1931 Michigan act was "a true statement of the operations and properties of such corporation," without further articulation. Michigan Gen. Corp. Act of 1931, No. 327, § 45, [1931] Mich. Pub. Acts 584.}

It was therefore a considerable innovation in American legislation when the Securities Exchange Act of 1934 required that statements of financial condition and of income and expense be filed for public use in conformity with accounting rules established by the Commission.\footnote{Securities Exchange Act of 1934, §§ 13(a)-(b), 15 U.S.C. §§ 78m(a)-(b) (1970).} It was not so much of an innovation in American practice, because the 1934 requirement applied only to companies with securities listed on stock exchanges, and these companies were already in the habit of publishing financial statements, partly in response to exchange requirements and partly out of a desire to maintain market favor for their securities.\footnote{See, e.g., MOODY'S INVESTOR SERV., INC., MOODY'S INDUSTRIAL MANUAL (1931).} The impact of the requirement was increased when extended in 1964 to all other companies with more than a million dollars in assets and 500 or more shareholders,\footnote{Act of Aug. 26, 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 566, as amended, 15 U.S.C. § 78l(g) (1970).} but most of these companies had also been publishing statements in the financial press prior to this amendment to the 1934 Act.\footnote{See, e.g., MOODY'S INVESTOR SERV., INC., MOODY'S INDUSTRIAL MANUAL (1960).}

In some respects, these requirements were long preceded by the legal norms of other advanced nations. English law required publication of balance sheets by all except private companies from 1908 on, and from 1929 on required that income and expense statements be distributed to shareholders.\footnote{Companies (Consolidation) Act of 1908, 8 Edw. 7, c. 69, § 26(5); Companies Act of 1929, 19 & 20 Geo. 5, c. 28, §§ 123(2), 130(1). See L. GOWER, supra note 185, at 454. See also note 257 infra.} Germany required presentation to the shareholders' meeting of a balance sheet as early as 1870, and of a profit-and-loss statement from 1900 on.\footnote{ADHGB § 225a, added by Law of June 11, 1870, [1870] BGBl. 375 (Jahres­rechnungen und Bilanzen); HGB §§ 260, 263 (1900).} The French law of 1867 required presentation of a balance sheet and profit-and-loss statement.\footnote{Law of July 24, 1867, art. 34, [1867] D.P. IV. 205 (requiring l'inventaire, le bilan et le compte des profits et des pertes).}

As in other matters, the federal securities legislation made up for lost time by the rigor of its provisions. It required that the statements be deposited for public inspection (whereas foreign laws generally...}
required only submission to auditors and shareholders) and enabled the Commission to issue detailed rules (as it promptly did) on the content and detail of these statements. The rules, contained in regulation S-X, far exceed the strictness of any comparable foreign decree.

D. Proxy Regulation

In 1834, it seemed to Chief Justice Hornblower of New Jersey that when the legislature gave votes to shareholders, it meant for votes to be cast personally, as in a political election. But legislators in New Jersey, and in other states as well, eliminated any doubt on this matter and provided universally for representation at corporate meetings by proxy, with very little limitation on who the proxy holder might be.

Their generosity in permitting shareholders to vote by proxy was not accompanied by any assurance that the shareholders would be informed about the affairs to be voted on. When fundamental changes were to be voted on, shareholders had to be given copies or summaries of the proposal, and in case of special meetings had to be notified of the subjects to be discussed. But there was generally no requirement calling for the distribution of financial information or any other information that would facilitate an intelligent decision, either on the subjects of the meeting or about the solicitor of the proxy. Courts did little or nothing to fill in the silences of the legislators.

This was the situation that made possible the "management control" of which Berle and Means wrote in 1932—three years after the stock market debacle and one year before the Roosevelt New Deal. It is hardly surprising that proxy regulation became one of the major impacts of the Securities Exchange Act of 1934. Basically, the Act authorized the SEC to force each proxy solicitor to disclose to shareholders whatever they ought to know. The Commission promptly

ordered managements to circulate essential facts about the financial affairs of the corporation and about the identity and qualifications of the candidates for directors. Additional information was required when fundamental changes were proposed, and all requirements were fleshed out with detailed schedules.255

The United States system of proxy regulation was not a close copy of anything that had formerly existed elsewhere, although some of its elements had antecedents in English law and practice. Before 1900, Chancery had rules that the notice of meetings laconically required by the Companies Act must disclose essential information, such as conflicting interests of directors.256 In 1929, England introduced the requirement of sending an income statement to the shareholders without waiting for individual requests.257 But a distinguished comparativist writing in 1957 still treated as unique the United States requirements for informing shareholders of the subjects of meetings.258

E. Insider Trading

A fourth impact of securities legislation is in the area of trading by insiders on inside information. This phase of regulation is intended to restrain the temptation that managers have to buy shares when notified of good news before the public, and to sell them when forewarned of bad news. Congress explicitly called for a forfeiture of all short-term gains by insiders;259 the courts added a forfeiture of all gains (short or long term) when the use of inside information could be proved.260

Of all the phases of securities regulation, this is the most distinctively American. Not until the past decade have European countries made a few tentative steps to develop comparable restrictions.261

256. Kaye v. Croydon Tramways Co., [1898] 1 Ch. 358; Tiessen v. Henderson, [1899] 1 Ch. 861. See Baillie v. Oriental Tel. & Elec. Co., [1915] 1 Ch. 503 (1914). In these cases, the court deduced the disclosure requirement from the statutory specification of notice; the court considered that the notice should be sufficiently detailed to enable the shareholder to determine whether he ought to go to the meeting and seek further information, or whether he could safely let the management do as it wished.
257. L. GOWER, supra note 185, at 454. This reflects a broad interpretation of Companies Act of 1929, 19 & 20 Geo. 5, c. 28, §§ 129, 130. The requirement is more explicit in Companies Act of 1948, 11 & 12 Geo. 6, c. 38, §§ 156(1), 158(I).
260. See text accompanying notes 208-23 supra.
261. See authorities cited in note 224 supra.
F. The Multiplicity of Securities Laws

Like corporation codes, securities laws exhibit a high degree of multiplicity, although in a lesser degree. In addition to the federal securities acts, every state but one has its own.262

Luckily, the burden of multiplicity is alleviated in a number of ways. The forty-nine states that have securities acts have only one apiece, in contrast to their two or three corporation codes and the federal government's six securities acts, and a substantial similarity among some of the various state acts has been promoted by the Uniform Securities Act.263 The state acts generally deal with only one of the four aspects of securities regulation mentioned above—that is, with the registration of new securities offerings264—and leave the federal law to speak with one voice on periodic reporting, proxies, and insider trading. A considerable number make the registration procedure very simple in cases where registration has also been effectuated under the federal Securities Act.265 Even so, counsel charged with legalizing a nationwide securities offering must file papers in fifty different offices, check the requirements of fifty different laws, and hazard the administrative delays of fifty different bureaus.266

G. The Obscurity of Securities Laws

A striking characteristic of the securities laws is their obscurity, which takes various forms. One is the occultation of the laws themselves; another is the hiding of their meaning, even after one has discovered the recondite texts; and a third is the SEC's practice of releasing hints that the laws and rules may proscribe much more than they appear to do.

