Cornell Law Review

Volume 50
Issue 4 *Summer 1965*

Article 3

Why Are Business Corporation Laws Largely Enabling

Elvin R. Latty

Follow this and additional works at: http://scholarship.law.cornell.edu/clr

Part of the Law Commons

Recommended Citation
Elvin R. Latty, *Why Are Business Corporation Laws Largely Enabling* , 50 Cornell L. Rev. 599 (1965)
Available at: http://scholarship.law.cornell.edu/clr/vol50/iss4/3

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

WHY ARE BUSINESS CORPORATION LAWS LARGELY "ENABLING"?

Elvin R. Latty†

Professor Wilber G. Katz was unquestionably correct when, a few years ago, he viewed the modern business corporation acts as being basically "enabling" in the underlying philosophy of their general structure and of most of their specific provisions.[1] Nothing has happened in the intervening years to change the picture. He classified the manifested philosophies as: first, those that are "enabling" in the sense that they are characterized by freedom of choice in who among the interested parties takes what in the way of risks, control, and profit; second, those that are still enabling but are supplemented with certain requirements to keep the basic decisions of the interested parties more in line with idealized notions of contract, tort, and fiduciary relations; third, those that reflect a "paternal responsibility" theory; and, fourth, those that reflect a "social responsibility" theory.

SOCIAL-RESPONSIBILITY PHILOSOPHY

The social-responsibility philosophy deserves a short word, if only because it is quite clear that our corporation law draftsmen and legislative committees have steered clear of it, with an exception or two to prove the rule. The theory is nothing new of course; students of corporation law recall the debate between Professors Dodd and Berle in the 1930's. Under this theory, management in publicly-held corporations is expected to pursue a "higher ideal" than maximizing profits for absentee shareholders; management would have a responsibility to its employees, customers, suppliers, the community, and the "public" in general. At times, exponents of this theory seem to view the passive shareholder as some sort of a tolerated vestigial anachronism—one who has no right to expect anything more than to be pensioned off at some "fair" return (presumably, low), with the rest of the corporate profits administered for other groups. (If the concern succeeds, that is; if it fails the shareholder takes the beating.)

Perhaps this theory is a companion to a production-for-use economic theory as opposed to production-for-profit, and looks to a system where

† Dean and Professor of Law, Duke University. The writer here wishes to acknowledge his intellectual indebtedness to Dean Robert S. Stevens, in whose honor these papers appear in this issue of the Quarterly, and whom the writer was privileged to have as a law teacher in his earliest days of law study.

[1] Katz, "The Philosophy of Midcentury Corporation Statutes," 23 Law & Contemp. Prob. 177 (1958). This was part of a symposium on "The New Look in Corporation Law."

eventually managerial decisions are made by public officials. But legislatures, in their corporation acts at least, are adhering to the classical concept of the corporation as an institution to make profit for the shareholders. Many would say that this is still a sound basis for the corporate economy, especially if management for profit is coupled with a liberal dose of another rather conventional corporation law doctrine—the business judgment rule. Under this doctrine, for example, no shareholder can successfully call management to account for paying higher than the lowest wage possible, or for charging less than "what the market will bear" for its product, or for paying a higher-profit margin to a dependable supplier, or for putting blue-collar workers on an annual salary basis, etc.[2] True, the current swing in corporation statutes permitting gifts to charity may conceivably be cited against the classical profits-for-shareholders theory and as supporting the view that "social responsibility" is being reflected in corporation statutes. The inference bears rechecking. Conceivably, all that is happening is a generous dose of the business judgment rule. What court is to say that "public" donations are not in the line of "good business"? Even so, the board of directors had better watch out if they contribute a substantial amount of the textile company's cash to the president's wife's pet charity, protection of penguins in Antarctica. Perhaps the ever-present judicial control over abuses of the business judgment rule, based as it is on the theory that the enterprise *does* belong to the shareholders, coupled with a broad tolerance of that rule's application, makes for a better setting for adjusting conflicting interests of various groups and for a more efficient allocation of resources than would a corporation statute purposely geared for "social responsibility." After all, with the presence of organized units of labor, suppliers, and consumers, plus antitrust sanctions and public opinion, the picture is not entirely devoid of elements of countervailing power. At any rate, one will not find in a twentieth century business corporation act provisions for social justice—not for full employment, labor-management sharing of administration, antitrust features, Robinson-Patman-like protection of suppliers or customers, fair employment practices, etc. I do recall seeing one early draft of a corporation act some years ago in which there were provisions for "labor shares," but nothing came of the idea. Actually,

