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Introduction

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INTRODUCTION

Joel Seligman*

On the weekend Don Schwartz finished the final revision of his article in this Symposium, he died after a long bout with cancer. Don was corporate law's renaissance man; at once scholar, teacher, practitioner, advisor to the New York Stock Exchange, consultant to the American Law Institute, a friend to virtually everyone in the field. His several books and more than forty articles earned him near universal respect; his wit and openhearted friendliness made him a beloved figure. Up to the end, his spirit never flagged. Two days before Don's death, Georgetown Law School's David McCarthy went from a Dean's search committee meeting to visit Don in the hospital and was greeted with the mock-serious declaration, "I decline your offer to be the next Dean." As the inventor of the thirty-second meeting—the longest time Don would spare between telephone calls—he doubtless would have been a superb Dean. As it was, he left the field of corporate and securities law a better place than he found it, having rowed a laboring oar on such projects as Campaign GM, federal chartering, and corporate governance reform. More than that, he had the capacity always to be one of your best friends no matter how long it had been since the last time you saw him. I count myself fortunate to have known this wise, kind, and charming man.

During the 1970s, the most significant consideration of corporate governance reform occurred since the New Deal period.¹ The origin of this examination was a series of major corporate bankruptcies and fraud cases that strongly suggested the existence of widespread deficiencies in the performance of corporate boards of directors. Most significant was the failure of Penn Central, which at the time of its bankruptcy in June 1970 was the nation's largest railroad company and sixth largest industrial corporation. After an exhaustive study, a staff report of the House Banking and Currency Committee concluded: "It is not

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1. See generally Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325, 328-40 (1987).

so much what they [Penn Central's board of directors] did, but what they did not do that helped cause the Railroad's decline."²

Subsequent financial press and academic literature emphasized that the somnolent Penn Central board of directors was typical of most giant corporations' boards in the postwar period. The most influential academic study, conducted by Harvard Business School Professor Myles Mace, began with the premise that the board's statutory legal duty to "manage" the business and affairs of the corporation was a myth.³ After conducting numerous interviews with corporate executives and directors, Mace concluded that boards of directors in large or medium-sized firms had ceased to function as meaningful checks on chief executive officers.⁴

No series of events better illustrated the deficiencies of the corporate board of directors than the Securities and Exchange Commission questionable payments (or corporate bribery) cases. Corporations involved in the cases had created "slush funds" and concealed their existence through the falsification of both internal corporate records and statements filed with the SEC. Through 1981, close to 400 firms voluntarily admitted having used the slush funds either to bribe foreign or American officials or to make illegal American campaign contributions. The SEC took another sixty-two firms to court, where it proved the existence of questionable payments.⁵ An SEC report published in May 1976 underscored the significance of these cases:

The almost universal characteristic of the cases reviewed . . . has been the apparent frustration of our system of corporate accountability . . . Millions of dollars of funds have been inaccurately recorded in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top manage-

2. STAFF OF HOUSE COMM. ON BANKING & CURRENCY, 92D CONG., 1ST SESS., *THE PENN CENTRAL FAILURE AND THE ROLE OF FINANCIAL INSTITUTIONS* 149 (Comm. Print 1972).

3. M. MACE, *DIRECTORS: MYTH AND REALITY* 8 (1971).

4. *Id.* at 178-90, 205-07.

5. *E.g.*, *The Activities of American Multinational Corporations Abroad: Hearings Before the Subcomm. on International Economic Policy of the House Comm. on International Relations*, 94th Cong., 1st Sess. 181-85 (1975); 44 SEC ANN. REP. 27-31 (1978); Personal Communication from Chiles T. A. Larson, Deputy Director, SEC Office of Public Affairs (Feb. 26, 1987).

ment, but often has been concealed from outside auditors and counsel and outside directors.⁶

In the aftermath of the questionable payment disclosures, several proposals to reform corporate governance were widely debated, among them former SEC Chairman William Cary's proposal to enact federal "minimum standards" for corporate law. Cary's proposal was motivated by his belief that state legislatures had long relaxed statutory corporate law requirements in order to increase incorporation fees, and that in Delaware, the state where a plurality of large firms were incorporated, the judiciary had rendered decisions "on the basis of a desire to foster incorporation in Delaware."⁷ To remove the incentive to incorporate in Delaware or other "chartermongering" states, Cary proposed enactment of a federal statute that would establish standards of officer and director conduct for all firms above a minimum size.⁸

In 1976, Ralph Nader, Mark Green, and Joel Seligman advanced a more far-reaching proposal. These authors recommended the federal incorporation of all industrial, retail, and transportation firms with sales in excess of \$250 million that employed 10,000 or more persons.⁹ Under a proposed federal statute, each federally chartered firm would be led by full-time directors.¹⁰ To ensure a board's independence from the operating management it reviewed, directors could be nominated only by shareholders not affiliated with the firm's operating executives.¹¹ The most controversial aspect of the Nader proposal was the utilization of "constituency directors," an attempt to ensure board concern for a corporation's chief effects on employees and neighboring communities, as well as on shareholders.¹²

The election of President Ronald Reagan in 1980 effectively ended the 1970s movement for corporate governance reform. Paradoxically, the *need* for a new approach to corporate governance may be greater than it was during the 1970s because of a serious erosion in corporate law standards.

6. SENATE COMM. ON BANKING, HOUS. & URBAN AFFAIRS, 94TH CONG., 2D SESS., SEC REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES at a (Comm. Print 1976).

7. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 670 (1974).

8. *Id.* at 700-03.

9. R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* 240 (1976).

10. *Id.* at 121.

11. *Id.* at 127.

12. *Id.* at 253-55.