The initial occultation results from the corporation codes, which purport to state the alpha and omega of corporate organization, without so much as a cross-reference to securities laws that deal with the same transactions. For example, the Model Business Corporation Act soothingly assures the reader that shares may be issued for the con-

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262. See 4 L. Loss, SECURITIES REGULATION 2209 (1969). The exception is Delaware.
263. The Commissioners on Uniform State Laws claim 27 adoptions of the Uniform Securities Act, but annotations reveal detailed variations from the original. 7 UNIFORM LAWS ANN. 691-787 (West 1970).
264. They deal with many other matters which I do not consider a part of "corporation law." Among these are remedies for fraud and licensing of securities brokers and dealers. See generally L. Loss & E. Cowett, supra note 9, at 17-21.
265. See Uniform Securities Act § 302 (registration by notification), § 303 (registration by coordination). These sections refer respectively to seasoned securities and to securities registered with the federal commission.
sideration fixed by the board of directors, but fails to note that if the shares are offered to more than a selected few, they must be registered with up to fifty state and federal securities commissions. The Model Act purports to state the requirements of a notice of shareholders' meetings, requiring a disclosure of the place, day, and hour of the meeting and its purposes, but says nothing about the financial statements, the compensation of officers, and the details regarding candidates that are required to be circulated by the federal securities acts. Moreover, the Act states that each corporation shall keep accurate books, but says nothing about the financial statements that must be publicly filed and made available under the federal securities laws. One can hardly find a better example than the state corporation laws of omitting "to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . ." 

The misleading is quite real. When a small company decides to "go public" and consult a securities specialist, it quite frequently discovers that it had been violating securities laws for some time and is obliged to make rescission offers to prior stock purchasers. When the lawyer has been alerted to the existence of securities laws that gainsay the assurances of the corporation codes, his troubles have only begun. Even a very careful and suspicious lawyer could read the Securities Act of 1933 without inferring that a client who had bought controlling shares on the open market could not sell them again in the same way without following certain formalities. He would naturally conclude, even after a minute perusal of the definitions, that his client is "other than an issuer, underwriter or dealer" and thus not restricted by the prohibitions of section 5. But he would be wrong, as Louis Wolfson discovered by spending a term in a federal penitentiary.

In order to grasp the full extent of the securities laws’ sweep, the lawyer would have to consult the regulations of the Commission, which are phrased in this kind of lucidity:

Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operation of Section 16(b) of the Act: Provided, however, That this rule shall not apply to the extent that there shall have been either (1) a purchase of any equity security of the class convertible (including any acquisition of or change in a conversion privilege) and a sale of any equity security of the class issuable upon conversion, or (2) a sale of any equity security of the class convertible and any purchase of any equity security issuable upon conversion, (otherwise than in a transaction involved in such conversion or in a transaction exempted by any other rule under Section 16(b)) within a period of less than six months which includes the date of conversion.275

The problem of SEC obscurity reached such notoriety that the American Law Institute undertook in 1969 to draft a new codification of federal securities laws.276 The task is a Sisyphean one because the norms that the Commission has developed are no less tortuous than the language in which it has encased them. Consequently, it seems almost impossible to simplify the form without first simplifying the substance, but the latter lies in the prerogative of Congress and the Commission.

SEC obscurity also stems from the Commission’s predilection for expanding statutory proscriptions by menacing releases, while avoiding the clarification that would be supplied by a formulated rule. A conspicuous example of this activity occurred in connection with secondary distributions of securities that had been originally issued in private sales. For more than thirty years the Commission followed a policy of issuing imprecise press releases, disciplining brokers, and even launching criminal prosecutions, before attempting to define for its justiciables what they may or may not do.277

The Commission’s problem of obscurity is not easy of solution. Many securities laws experts are inclined (as are experts in other fields) to accept the intricacies of their craft as inseparable from its excellencies. The delightful simplicity of state corporation codes, they say, is due to the fact that the codes are also intolerably permissive. It remains to be seen whether securities regulations can be made limpid without being made limp.

If the American regime of securities regulations is insufferably hypertechnical and burdensome, there is a certain irony in the extent to which the victims of its toils have brought their troubles upon themselves. For nearly a century, businessmen and their leaders have resisted the encroachment of federal legislation, and have carefully preserved a system of permissive corporation codes in the various states. As a price for their fifty permissive corporation systems, they now submit to forty-nine state securities law systems, overlaid with rigorous, duplicative, technical, and burdensome federal securities law. The combined system of corporation and securities laws is probably the strictest in the world, and certainly the most cumbersome.

V. THE SECURITIES TRANSFER LAWS

Still another essential fragment of the law of corporations is the body of rules governing the evidence of ownership of investors’ interests, and the transfer of these interests. Thanks to some curious accidents of history, this fragment is embodied today in article 8 of the Uniform Commercial Code.

One might wonder whether any special law of securities transfer is necessary. Would it not be sufficient to leave these interests to the general principles that govern the transfer of other property of the same general category? This is the solution in Germany where, despite the Teutonic passion for codification, the transfer of shares is governed by the general principles of negotiable instruments (wertpapiere).

278. For example, ALI FEDERAL SECURITIES CODE § 509(a) (Tent. Draft No. 1, 1972) offers the following formulation:

Secondary distributions. (a) Scope of section. When (1) a distribution is solely by or for the account or benefit of a secondary distributor, (2) the issuer is a one-year registrant, and (3) the security was not the subject of a limited offering during the one-year period specified in section 227(b)(2), this section applies, at the election of the secondary distributor, instead of sections 501, 502(a), and 503; and in that event sections 504(c), 505 (except 505(b)), 506 (except 506(a)), and 507 (except 507(a)(2)) apply as if the secondary distributor were the issuer and the distribution statement were an offering statement (including a prospectus).

279. AKTG § 68 (1965). See A. HUECK, RECHT DER WERTPAPIERE 16 (1967); A. HUECK, GESELLSCHAFTSRECHT 129 (15th ed. 1970). England and France, in contrast, have several sections on share transfer, but less detail than the UCC. See Companies Act of
In the United States, legislatures moved more tortuously toward this position. The first provisions on transfer merely repelled the possible inferences that shares were "incorporeal hereditaments" transferable by the rules of real property, or that they were mere "chooses in action" transferable only by the grace of equity. Corporation codes up to the first decade of the twentieth century commonly provided that shares were personal property, and could be transferred on the books of the company.

These provisions proved insufficient. Frequently, share certificates that had been endorsed and sold were reclaimed by their former owners who claimed to have lost them by theft, fraud, or breach of trust. Judges attempted to solve the disputes by applying the principles of apparent agency, estoppel, and indicia of ownership, but never the rules of negotiable instruments. The results were conflicting and often unsatisfactory to the investment professionals.