[2] Even in the heyday of "antisocial" capitalism, the shareholder could not hold corporate management to account for extending to employees a generosity that went beyond the corporation's bare legal duty. Said Bower, L.J., in Hutton v. West Cork Ry., 23 Ch. D. 654, 672-73 (1883), in the contest of a disputed gratuity, "it is for the directors to judge" so long as reasonably incidental to business; he added, "the law does not say that there are to be no cakes and ale . . . ." A railroad company, he said, "might send down all the porters at a railway station to have tea in the country at the expense of the company."

with the free-wheeling available under "enabling" corporation acts, even "labor shares" could rather easily be worked out.

THE "ENABLING" PHILOSOPHY

The "enabling" philosophy that underlies modern American business corporation laws presents four main facets. One is to free the participants in the corporate venture from the fetters that had accumulated through the centuries in corporate enterprise (many going back to mercantilism days of regulated economy and reflecting notions of "concession" from the Sovereign), and to put the arrangements for the allocation of risk, control, profit, and residual ownership on a free contract basis, just as in a partnership. Except for consequences that flow from limited liability, a corporation law under the "enabling" philosophy should not, any more than a partnership code, tell the associates what kind of business they can or cannot do, how big or little the enterprise can be, when or where it shall operate, or what their arrangements are to be *inter sese* for running the business. This, of course, is heresy to nineteenth century straight-jacketing of corporations.

The second facet of "enablingism" is that the corporation law should combine the best elements of a blue print for building, mending, expanding, and dismantling the corporate mechanism and of a sailing chart that clearly marks the rocks, channels, depth of water, and buoys. The need that management feels for this chart-blueprint stems from many causes: the mystique of the corporate entity; the hierarchic structure of corporate statutes, charter, and by-laws; the frequently complex structure of ownership and management; the tradition of sovereign permission; the documentary record for collective action and for registering decisions; and, the role of "paper." The "corporation" itself is born, lives, and dies all by and upon paper; when it eats, sweats, emotes, gets buried—"it" emits paper. What is wanted, then, is a statutory chart-blueprint to tell the decision-makers what they can do and how to do it—anything from a stock option to a merger.

The third facet of the prevailing enabling philosophy is that the power structure within the corporation (the promoter group in the early stages but, in any event, the managerial group) should be free not only to move fast and efficiently in conduct of the business operations but also should be free to determine the basic structure of the corporation and to propose its later changes. Free, that is, to determine the contents of the associational contract, however much it be a contract-by-adhesion, leaving to the passive associates only, or just about only, one basic free-

dom: to come in or stay out. In other words, if they do not like it, let them sell their stock. One might suggest that this "enablingism" inevitably leads to strong pro-management sets of charter and by-law clauses in matters of managerial powers, privileges, compensations, exculpatory clauses, bonuses, and stock options.

The fourth facet of "enablingism" is that it is not very concerned with reform or with preventing or minimizing abuse of power.