The major aspects of this deterioration have been:

- The adoption by the SEC of a rule that cuts back in part on the principle of one common share, one vote—a requirement of all companies listed on the New York Stock Exchange since 1926, and, in effect, the foundation of corporate governance.¹³ The one common share, one vote rule is essential to ensuring that shareholders can elect “independent” boards of directors and defeat those management proposals that are perceived by shareholders to be self-serving. In contrast, elimination of the rule will permit managers with minority common stock interest to cast a majority of the votes. Removal of the one common share, one vote principle, thus, may make it impossible to replace senior management, no matter how incompetent, and will remove a significant device for ensuring economic efficiency.¹⁴
- The decision by the Delaware legislature to permit businesses incorporated in that state to “opt out” of the possibility that directors will be held personally liable for violations of the duty of due care.¹⁵
- A number of highly questionable practices in the corporate takeover arena. Two deserve special comment. In 1985, the Delaware Supreme Court sustained the use of the “poison pill.”¹⁶ In the form approved, this device permitted a corporate board of directors, without shareholder approval, to issue rights to its own shareholders permitting them, under specified conditions, to buy shares in any bidding corporation at a fraction of their then market value.¹⁷ The practical consequence of this technique is to discourage tender offer bids. While this result may be desirable as a matter of national economic (or antitrust) policy, it is a dubious development in corporate law for management to be able to deprive shareholders of a bid significantly above market value without shareholder consent.

“Greenmail” is another question-begging practice. Again, without shareholder approval, management in many instances has paid corporate bidders a substantial premium above market value to sell their shares. This deprives shareholders of a possible above-market bid themselves. Nonetheless, in cases dating

13. Voting Rights Listing Standards—Disenfranchisement Rule, Exchange Act Release No. 25,891, 25,891A, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,247 (July 7 and 13, 1988).

14. See generally Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986).

15. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988).

16. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

17. *Moran*, 500 A.2d at 1348-49.

back to 1964, the courts of Delaware and other jurisdictions have generally permitted greenmail payments.¹⁸

- The holding by the United States Supreme Court in 1987 that federal securities claims under the Securities Exchange Act, including those arising under Rule 10b-5, the commonly litigated fraud remedy, may be committed to arbitration when standard language appears in a securities broker-customer agreement.¹⁹ The Court justified this result, in part, on the customer's voluntary acceptance of the standard arbitration clause.²⁰ To date, however, the SEC has been unwilling to adopt a rule requiring brokerage firms to give customers a meaningful choice whether to adopt or reject arbitration as a dispute-resolution device. In reality, virtually every small individual shareholder account is now subject to arbitration.

- Perhaps most significantly, the near universal approval by the state courts of the "litigation committee" device to permit boards of directors, when properly named as defendants in derivative litigation, to name other untainted directors to a litigation committee for the purpose of recommending the dismissal of the action. Before the 1970s, the power of the board to seek dismissal of derivative actions against third parties had been clearly established. But the extension of this power to seek dismissal of actions properly brought against the board itself is a novel development. Unless ultimately reversed by the state courts or by developments at the federal level, the policy will significantly undermine the ability of the derivative action to deter conflicts of interest or waste on the part of the board of directors.²¹

It is, thus, an appropriate time to consider again the wisdom of current corporate governance standards. The three articles in this symposium do so from quite different perspectives.

Donald Schwartz, who was a major actor in the corporate reform debate of the 1970s,²² as he has continued to be in the cur-

18. See *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964). But see *Heckmann v. Ahmanson*, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

19. *Shearson/American Express, Inc. v. McMahon*, 107 S. Ct. 2332, 2343 (1987).

20. 107 S. Ct. at 2341, 2346.

21. See discussion and citations in Schwartz, *Federal Chartering Revisited*, 22 U. MICH. J.L. REF. 7, 10-12 (1988).

22. See, e.g., Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71 (1972); Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 421 (1971).

rent American Law Institute Corporate Governance project,²³ begins with a reprise of developments in the last two decades. These developments persuade him that "federal legislation [is] a more tenable thought" now than it previously had been.²⁴ He highlights the role of the ongoing American Law Institute project, suggesting that "this effort may be the most important attempt by the corporate community to reform itself."²⁵

From a different point of view is the work of Lynne Dallas.²⁶ Professor Dallas broadens the theoretical debate concerning corporate governance that recently has been dominated by the "law and economics" school, contrasting it with a highly original synthesis of psychological and sociological literature. By comparing her "efficiency" and "power" models, she is able to suggest that our terms of reference in corporate law are too narrow, too artificial, and too brittle. In effect, she achieves in a broad terrain the same type of reorienting of the theoretical debate that the structural bias articles of James Cox earlier achieved in the context of litigation committees.²⁷

Alfred Conard, in a major exploration of one of the most significant institutional changes of the past three decades, focuses our attention on the sleeping giants of corporate governance, the institutional investors. He goes beyond the fashionable conclusion of a decade ago that they would remain quiescent, either because of the realities of portfolio management or the convenience of the "Wall Street Rule,"²⁸ and poses serious questions that long ago should have been asked: Why are institutional investors so inactive in corporate governance? What would it mean if they were activated? And, most significantly, what should be done now?²⁹

23. See, e.g., COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE: THE ALI-ABA SYMPOSIUMS 1977-1978 (D. Schwartz ed. 1979); Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511 (1984).

24. Schwartz, *supra* note 14, at 16.

25. *Id.* at 17.

26. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REF. 19 (1988).

27. See, e.g., Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83.

28. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117, 144 (1988).

29. Cf. L. LOWENSTEIN, *WHAT'S WRONG WITH WALL STREET* (1988) (answering related questions in a very different fashion).