Since the securities market is highly interstate, no solution under a single state's corporation code would have done much to relieve the uncertainties of brokers and bankers. It was a case for uniformity, and the Commissioners on Uniform State Laws stepped quickly into the breach. In 1909, they promulgated the Uniform Stock Transfer Act, which became one of their most successful projects. In 1950, on the eve of adoption of the UCC, it was one of only two uniform commercial laws that enjoyed nationwide acceptance. Its adoption by over fifty states and territories put it far ahead of the Uniform Sales Act, the Uniform Bills of Lading Act, and the Uniform Warehouse Receipts Act. Its interpretation had occasioned very little difficulty, and no one was demanding major changes in it.


280. Since this was true of advowsons, offices, dignities, and annuities (2 W. Blackstone, Commentaries *2-43), it was not an inherently improbable status for shares—especially if the principal property of the corporation was a mill, a turnpike, or a bridge. The English act also repels the possibility of shares being regarded as real property. Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 75.


285. Some minor changes were needed with regard to transfers of stock held in decedents' and trust estates. See Conard, Simplifying Securities Transfers, 30 Rocky Mt.
However, the Commissioners became involved in the 1940's in rewriting the Uniform Negotiable Instruments Act. One of its difficulties was that its definition of "negotiable instrument" was broad enough to include some corporate bonds, but not broad enough to include all.\textsuperscript{286} Negotiability was deemed desirable for all bonds, but many other provisions appropriate to bills, notes, and checks (then called "negotiable instruments" and now called "commercial paper") were inappropriate for or inapplicable to corporate bonds. For example, it would be outrageous to presume that someone who had written his name on the back of the bond meant to guarantee the payment of the principal.\textsuperscript{287} It would also be farfetched to say that negotiation of a bond after it was due gave notice of equitable defenses.\textsuperscript{288} Consequently, it was important to exclude bonds from the article on commercial paper, then being prepared for the new Uniform Commercial Code.\textsuperscript{289}

The Commissioners believed that if bonds were to be excluded from the law on commercial paper, they must be tucked into some other bed and not left out in the cold world of the common law. A logical refuge, in view of the similarities between stocks and bonds, was the Uniform Stock Transfer Act, and the Commissioners undertook to rewrite the Uniform Stock Transfer Act to include bonds as well as shares.\textsuperscript{290} As a matter of legislative packaging, it also seemed convenient to put the new stock-and-bond transfer act into the Uniform Commercial Code. Through this train of accidents the law governing transfer of stock—although functionally closer to corporation acts and securities acts—found itself a bedfellow to those laws regulating sales, checks, bills of lading, and chattel credit.

Article 8 was drafted under considerable difficulties. It was an afterthought, and the drafting committee included no one who had previously written on securities transfer.\textsuperscript{291} To aggravate their handicap, the Commissioners were not even consulted.
cap, the draftsmen cast aside the tested model of the Uniform Stock Transfer Act and adopted new modes of expression based on the negotiable instruments article of the Code.292 Apparently, they thought that shares of stock, like negotiable instruments, have no existence apart from the paper evidencing them, and forgot that shares may exist, and are even required to exist, without certificates.293 Under the "final draft" of 1952, which the Pennsylvania legislature credulously adopted by unanimous vote,294 stock in the name of a decedent could not be transferred at all, since a transfer could be signed only by the owner named in the instrument.295

Thanks to criticisms offered by the New York Law Revision Commission296 and many others, article 8 was remolded into tolerable form,297 and has now been adopted (like the rest of the UCC) in all closely held corporations: planning and drafting, 65 Harv. L. Rev. 773 (1952); B.F. Cataldo, author of stock transfer restrictions and the closed corporations, 37 Va. L. Rev. 229 (1951); Berto Rogers and Carter Chinnis, authors of stock transfer under the uniform fiduciaries act and nominee statutes, 7 Wash. & Lee L. Rev. 150 (1950); and Frank L. Dewey, author of transfer agent's dilemma—conflicting claims to shares of stock, 52 Harv. L. Rev. 553 (1939).

292. Section 1 of the Uniform Stock Transfer Act distinguished between the "certificate" (a piece of paper) and the "share" (a bundle of proprietary rights), and stated explicitly that the share as well as the certificate pass by a proper transfer. Similar terminology is used in the English Companies Act of 1948 with respect to shares and debentures alike (11 & 12 Geo. 6, c. 38, §§ 80-81).

In contrast, article 8 employs the term "security" ambiguously. Although section 8-102 defines "security" as the paper, section 8-301 on transfer must be construed to include the rights as well; otherwise the Code remains silent on the transfer of the shares and obligations, while promulgating insignificant rules on the transfer of paper.

Article 8 also declares that securities "are negotiable instruments" (section 8-105(1)). However, the purpose of this declaration is not disclosed, for the term "negotiable instruments" is not used elsewhere in the article, and securities are expressly excluded from article 3 (section 3-103), which governs traditional "negotiable instruments." Perhaps it is to be read as a sort of credo, announcing allegiance to the basic identity of investment securities and banking documents.

293. The widely copied Model Business Corporation Act specifically forbids the issuance of certificates for shares which are not fully paid for, while implying recognizing that such shares may exist and be voted. ABA-ALI Model Bus. Corp. Act § 17 (calls for payments on shares); § 23 (no certificate issued for shares until fully paid) (1969).


295. Uniform Commercial Code § 8-308 (Official Draft 1952): "An indorsement of a security in registered form is made when the person specified by the terms of the instrument . . . to be entitled to the security signs . . . ." This was later amended to list other persons (including an executor, administrator, guardian, etc.) who could indorse. The draftsmen would have been alerted to this problem if they had consulted the English Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 76. Section 2 of the Uniform Stock Transfer Act had expressly mentioned executors and other personal representatives with an implication of authority to indorse.

296. 2 N.Y. Law Revision Commission, Report 1877-2004 (1953) (comments); N.Y.


297. See Uniform Commercial Code (Official Text 1988). There remain sections
states but Louisiana. It does the job of providing a uniform, readable, and readily available code of transfer, applicable equally to bonds and to shares of capital stock.

VI. THE ANTITRUST LAWS

One usually thinks of antitrust laws as dealing with practices or agreements that directly affect prices. Illustrations run from the agreements of railroads to fix freight rates298 to a manufacturer's "franchising" system that restricts the sales territories of distributors.299 Although these laws apply more often to corporations than to anyone else, they are not in any sense "corporation laws."

But there is another branch of the antitrust laws that deals directly with corporate structure, through provisions on trusts, stock holdings, and mergers. In these areas, the antitrust laws virtually contradict the corporation codes.