One finds little evidence that draftsmen of modern corporation laws in the United States are interested in exploring abuses that arise from the legal structure of corporations with a view to seeing what, if anything, can be done about it in a corporation law. A different attitude prevails in England. The famous Cohen Report, prepared to suggest amendments to the English Companies Act of 1909, while showing no trace of a witch hunt against companies and the control group, did find conditions that generated abuses, and it showed a balanced and sober concern for needed reforms.[3] That same tradition is maintained in the more recent Jenkins Report, which again considers amendments to the English Companies Act of 1948.[4]

Can it be that so many of the fears expressed by critics in the early days of the new "enablingism" (though this was not then the term for it) have turned out to be groundless that we now have little urge to call forth any legislative reform effort, at least in a "mere" corporation law?

TURN-OF-THE-CENTURY FEARS OF CORPORATE FREEDOM

At the turn of the century critics viewed the then new New Jersey and Delaware corporation laws with great alarm. Today most (but not all) of their fears seem a bit foolish. The twentieth century accepts a long list of corporate "freedoms" as a natural state of affairs, whereas the nineteenth century mind saw the relaxation of seemingly logical and "natural" restrictions as shocking invitations to irresponsibility and chaos. For example, a rather hysterical note in the American Law Review in 1899,[5] commenting on the new Delaware corporation law, in extravagant language ridicules the features of the law whereby a Delaware corporation:

1. can be organized for *any* lawful business except banking;
2. can conduct business anywhere in the world;
3. can have perpetual existence;

[3] Board of Trade, Report of the Committee on Company Law Amendment, passim (1945).
[4] Board of Trade, Report of the Company Law Committee, passim (1962).
[5] Note, "Little Delaware Makes a Bid for the Organization of Trusts," 33 Am. L. Rev. 418 (1899).

4. need have no local shareholders—the individuals composing the corporation can reside anywhere and everywhere;
5. need have no Delaware resident in its officialdom except one director;
6. need have no relation whatsoever to any business in Delaware—it could be a Delaware corporation farming in Kansas;
7. need have no more than 2000 dollars worth of *authorized* "capital stock;"
8. need ouly have 1000 dollars worth of the authorized stock subscribed for;
9. may issue stock for something other than cash, and at whatever valuation is put upon that something "in good faith" (a term apparently fit only for ridicule);
10. need hold neither its shareholders' meetings nor its directors' meetings in Delaware;
11. can keep its stock books and transfer books out of state, wherever it wishes;
12. need require no payment on the issued shares before starting business;
13. has no limit to its authorized "capital stock" except what limit the organizers want to write into the charter;
14. can, in other words, be as big as it pleases ("you can bloat yourselves out according to your own sweet will"[6]);
15. can readily amend its charter;
16. can merge or consolidate with other corporations;
17. can easily increase or decrease its "capital stock;"
18. can own and vote the stock in other corporations.

To this list another writer[7] in the same issue of that law review adds a few more objectionable new powers of corporations:

19. to incur debts without limit, unless limits are stated in the charter;
20. to make examination of its books by "intermeddlers" more difficult;
21. to operate without significant information through an Annual Report;
22. to own land in any amount, situated anywhere.[8]

Today, no one gets excited over the "evils," actual or imagined, in most of that list. Indeed, what was a house of horrors for the critics of that day has become the architectural model for subsequent corporation statutes. Thus, the Model Business Corporation Act of the American Bar Association really accepts Delaware, in substance, as the model to follow, and rightly so, on the whole. If there is something wrong in our corporation statutes, the cure does not lie in simple nineteenth century straight-jacketing. Even in this magnanimous mood, however, one may have occasional misgivings. One may wonder what the structure of American large scale enterprise would be today if we had stuck to the old nineteenth century notion that one corporation cannot hold stock in another corporation. Perhaps we would not have had that fantastic pattern

6 Id. at 422.
7 Letter From W. Wooley West to the Editors entitled "Delaware Missionary Enterprise," 33 Am. L. Rev. 794 (1899).
8 To the Illinois lawyer of that day (see note 7 supra), this really was heresy.