The corporation codes, for example, provide that groups of shareholders may transfer their shares to trustees, who will vote them on behalf of the shareholders, and receive trust certificates in exchange for their stock.300 But the Sherman Antitrust Act makes such an arrangement illegal if shares of competing corporations are placed in the same trust with a view to reducing competition.301 While modern corporation laws provide without qualification that a corporation may hold shares in other corporations,302 the antitrust laws declare that such a purchase of securities is unlawful if it may tend to injure competition.303 And even though modern corporation laws provide that a company may sell its entire assets to another, or merge with another, on obtaining the requisite number of favorable.

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votes from its shareholders and filing the proper papers, one relying on this authorization might find his transaction illegal if the merger he had effectuated would tend to lessen competition in interstate commerce.

As a matter of history, the "trust" in a formal sense does not seem to have been a widely used method of restraining trade or creating monopoly either before or after enactment of the Sherman Antitrust Act. However, it was employed from 1882 to 1892 by Standard Oil—the most notorious of the industrial monsters of the later nineteenth century—and so became a nickname for business combinations of all shapes. Reflecting this popular usage, and with the Standard Oil instance clearly in mind, Congress in the Sherman Act of 1890 denounced "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade," and the term "antitrust" became firmly attached to American rules in defense of competition.

For the next twenty-four years, the path of corporate empire was characterized by holding companies, rather than by associations or trusts. Standard's quick switch from trust to holding company did not save it from conviction and dismemberment, but the opinion condemning Standard indicated that a holding company of competitors would not be a per se violation in the absence of the high degree of domination and the history of price-fixing that characterized Standard.

Congressmen—or a majority of them—concluded that a more positive prohibition of holding company structures that would restrain competition should be enacted. In 1914—three years after the Standard Oil Co. decision—Congress, through the Clayton Act, forbade the acquisition of stock in other corporations where the effect

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306. Standard Oil was first organized as a trade association in 1874, and converted to a formal trust in 1882. See generally 1 A. NEVINS, JOHN D. ROCKEFELLER 603 (1940); 2 id., at 140; 2 I. TARBELL, THE HISTORY OF THE STANDARD OIL Co. 364 (1904); Larson, supra note 301.
309. See authorities cited in note 306 supra.
310. Standard Oil Co. v. United States, 221 U.S. 1, 75 (1911).
From 1914 on, the preferred method of combining enterprises was not to form holding companies, as had been done by Standard Oil of New Jersey, but to purchase assets, or to "merge." General Motors, which had purchased stock in Buick and Cadillac in 1908 and 1909, purchased assets of Chevrolet and United Motors in 1916 and 1918. American corporation codes sprouted detailed provisions for "merger and consolidation" and "sale of assets," which had no parallel in foreign legislation.

It was 1950 before Congress again found itself in the mood to restrain the buildup of corporate giants, although it was an open secret that the Clayton Act was being evaded by mergers and consolidations. In the course of the Truman "Fair Deal," Senator Kefauver and Congressman Celler teamed up to push through the "Celler-Kefauver bill," which forbade acquisitions of assets that might impair competition. Since 1950, corporate amalgamators have increasingly shunned combinations in the same line of business and have turned their ingenuity toward the "conglomerate merger," thus giving birth to a whole new line of thinking about "any line of commerce in any section of the country.

As with the securities laws, the corporate structure provisions of the antitrust laws are hidden far from the habitual paths of a corporation lawyer. Like many other provisions of federal law, they seem better designed to trap the unwary than to forewarn the dissuadable malefactor.

No other nation has adopted anything very close to the structural provisions of the United States antitrust laws. Many of them encouraged, rather than discouraged, restraints on competition until

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312. L. Seltzer, A Financial History of the American Automobile Industry 151-58 (1928). However, instances of stock purchase continued. General Motors bought Fisher Body shares, and Chevrolet bought controlling shares of General Motors shortly before General Motors bought Chevrolet's assets and dissolved the company (id. at 180-81). Moreover, du Pont bought shares of General Motors (id. at 190-91); this was found four decades later to have been a Clayton Act violation (United States v. E.I. du Pont de Nemours Co., 353 U.S. 586 (1957)).

313. Before adoption of the business associations law of 1966, the French corporation law had no explicit provisions on merger or sales of assets. See Conard, Corporate Fusion in the Common Market, 14 AM. J. COMP. L. 573, 584 (1966).


quite recently. Since 1957, there has been a sudden surge of interest in antitrust laws in the countries of Western Europe, because of a general inhibition on restraints in trade in the Treaty of Rome, which established the European Economic Community. But there is no such inhibition on acquisitions or mergers. The most the Treaty does in this direction is to prohibit enterprises from taking "improper advantage of a dominant position." Apparently, the Common Market Commission intends to interpret this clause in a way that would inhibit the formation of a monopoly, but this does not come close to the American prohibitions.

VII. Tax Laws

Whatever taxes touch, they in some measure deform or reform. Thus, family exemptions become a factor encouraging the growth of families, and the absence of such exemptions becomes a penalty on raising families. However, among the myriad tax provisions affecting human behavior, one can distinguish those that are relatively neutral from those that, by accident or design, strongly impel a specific course of conduct. I will mention some of the provisions of tax law that have a conspicuously coercive effect on corporation procedures.

A. Stock Option Rules

Foremost among the tax rules that shape corporate operations are those relating to "employee stock options." When legislative approval was awarded to employee stock option plans in 1950, tax rates for ordinary income ranged up to eighty-seven per cent, but stock option income would incur a maximum rate of only thirty per cent. These facts alone would have made stock options alluring.
Yet, they had the additional nontax attraction—probably not recognized by the enacting Congress—that the amount of income derived need never be reported to shareholders, or even be estimated. The shareholders would be told how many shares were under option, and at what prices, but were never specifically informed of the gains that the beneficiaries actually realized. \(^{324}\)

By the early 1970's, the attractiveness of stock options relative to other forms of compensation had been reduced. Maximum tax rates on the salaries and bonuses of executives had dropped to fifty per cent, \(^{325}\) and taxes on capital gains from stock options could rise as high as thirty-five per cent. \(^{326}\) But it was still a preferential way of obtaining income. \(^{327}\) and still escaped a disclosure of the amount of enrichment realized.

The stock options provisions are a striking example of laws whose primary result was to mold corporate procedures. They provided an almost irresistible impulse to turn part of executive compensation from cash into investment opportunities, and thereby to conceal from shareholders the amounts by which executives are enriched. These results did not flow from the application to corporation executives of tax rules that applied equally to others; on the contrary, they flowed from a special set of rules applicable only to this special set of people. \(^{328}\)

The specialness of the legislation was emphasized by several provisions that have no relevance to revenue considerations, but were

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\(^{324}\) Since the principal benefit of stock options comes from price appreciation, it never appears in the company accounts as an expense, although it represents a lost opportunity for gain to the corporation. For an analysis of this problem, see D. Sweeney, Accounting for Stock Options, Michigan Business Studies, vol. 14, no. 5 (1960).