of public utility holding companies that led finally to the Public Utility Holding Company Act of 1935 and its unscrambling to three-or-less-tiers of corporate structures. We might not have had the "leverage" that accentuated the boom of the '20's and the bust of the '30's. On the other hand, legal ingenuity might have recreated the entire problem of holding company devices through that good old device of equity, the trust. At any rate, one of the prime targets of the turn-of-the-century critics of the New Jersey and Delaware corporation laws was the newly legalized stockholding power of a corporation. Apparently it was reasoned that these laws now gave statutory support to those very combinations in restraint of trade that were otherwise forbidden to pool the controlling shares of competing corporations into the hands of a trustee or a board of trustees. The fallacy is easier to spot today than in those days when, with thoughts focusing on ultra vires, corporate power and privilege and legality all flowed imperceptibly into each other. It was an easy jump from saying that since a corporation had power to acquire stock of another, all stock acquisitions were now permitted and legal. Thus Lincoln Steffens observed of the stock-holding section of the new New Jersey corporation law: "There we have the holding company, which makes the trust lawful and strong"[9]—a *non sequitur*, of course. It seems to be a common fallacy to believe that if a corporation law confers a power, carte blanche goes with that power. (One criticism of an early draft of the present New York Business Corporation Law provision permitting a corporation to buy up fractional shares was that a corporation might issue *all* its shares as fractions and then buy them up!)[10] Probably what Mr. Steffens and his contemporaries feared was sheer size of business ventures. The logical result of the attitude would be to put a legal limit to size. But, aside from the impossibility of limiting size by self-effectuating legislative fiat, "Big Business" was inevitable under modern technology and marketing. The problem of what to do about the "bad" ramifications of bigness could not be cured by a "mere" corporation law, unimplemented by tailor-made legislation with administrative regulation. It was futile for the early critics to direct their barbs against removal of the old straight jackets in the corporation statutes.

---

[9] Steffens, "New Jersey: A Traitor State (pt. 2)," 25 McClure's Mag. 41, 47 (1905).

[10] N.Y. Bus. Corp. Law § 509 was, in fact, finally redrafted to meet the criticism. The criticism seemed to be way out in left field. Where are legislative draftsmen to stop under this carte blanche theory of granted power? Some far-out critic will suggest that New York's freedom to hold shareholders meetings any place stated in the bylaws would permit meetings to be scheduled for Antarctica if the bylaws so provide, even if the motive of the power-wielders who adopted the bylaws is to oppress the minority. If the reader thinks this is farfetched, this precise criticism was made when the present North Carolina Business Corporation Act, permitting meetings to be held any place stated in the bylaws, was under consideration.

SENSITIVE AREAS

Nevertheless, the new freedoms brought new problems and abuses or intensified old ones. Consider, for example, what a Pandora's Box of troubles was opened by the new freedom permitting shares to be paid for in property or services, as well as in money, especially when coupled with the provision that the valuation set by the directors "in good faith" is not to be questioned. Actually, both provisions are quite justifiable, economically and juridically, although not enough attention has been given to the relationship of "good faith" to self interest and breach of trust. Perhaps this too is an area where nothing can be done short of administrative supervision and licensing. State Blue Sky Laws and, in 1933, the Federal Securities Act eventually had to step in. At any rate, practically no state *corporation law* tries to set any basic rules of fair play in this area, even though many issues of shares in corporations are not covered by the Securities Act or are not effectively regulated by any Blue Sky commissioners. Apparently the attitude today is that if shares are being issued at overvaluation or for a discriminatory consideration, the problem should be thrown into the lap of those responsible for amending the Blue Sky statutes and regulations or the SEC statutes and regulations. Yet it would not be impossible to improve by legislation that considerable body of irrational and inconsistent common law that holds promoters liable in damages or to a cut-back in shares for their overreaching transactions.[11]