\(^{326}\) The computations to reach this result are rather complex, so the following description is simplified. In 1969 the maximum rates on ordinary income were reduced to 70 per cent. Act of Dec. 30, 1969, Pub. L. No. 91-172, tit. VIII, § 803(a), 83 Stat. 678, amending Int. Rev. Code of 1954, § 1. The allowance for a deduction of one half of long-term capital gains remained unamended. Int. Rev. Code of 1954, § 1292. However, the alternative tax, which had previously imposed a maximum rate of 25 per cent on long-term capital gains, was amended to become inapplicable by 1972 when long-term capital gains exceeded 50,000 dollars. The maximum rate of 70 per cent combined with the one-half deduction allows for an effective maximum rate of 35 per cent on long-term capital gains. Act of Dec. 30, 1969, Pub. L. No. 91-172, tit. V, § 511(b), 83 Stat. 635, amending Int. Rev. Code of 1954, § 1201.

\(^{327}\) For a thumbnail sketch of the tax workings of stock options, see H. Henn, supra note 58, § 248; 2 C. Washington & V. Rothschild, Compensating the Corporate Executive 599-612 (3d ed. 1962).

\(^{328}\) It has been argued that stock options were necessary to equalize executives with shareholders, who enjoy capital gains treatment. But shareholders do not have options to buy stock at the market price of one to five years earlier.
obviously designed to protect shareholders' interests. For example, to receive the Code's blessing, a stock option plan must have the approval of shareholders and must be exercised while the beneficiary is working for the corporation, or within three months thereafter.329

B. Pass-Through Tax Regime

Another segment of the Internal Revenue Code exerting a direct and deliberate influence on corporate behavior is subchapter S,331 which permits "certain small business corporations" to elect a favored tax status. An enterprise that conforms to these prescriptions may attribute its earnings (for tax purposes) directly to the shareholders, and escape the separate tax on corporate income.332 The profits are treated as "passing through" the corporation to the shareholders, whether or not they are actually distributed. In order to receive these benefits, the corporation must (1) restrict its shareholders to ten persons or less, (2) restrict its capital shares to a single class, and (3) exclude corporations, business associations, trusts, estates, and non-resident aliens from shareholding.333

The apparent purpose of subchapter S is to achieve, in a limited sector, tax neutrality between the corporate and the partnership forms of organization—to let a closely held enterprise decide between partnership and corporate form without regard to the impact of federal tax law.334 The limits on membership are presumably designed to prevent the hiding of profits among shareholders too numerous to trace easily, or to confine subchapter S to enterprises that have a real potential for operating as partnerships. However, if an enterprise once succumbs to the attractions of subchapter S, its structural mobility is restricted severely,335 and far beyond any realistic criterion of susceptibility to tax evasion. In particular, the limitation to ten shareholders inhibits the normal dispersion of shares among employees and among children and grandchildren of the founders. Moreover, some

of the principal modes of financing small businesses—through blocks of common or preferred stock sold to investment companies—are cut off.\footnote{335}

Fortunately, these restrictive consequences are suffered by only a small percentage of the corporations that are invited to incur them. There are about 1.33 million corporations with no more than ten shareholders,\footnote{337} but only about 200,000 choose to report their taxable incomes under subchapter S.\footnote{338} The others may well be deterred not only by the inconveniences mentioned, but also by some special tax exposures of subchapter S corporations, and, above all, by the mere complications of maintaining eligibility and filing returns under these provisions.\footnote{339}

\textbf{C. Tax-Free Reorganizations}

A third area in which the Internal Revenue Code imposes detailed rules of procedure on corporations is the one defining tax-free reorganizations. Under general principles of taxation, the exchange of one kind of property for another is a taxable event. This principle, if left to run its course, would have a dampening effect on the agglomerative growth of corporations, or drive them to seek subterfuges such as the management-sharing and profit-splitting arrangements common in Germany.\footnote{340} Taking a favorable view of corporate agglomeration, the lawmakers have provided a set of formulas designed to comprise nearly every legitimate need of reorganization.

Although these provisions are tolerant in the sense that they permit amalgamation in a wide variety of circumstances, they are meticulous in forcing reorganizations into specific formulas. For example, if corporation X, which has voting and nonvoting stock outstanding, wants to absorb corporation Y, which also has voting and nonvoting stock, X might reasonably offer to exchange voting shares in X for voting shares in Y, and nonvoting shares in X for nonvoting shares in Y. But this would miss the definition of a class B reorganiza-

\footnote{337. This estimate is based on a pilot survey by the author that is to be published elsewhere.}
\footnote{339. F. O'Neal, supra note 335, § 2.04b.}
the lawyers must restructure the plan so that only voting shares of X are exchanged. Alternatively, X might reasonably offer its two classes of stock for assets instead of stock, but this would miss qualification as a tax-free reorganization unless eighty per cent of the property received was exchanged for voting stock. Through these measures, the Treasury exerts the weight of its taxing power on the corporation's choice of investment media.

Besides forcing reorganizations into particular molds, these tax provisions impel small corporation owners to amalgamate their businesses with those of others, rather than selling out for cash, which would trigger large, immediate tax liabilities. In this way, it favors the snowballing of bigger and bigger enterprises, in preference to selling small enterprises in their existing dimensions.

D. Other Income Tax Rules Affecting Corporate Structure

Aside from the tax provisions mentioned above, which specify in detail how a corporation shall behave, there are many other provisions of the federal income tax law that are stated in more general terms but have powerful effects on corporate behavior and structure. Foremost, perhaps, is the deduction of interest payments, which rewards corporations for financing with debt capital instead of equity capital. This feature turns principles of prudent management upside down, inducing "thin incorporation" far beyond the limits commended by the advantages of "trading on the equity."

Close behind the interest deduction is the indulgent taxation of capital gains, which rewards shareholders for keeping profits in the corporation (so as to enhance the value of the shares, which may be sold for capital gains), and discourages distributions to the shareholders (in whose hands they would be taxed at ordinary income rates).

During the 1940's and 1950's, the maximum tax rate on ordinary income was more than three times the rate on capital gains. As a result, taxation, rather than the relative utility of funds to the company or its shareholders, tended to dominate dividend policy. During the 1960's, the gap was narrowed by reductions in ordinary income.

346. See notes 321-26 supra and accompanying text.
rates, and by increases in capital gains rates; recent political declamations concerning tax reform indicate that the narrowing of the gap is likely to continue. Consequently, tax favoritism to capital gains is a diminishing factor in corporate financial policy.

A third feature of taxation that molds corporate behavior is the relationship between corporate and individual income taxes. Under the American system of "double taxation," corporate income is taxed to the corporation, and dividends are taxed to the shareholders without any allowance for the tax already paid by the corporation. This presents a contrast with the French system, in which the tax paid by the corporation is treated as a "prepayment" of the shareholder's tax on dividend income.

One effect of the American system is to create a powerful impulse to draw money out of the corporation by salaries (which reduce the corporation tax) rather than by dividends. It also creates an impulse for corporations to reinvest their own profits, rather than to distribute them to shareholders for reinvestment.