The power of the insiders—"management"—to make self-serving decisions has always been a source of problems in corporation law. There are many occasions in the organization and operation of a corporation where insiders make decisions affecting their own interests, *e.g.*, as to their own compensation and fringe benefits. It is something of a strain, even upon the most conscientious soul, to determine how much his talents and services are worth. Even within the bounds of "good faith," a standard which equity is presumably ever ready to apply, a little liberality can run salaries up to very handsome returns—much more than the recipient would ever get in a competitive free market. Stock options and bonuses in particular invite abuse when not granted in competitive arm's-length dealings. Yet very little protection against the possibility of self-serving decisions in those matters is found in corporate laws. True, the New York Business Corporation Law, like the laws of many states, requires that stock options to directors, officers, or employees be approved by a majority of the shares entitled to vote, but, here again, the

[11] Cf. N.C. Gen. Stat. § 55-53 (1965).

beneficiaries of the proposal are in the strategic position of operating the proxy machinery, the device that brings in the votes. Actually, more protection against abuse in stock options has probably been brought about by the federal income tax laws which give favorable tax treatment to "restricted" stock options and (since 1964) to "qualified" stock options to employees than by the general corporation laws of the fifty states. Corporate managements themselves have been more conscious of a need for objective determination (or at least of an appearance of objectivity) in their stock-option plans than have legislatures. Many corporations subject their plans to outside experts or nonparticipating directors for approval, or request these parties to present plans.

In general, the standards of fiduciary loyalty that we do have in corporation law have been created by judicial decision. The role of the state legislatures has been, it seems, only to relax those standards. Common-law decisions invalidating directors' decisions because of adverse interest are at times replaced by the statutory "fairness" standard. I find it difficult to quarrel with that. But that only makes the point sharper: is there anything the corporation statutes can do in such matters as self-voted salaries, stock options, and bonuses? Probably not much, but one would at least like to see some proposals, aside from the stockholders' approval requirement, if only to reject them as impractical. That requirement is for the most part a meaningless ceremonial. Not even that alleged safeguard, however, is required by statute for self-dealt salaries. Would it improve matters to shift from a general standard like good faith or fairness to a more particularized standard? In the matter of salaries, for example, the required standard might be "what would be paid for such services at arm's length under competitive conditions." North Carolina has such a standard for self-voted salaries[12] but apparently believed that such a test was not quite feasible for stock options; and even for self-voted salaries that standard ran into strong opposition in legislative hearings.

Another area where management makes self-serving decisions is in planning what "pro-management" provisions to put into the charter. Here again the "enablingism" of modern statutes plays into management's hands. Today all but a handful of state corporation laws permit the charter to contain any provision (not expressly forbidden) for the regulation of the internal affairs of the corporation (Model Act) or, as New York puts it:

> The certificate of incorporation may set forth any provision, not inconsistent with this chapter or any other statute of this state, relating to the

[12] N.C. Gen. Stat. § 55-30 (1965).

business of the corporation, its affairs, its rights or powers, or the rights or powers of its shareholders, directors or officers including any provision relating to matters which under this chapter are required or permitted to be set forth in the by-laws.[13]

Since those who organize the corporation are normally those who expect to run it, the standard charter today contains clauses validating adverse interest transactions of directors and officers, exculpatory clauses to relieve from liability for mismanagement, and indemnification clauses to reimburse management for expenses in defending itself when called to account by shareholders or sued by outsiders to enforce some liability. Except possibly in indemnification clauses, management (actually, the counselling attorney) has not sought to push the pro-management provisions to the very extreme, in part for fear that the effort would boomerang and tempt courts to strike down even mild applications of the provision. Indemnification clauses, however, frequently go so far as to reimburse for expenses even those who have not been judicially declared blameless, but this attitude is no more liberal than that reflected in most legislation on such clauses.[14]

In all these charter clauses, state legislatures have shown little concern for abuses that might be expected from conflicts of interest and have been very sparing in enacting any off-limits markers. Indeed, one almost suspects that the Model Act's section 4(*o*) not only wanted management to get reimbursed for any reasonable expense in defending itself so long as not judicially declared culpable (which is questionable enough), but wanted to make sure that the charter could "make any other indemnification," above and beyond all that, entirely possible and unquestioned—all as provided for in the charter, by-laws, special agreement, etc.

Nevertheless, some states have shown concern over the possibility of abuse in self-dealt indemnification, particularly California, New York, and North Carolina, and to a lesser degree a few other states. Only North Carolina, however, attempts to forbid exculpatory clauses exempting management from all liability. Also, by North Carolina's fairly complete (and liberal) statutory treatment of directors' adverse interest, it would seem quite clear that clauses on that topic in the charter would be invalid if they ran counter to the policy reflected in the statute.

Why the almost studious avoidance in corporation statutes of the basic problem of management's adverse interest? A partial explanation lies in the business community's touchiness at the mere suggestion that management might yield to temptation in adverse interest situations. It

---

[13] N.Y. Bus. Corp. Law § 402(b).

[14] See Frampton, "Indemnification of Insiders' Litigation Expenses," 23 Law & Contemp. Prob. 325 (1958) (written before enactment of the new N.Y. Bus. Corp. Law).

is something that one does not talk about. I am reminded of an incident at a legislative hearing when the present North Carolina Business Corporation Act was under consideration. One spokesman wanted to eliminate entirely section 32 on directors' liability for illegal dividends, distributions, loans, etc. Actually, that section is very kind to management, and takes pains to bail it out of some tough rules of liability to which management is subject in the absence of such statutory treatment. But the spokesman's comment was along this line: the long section (all of two pages) on directors' liability looks bad—it gives people ideas, and wrong ones.

Other sets of fiduciary problems, where perhaps the fiduciary element is more subtle, include repurchases of its shares by a corporation from favored holders, which is but another side of the pre-emptive rights coin. And not to be overlooked is that growing realization in modern common law of the fiduciary duties of the shareholder "control" group—including the questionableness of their "right" to a higher price per share for their blocks of stock than the price to noncontrol-group shareholders when a purchaser is out to buy up the shares. It is submitted, moreover, that a whole set of fiduciary duties should attach to the "dominant" shareholders. On all these fiduciary matters, state statutes are silent. Even when draftsmen do give thought to such provisions, they may get set back by skittish legislators. For example, the following mild provision in the bill presenting the present North Carolina Business Corporation Act to the legislature was stricken out by the Senate Judiciary Committee. After defining "dominant shareholder," the bill provided, in what would have become section 55-74:

> Dominant shareholders stand in a fiduciary relation to the corporation and to other shareholders and shall exercise their power in good faith for the benefit of the corporation.[15]

Except for the phrase "for the benefit of the corporation," which arguably might have been stricken out as not leaving enough play for *legitimate* self-interest, it seems about as difficult to be against that proposition as to be against God, Country, Motherhood and Social Justice.

Another "sensitive area" relates to the twentieth-century freedom of a corporation to issue and sell shares and creditor-securities with whatever rights management wants to give those participants in the venture. Again, human nature being what it is, one might expect that management will reserve the best set of rights for its own securities or for those of a favored class—perhaps with some self-identified group.

---

[15] N.C. Sen. Bill 49, 1955 Sess., § 55-74.

Of course this invites the observation: so what? In a free market, self-interest is best served by free choice, and nobody *compels* anyone to buy securities with weak sets of rights. If the security is a poor one, nobody, or only a fool, will buy it. If you make a poor mousetrap nobody will beat a trail to your door. Disregarding for the moment the power of modern advertising, the danger to the economy and the possibility of distress from fraudulent security sales are so great that for over fifty years we have, in most parts of the country, shown concern with such sales, as is indicated by Blue Sky Laws. By the vigilance of administrative officials, Blue Sky Law is perhaps the better way to protect the public. But some features of corporate shares are so useless economically and so fraught with danger juridically, or so easy to proscribe, that a general corporation law might well be a proper place for outlawing or restricting those features. Such features would include the "once-gone-gone-for-good" feature of unpaid dividends on noncumulative preferred shares even when dividends are passed in the face of current earnings or earned surplus. Also, except in open-end investment companies, shares that purport to be redeemable at holders' option can be a mirage. Yet no state corporation law shows any concern for these matters, except North Carolina for the former, and that state and New York for the latter. Of course, administrative officials under a full disclosure statute like the Federal Securities Act of 1933 might force the prospectus to paint such a complete (and hence bleak) picture of noncumulative preferred as to discourage its use. So far as I know, that has not been done.