The result of these impacts of federal tax law (reinforced by many others) is that nearly every step of corporate organization and finance is influenced primarily by tax considerations, and secondarily by market considerations. Accordingly, the corporate planner must move not merely with the corporation code in one hand and the securities laws in the other, but with the Internal Revenue Code and regulations within easy reach. From this challenging situation no country is completely free, but there are some that have made greater efforts to achieve tax neutrality.

E. Capital Stock Taxes

Another set of taxes that exert a persuasive influence on the structure of some corporations are the state taxes on authorization, issuance, and transfer of capital stock. Illustrative is the Delaware tax on authorized capital, payable when the corporation is first organized, and at each later date when the capital is increased. This tax is not

347. The maximum rate on personal income dropped from 88 per cent in 1963 to 70 per cent in 1965 and later years, with proportionate reductions at all levels. For a summary, see CCH 1973 STAND. FED. TAX REP. ¶¶ 152-53A.

348. See note 326 supra.


related in any way to actual value or sales price of the shares; when shares have par value, it is based simply on the aggregate par value. When they have no-par value, it is based simply on number of shares. The tax is slightly lower on no-par shares than on one-hundred-dollar par shares, but much lower if ten-dollar par or one-dollar par shares are used. The comparative tax burdens are as follows:

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<tr>
<td>100,000,000 shares of no-par value</td>
<td>$201,050</td>
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</tbody>
</table>

Taxes under this plan, which may be found in several other states,\(^{351}\) have an obvious tendency to favor the use of low-par value shares, but the weight of their impact on selection of par values is difficult to assess. Certainly the use of low-par stock is the prevailing practice today, but there is at least one other factor impelling corporations in the same direction—the fact that an automatic “surplus” appears on the company accounts when par values are below the price of issue.\(^{352}\) Most corporations refrain from fixing par values at one tenth or one one-hundredth of a cent,\(^{353}\) which they might well do if tax-saving were their sole motivation.

**VIII. Stock Exchange Requirements**

**A. Are They Laws?**

On the fringe of norms that can be called “laws of corporations” are the requirements of structure and practice imposed by stock exchanges. The best known of these requirements are those promulgated by the New York Stock Exchange (NYSE) and published in its *Company Manual*,\(^{354}\) which explain what a company must do and be to obtain listing on the Exchange and to avoid delisting.

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\(^{353}\) This is a casual observation, based on examining numerous corporation reports without tallying numbers on this point.

\(^{354}\) NYSE Company Manual, supra note 155. The Manual consists of principles that are not phrased as commands, but as policies embodied in the “listing agreement” to which the issuers of listed securities must subscribe. The Company Manual should be distinguished from the Rules of the New York Stock Exchange that govern conduct of the member brokers, rather than of the companies listed.
Stock exchange requirements are not "laws" in the formal sense of enactments of the legislature. They are, nevertheless, rules of uniform application to a broad category of companies. Several of the rules involve the structure of the company in such a way that lawyers must think of them long before they seek exchange listing. If they are not "laws," they are at least rules that a company founder ought to think about at the same time he is thinking about statutory provisions.855

Requirements of the NYSE comprised in the Company Manual may be divided roughly between those regulating a company’s relationship with the Exchange as an institution and those governing its relationship with its shareholders. The former are not “laws of corporations” in the sense in which I use the term; an instance is the requirement of direct notification to the NYSE in regard to financial events.856 But the rules governing the relationship of shareholders with their corporations deal with exactly the type of questions that corporation codes normally govern. Among the most obvious examples are rules requiring that common shareholders have full voting rights and that preferred shareholders have voting rights on default of dividends; and rules concerning notices of shareholders’ meetings, notices of redemptions, and notices of rights to subscribe; and rules regulating accounting for stock dividends.857 A considerable number of these rules duplicate or reinforce the rules and regulations imposed by the Securities and Exchange Commission.858 Others go beyond them.859

855. Although exchange rules apply only to companies that have voluntarily listed their securities on exchanges, this limitation does not distinguish them from true “laws.” From 1934 until 1964, the principal rules of the Securities Exchange Act of 1934 applied only to listed companies. See Act of Aug. 20, 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 566, adding Securities Exchange Act of 1934, § 12(g), 15 U.S.C. § 78l(g) (1970).

856. NYSE COMPANY MANUAL, supra note 155, § A6.


858. See, e.g., NYSE COMPANY MANUAL, supra note 155, § A4, at A-64 to 69; Securities Exchange Act of 1934, rule 14a-3, 17 C.F.R. § 240.14a-3 (1972) (both require submission of annual reports to shareholders).

859. The requirements on voting rights furnish the best example. See note 360 infra and accompanying text.
B. Voting Rights

Among the most law-like provisions of the NYSE company laws are those that relate to the voting rights of shareholders. These require that common shares listed on the Exchange have full voting rights; listed preferred shares have rights to vote in case of default in dividends; shares not be burdened with a voting trust or irrevocable proxy; and stockholders be permitted to vote on acquisitions of property that involve an increase of twenty per cent of the outstanding shares. 860

Because of these rules the generous state corporation code provisions, which permit issuance of shares of any class with or without voting rights, 861 are something of a snare and a delusion. When a company seeks to register its nonvoting shares on the Exchange, they will have to be given voting rights, and this will probably require compensating the shares that already have voting privileges for their “loss of control.” 862

The provision requiring shareholder approval of a twenty per cent or greater stock increase in exchange for assets is a particularly interesting qualification of the freedom of American corporation codes. France requires an exchange of shares for property specifically to be approved by the shareholders, 863 and Germany by the supervisory council, 864 but typical United States laws permit stock to be issued for property on the mere decision of the board of directors. 865 As a result, companies can acquire assets that may greatly alter the character of the company without any consultation of the shareholders. 866 The NYSE policy has the effect of negating this freedom.

360. NYSE COMPANY MANUAL, supra note 155, § A15, at A-280 to 85.
362. See Honigman v. Green Giant Co., 309 F.2d 607 (8th Cir. 1962), cert. denied, 372 U.S. 941 (1963), in which voting shares received a stock dividend of approximately 9300 per cent in exchange for sharing their voting power with common shareholders.
364. AKTG § 205 (1965).
366. See Hariton v. Arco Electronics, 40 Del. Ch. 326, 183 A.2d 82 (Ch. 1962), aff'd., 41 Del. Ch. 74, 188 A.2d 123 (Sup. Ct. 1963). Although the objections in this case were to the company’s selling its assets, the reasoning is equally applicable to the company’s purchasing. Purchases without consulting shareholders have, however, been enjoined where the stock to be issued would increase the outstanding shares by more than 100 per cent. In such cases, sometimes called “upside-down transactions,” the company that is nominally “acquiring” another is more realistically being acquired
with regard to companies subject to its rules. They have to obtain their shareholders' consent when effectuating an acquisition that amounts to a fifth or more of their capital.