Besides the disillusion potential in the noncumulative and holder-option-redemption features, preferred shares are exposed to even more serious dangers by the new freedoms. The freedom universally conceded to a corporation to buy its own shares, coupled with the freedom to create a surplus by the mere legal device of reducing legal capital, plus the availability (more or less free) of unearned surplus for dividends and share repurchases—all expose the preferred shareholders to encroachments on their "cushion" through repurchases of junior shares and, except where the preferred is in arrearage, to dividends on junior shares. Some state statutes do concern themselves with some of these problems. Even the Model Act and its followers, not particularly noted for a protective philosophy, forbid "distributions" from capital surplus (but not from earned surplus) if net assets would then be below the liquidation priority of preferred shares.[16] New York has made a gesture in the right

[16] ABA-ALI Model Bus. Corp. Act § 41(d), (1960) (not clear whether the prohibition applies even to the under-water preferred that is receiving the distribution).

direction by lifting no-par preferred's involuntary-liquidation priority virtually to the lofty status of protected "capital,"[17] and North Carolina forbids dividends and share purchases that would reduce net assets below the liquidation priority of a class senior to the class getting the dividend or being purchased, and forbids purchases of junior shares in the face of arrearages on senior shares.[18] Texas forbids repurchase of shares if there are any arrearages, though it is not clear whether that means arrearages on those shares, on shares senior thereto, or on *any* shares.[19] It probably means arrearages on *those* shares, which is another problem that needs attention in view of the possibility of the corporation depressing the price by not paying preferred dividends and then buying up the shares at depressed prices.[20]

This discussion of preferred's headaches brings up preferred's biggest headache: that its preferences, arrearages, and all may be wiped out in a recapitalization by charter amendment or merger. The new freedom not only has put an end to "vested rights" of preferred shares[21] but also (perhaps) to any "fair plan" requirement with any kinship to the fairness test in insolvency reorganizations.[22] Indeed, say some, courts have no business putting the label of "fraud" on a recapitalization that wipes out preferred's rights so long as the plan manages to bring in enough votes, including the preferred's votes, to put the plan through. They contend that there is no such thing as a fraudulent recapitalization plan if it is legally voted and gives equal treatment of all shares of the same class.[23] I here suggest, nevertheless, as I have suggested before,[24] that corporate law contains too many sticks with which to beat the preferred shareholders into voting and too many carrots with which to induce them into voting for plans loaded in favor of junior classes to justify letting the problem be solved by the proxy count. Yet the proxy count is the hapless solution to the problem in all states except California (where the plan is screened by the Blue Sky machinery), Nebraska (where judicial screening can be sought), and North Carolina (where half a dozen road blocks are thrown up against possibly unfair plans).

Finally, no general corporation law has shown much inclination to give

[17] N.Y. Bus. Corp. Law § 506(b).
[18] N.C. Gen. Stat. §§ 55-50(c),-52(e)(3)-(4) (1965).
[19] Tex. Bus. Corp. Act art. 2.03(c) (1956).
[20] Cf. N.C. Gen. Stat. § 55-52(f) (1965), with its requirement of prior notice of intention to buy.
[21] Gibson, "How Fixed Are Class Shareholder Rights?" 23 Law & Contemp. Prob. 283 (1958).
[22] Ibid.
[23] Ibid.
[24] Suffice it to refer to Latty, "Exploration of Legislative Remedy for Prejudicial Changes in Senior Shares," 19 U. Chi. L. Rev. 759 (1952).