C. Share Certificates, Their Issue and Transfer

Other law-like provisions in the Company Manual relate to the issuance and transfer of share certificates; they are the only visible rubric for practices that are religiously observed by major corporations. The corporate codes say nothing about the form of stock certificates or how they are transferred. In contrast, the NYSE requires that certificates be printed from engraved steel plates, with a pictorial vignette embodying a human figure; for the registration and transfer of these certificates, there must be a transfer office and an independent registrar, located in the financial district of New York. The practices imposed by the Exchange have become a standard of conduct for nearly all publicly held companies.

D. Other Exchanges and Over-the-Counter Securities

Exchanges other than the NYSE do not publish company manuals, and one cannot speak so authoritatively of what they require. However, they all have listing officials who impose on listed companies the requirements of company practice that they think are suitable. In general, these conform to the standards of the NYSE. By this means, the requirements contained in the NYSE Company Manual have become a code of practice for all listed companies.

With regard to companies whose shares are traded “over-the-counter,” the picture is more mixed. The larger of these companies generally comply with the standards that the NYSE has set up. But there is infinite variation. There occasionally appear on the over-the-counter market companies with no standards at all, and even a dubious existence.

by the other’s shareholders. For examples, see Rath v. Rath Packing Co., 257 Iowa 1277, 136 N.W.2d 410 (1965); Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25 (1958).

367. E.g., DEL. CODE ANN. tit. 8, § 158 (Supp. 1968); ABA-ALI MODEL BUS. CORP. ACT § 23 (1969).

368. NYSE COMPANY MANUAL, supra note 155, § A12(II), at A-219 to 20.

369. Id. at A-1 at A-3 to -7.

370. SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKET 603-04 (1967).
IX. GENERALLY ACCEPTED PRINCIPLES OF ACCOUNTING

Many accounting principles are not so much matters of corporation law as of corporation housekeeping. Accounts should be kept accurately and balanced regularly in order that a corporation may know how its business is progressing, and whether funds are leaking away. But these are rules for its own guidance rather than imperatives affecting its relationships with the government or with investors and customers.

There are other accounting principles—particularly those pertaining to financial statements—which have a great deal of legal force behind them. These principles are not concerned merely with recording correct figures; rather, they determine, for instance, whether assets acquired in exchange for shares should be entered on the balance sheet at their existing book values, or at new values that reflect the value of the stock exchanged for them. The larger of these figures will result in higher depreciation charges, possibly wiping out profits and making dividend payment illegal. If the wrong figures are entered, officials may become liable to buyers of the company's securities for vast amounts.

Because of the liabilities imposed on corporations and their officials for misleading financial statements, the principles that determine what forms of statement are permissible are just as coercive of human conduct as the rules defining larceny. They are, however, somewhat harder to find. Nowhere does the law expressly identify these principles, or say who has authority to announce them. But the Securities and Exchange Commission in 1938 furnished some guidance in this area when it declared,

[W]here financial statements filed with this Commission . . . are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate . . .

In response to this often echoed and generally accepted view, corporations and their accountants are in a tireless search for “generally accepted accounting principles”—a phrase that has become a term of art.

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372. See Accounting Principles Board, American Institute of Certified Public Accountants (APB, AICPA), Business Combinations (1970) (APB Opinion No. 16); Watt, Pooling of Interest Concept Validated, 26 Bus. Law. 215 (1970); Schapiro, Comment, id. at 285; Bilyou, Pooling—Excesses and Solutions, id. at 297.


Before the SEC spoke, the American Institute of Certified Public Accountants (AICPA) was already seeking to distill a consensus on points not covered or not agreed on in the standard texts and handbooks of accountancy. It had begun in 1932 its Accounting Research Bulletins, which continued until they were succeeded in 1962 by the current series, called Opinions of the Accounting Principles Board.

By 1965, the bulletins and opinions had dealt with many of the especially troublesome problems of accounting, but they still fell short of being an accounting bible. They lacked specificity in some areas, they failed to articulate many basic assumptions, and they lacked transitional comment to knit the opinions together. To fill these voids, the AICPA in 1965 issued its Inventory of Generally Accepted Accounting Principles. This document and the Accounting Principles Board (APB) opinions that supplement it are generally followed by corporation lawyers with the same respect (and sometimes the same reluctance) as regulations of the SEC. After the appearance of three opinions bearing heavily on some of the accounting practices that had favored conglomerate takeovers, financiers were heard to say that the accountants had “closed the door” on further mergers. The true influence of these opinions is difficult to weigh because their appearance was concurrent with a general deflation of stock market prices and the Tax Reform Act of 1969, and followed upon some pronouncements against conglomerate mergers by the Antitrust Division and by the Supreme Court.

Perhaps the fairest statement of the weight of the APB opinions is that they operate as presumptions. The SEC and most courts may be expected to assume, until it is proved otherwise, that financial statements in accordance with APB principles are accurate and in-

375. AICPA, Accounting Research Bulletins, Nos. 1-53 (1939-1961). Numbers 1-42 of this series were consolidated and restated by No. 43 (1959). In 1961, No. 43 was reprinted with the rest of the series (Nos. 44-51) and certain other items as Accounting Research and Terminology Bulletins.

376. To date, 22 opinions have been issued by the Accounting Principles Board.

377. P. Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises (1965) (AICPA Accounting Research Study No. 7).

378. The inventory, the opinions, and related documents are conveniently assembled in a CCH looseleaf service entitled APB Accounting Principles.


formative, and that statements in discord are inaccurate and misleading.

This state of affairs is unsatisfactory in various ways. For one, businessmen cannot be quite sure whether adherence to the APB opinions will in the end be held sufficient, or whether the SEC and the courts will impose different standards. For another, government and private representatives are not quite sure that accountants—who compose the Accounting Principles Board—are free from biases resulting from their own professional interests, or from the interests of the corporation officers who are their principal clients. The Institute recognized these problems (and others), and appointed a special committee to report on how and by whom accounting principles should be established. In March 1972, it produced a thoughtful report that proposed the creation of a Financial Accounting Standards Board of full-time, salaried members, only part of whom need be accountants. Their study and proposal seem certain to provoke further evolution in the development of the laws of corporations governing financial disclosures.

X. THE ROAD AHEAD FOR THE LAWS OF CORPORATIONS

Few, if any, lawyers could sincerely deny that the laws of corporations are a maze of meaningless multiplicity, teeming with contradictions and conflicts. But many can be found to deny that there is any exit from the maze.

The most obvious problem is the multiplicity of divergent state corporation code provisions, but this is only one of many. There is also the diversity of state judge-made laws, and the diversity of blue sky laws. The interlock and overlap between corporation codes, judge-made laws, securities laws, antitrust laws, and tax laws are additional sources of confusion.

There are also problems involving the quality of these laws. With respect to the state corporation codes, there is the notorious permissiveness. With respect to the federal securities laws, there is the abstruseness of their formulation plus the Commission's practice of extending their scope by menacing releases. With respect to the antitrust laws, there is the restless movement of meaning that results

382. AICPA, ESTABLISHING FINANCIAL ACCOUNTING STANDARDS: REPORT OF THE STUDY ON ESTABLISHMENT OF ACCOUNTING PRINCIPLES (1972). This is sometimes known as the "Wheat Report" after its chairman, but must be distinguished from another famous "Wheat Report" that is more properly designated as SECURITIES AND EXCHANGE COMMISSION, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (1969).
from the courts' acceptance of the shifting policies of the Antitrust Division.

A. Federalization?

The favorite remedy of reformers for the past seventy years has been a federal corporation code. There can be little doubt that this is a necessary step in any fundamental simplification of the corporation regime. But the job is an incredibly complex one. If the process of incorporation were summarily removed from the jurisdiction of the states, an important source of revenue and means of employment would be subtracted from the statehouses; some compensatory arrangement would have to be worked out. In any realistic view, the federal regime would be limited to some classification of large interstate corporations, perhaps those now registered under section 12 of the Securities Exchange Act of 1934.

Moreover, the simplification would be somewhat illusory unless those securities law sections that govern corporation practice were integrated with the corporation codes. This would mean breaking up the Securities Exchange Act to separate the parts regulating corporate conduct from those that regulate brokers, dealers, exchanges, and the Commission itself. And there would be no simplification at all if the SEC proceeded to issue obscure releases and unintelligible regulations over the whole area of corporation law.

The most likely line of progress seems to lie through the path, recently opened by the American Law Institute, which involves combining and recodifying the Securities Act of 1933 and the Securities Exchange Act of 1934. This effort will probably involve stating in plain English some of the rules that the Commission has had to conjure up out of implication and threats.

By the time the recodification is completed, or soon after, there will probably be further extensions of the federal securities legislation into matters of corporate governance. The board of directors is due for some remodeling by way of greater assurances of independence, representation of laborers and consumers, restrictions on


385. See note 276 supra and accompanying text.
indemnification and insurance, and limitations of individual liability, or some combination of these.\textsuperscript{386}

After federal penetration of corporate governance has proceeded so far and the SEC has demonstrated a new talent for lucidity, there will no longer be any reason for the business community to resist federalization of the laws of large corporations. In fact, the business community may come to welcome federalization if it frees them from some of the burdens of gaining admittance to each of the fifty states in which its salesmen set foot, or to which its goods are shipped.

If a federal corporation code is adopted, it should not only incorporate the applicable provisions of securities laws, but also the appropriate provisions of antitrust law relative to trusts, stockholdings, and mergers, and some of the details of tax law relative to voting on executive compensation and the use of voting stock in mergers. It should surely codify the principles of fiduciary duty, which courts generally avow and which state codes so often pretermit. It could easily embody a streamlined version of the law of securities transfer.

\textbf{B. Uniformity?}

An alternative escape from the swamp of laws of corporations might lie through uniformity of state laws. An intriguing model for this solution is supplied by the experience of the European Economic Community, where countries with far greater cultural differences have launched on a program of “equivalent safeguards” for corporate investors and creditors in all corners of the Community.\textsuperscript{387}

The basis for this movement is found in a chapter of the Treaty of Rome (the Communities’ equivalent of a constitution) which enunciates the freedom of citizens of any Communities state to travel, reside, and do business in any other state.\textsuperscript{388} This freedom, known in treaty parlance as the “right of establishment,” is similar to that conferred by the privileges and immunities clause of the United States Constitution, except that, unlike the latter, it includes

\textsuperscript{386} See generally Moscow, The Independent Director, 28 Bus. Law. 9 (1972); Symposium, Officers’ and Directors’ Responsibilities and Liabilities, 27 Bus. Law., Feb. 1972 (special issue), at 1, esp. 165-78.

\textsuperscript{387} For a general view, see E. Stein, Harmonization of European Company Laws 5-22 (1971).

\textsuperscript{388} Treaty Establishing the European Economic Community, March 25, 1957, arts. 52-58, 298 U.N.T.S. 37.
corporations within its cloak of protection. With respect to corporations, the Treaty authorizes the Communities' government to make the safeguards equivalent in all the member states by coordinating the safeguards required of companies for the benefit of investors and creditors.

The government of the Communities has proceeded by a unique legal device, the "directive." This is an order to the various member states to alter their national legislation to meet standards established by the Communities. The directives are binding on the member states, but the practice to date has not required active enforcement. Each directive has been first proposed by the Commission to the Council; it has then lain dormant for several years, awaiting Council action. During this period, the member states amend their laws in appropriate ways, so that when the Council makes the directive effective, each state will already be in compliance. So far, only one directive on company law has reached the effective stage.

Starting with very minimal safeguards, the successive directives have now broadened out to cover virtually all the key points of company law. The first sought only to facilitate the enforcement of corporate contracts by regulating the public filing of documents regarding corporations and their officers, defining the authority of officers, and limiting the defense of ultra vires. The second directive went further, imposing requirements to ensure the contribution of capital and to prevent its dissipation. The third outlined procedures for corporate fusions, whether accomplished by corporate resolution or by purchase of assets. The fourth prescribed the contents of financial statements and defined the obligations of companies to prepare and publish them.

The fifth directive goes much further, and proposes a system of internal organization, which must be adopted (when the directive takes effect) by negotiable share companies in all of the member


391. See E. Stein, supra note 387, at 6-9.


It requires every such company to have a two-tiered government, divided between management and supervision, in accordance with the system prevailing for many decades in Germany. One third of the supervisory council must be chosen or approved by the employees. Derivative suits by five per cent shareholders are expressly authorized. There are proxy rules, and rules for shareholders’ meetings, and a rule that votes of “interested” shareholders cannot be counted in a shareholders’ meeting. Independent auditors are required, with rules about their selection and their liability.

Contemplation of the European model for achieving uniformity of state laws can lead only to the conclusion that it will never work in the United States. It is unimaginable that the state legislatures would accept direction from Congress, and the Constitution clearly contemplates that where Congress has power it should legislate directly. The European model is significant for Americans chiefly in demonstrating the importance that the most advanced foreign countries ascribe to “equivalence” in an economic union, and the wide area in which they deem equivalence to be desirable.

The closest United States parallel to the Communities' drive for “equivalence” is the movement for uniformity in state laws. This movement has been brilliantly successful in areas of commercial transactions, but has been flatly rejected, notwithstanding decades of effort, in the matter of corporation laws and securities law. Delaware and California will never agree. American experience makes it clear that uniformity is not the road to simplification of the laws of corporations in the United States. The persistent attempts to unify in the United States, and the effective drive to do so in Europe, confirm the need of an eventual move in that direction. But the means will have to be through federal legislation. To bring about a true simplification through that route will require passing through several difficult stages.

397. See text accompanying notes 29-37 supra.