legislative attention to certain "entity" problems created by the new freedom to incorporate for any purpose, with or without the further freedom of a corporation to hold some or all shares of other corporations. These are the problems of the multicompartmentalized business and of the inadequately capitalized corporation—the creditor-proof trap for the tort claimant or the unwary contract creditor. Again, legislatures are skittish about any statutory hint that the entity created can, when necessary, be disregarded. The bill presented to the legislature proposing the present North Carolina Business Corporation Act contained a very orthodox section about corporate existence beginning with the filing of the articles, and then contained this final sentence:

> Nothing herein relating to corporate existence shall be construed to curtail or to abrogate any principle of law or equity which imposes upon shareholders, as co-owners of an inequitably capitalized enterprise, liability upon any claim against the corporation.

This was stricken out by the Senate Judiciary Committee.[25] Yet all it really amounted to was a reminder to courts that nothing in the statute is meant to arrest the development of common law or equity in placing safeguards upon the abuses to which the unrestricted privilege of limiting one's (or a group's) liability can lead.

WHY NOT ENACT "PROTECTIVE" CORPORATION LAWS?

There are many reasons why no serious attempt has been made to cope with the problems that twentieth-century "enablingism" has created or intensified for corporation law.

(1) *The Threat of Foreign Incorporation*

First, and perhaps foremost, is the conviction that a general corporation law less liberal than that of some other state will merely drive local business to incorporate in that other state. Even if we accept this version of Gresham's Law, be it noted that this is not saying that local illiberality will drive *business* out of state; most of the time all that will happen is that the business will merely incorporate elsewhere and this corporation, then of another state, will simply qualify to do business in this state as a "foreign" corporation. True, perhaps an occasional local-resident entrepreneur embarking upon a cosmopolite venture would, with an illiberal local corporation law, incorporate in, say, Delaware, without coming back home as a foreign corporation, to the loss of local incorporating fees and of "franchise" taxes due annually thereafter. But the day has passed

[25] However, the Committee was not sufficiently eagle-eyed to catch and delete the repetition of that very same principle in N.C. Gen. Stat. § 55-53(h) (1965) where, indeed, it is stated with even greater force.

when states seriously considered charter mongering for revenue purposes. Whatever faults one may find with corporation laws of the states in the second half of the twentieth century, no one can say of the states today, as Lincoln Steffen said of New Jersey in the early years of the century:

> New Jersey sold us [the rest of the country] out for money. She passed her miscellaneous in corporation acts for revenue. And she gets the revenue. Her citizens pay no direct tax.[26]

Nevertheless, even if illiberal local corporation laws do not drive out business or cause loss of substantial revenue, they are futile. Local business, whether really local, or nation-wide, or world-wide in character, will simply take the form of an outside corporation, a Delaware corporation, for example, and thereupon Delaware law governs, or so we have assumed. But perhaps that assumption can today be challenged. My colleague, Professor Brainerd Currie, has demonstrated that there is much more punch in local law, in competing with out-of-state law for application to an act or transaction, than Beal and the Restaters had led us to believe.[27] Moreover, courts are not the sole makers of new conflict of laws rules. A corporation law can, within constitutional limits, well prescribe its own set of rules for applying local law to foreign corporations, no matter how "internal" the affair in question is. Why then do not abuse-conscious, reform-minded legislators and draftsmen legislate accordingly? Passing over for the moment the fact that such abuse-conscious, reform-minded persons are rare indeed, there is the sheer difficulty of selection: what parts of local corporation law shall we apply to which doings of foreign corporations? The local corporation law cannot simply say: In the courts of this state all foreign corporations [that do business in this state] shall be deemed governed by the corporation laws of this state. Just imagine what a mess—all of the contents of the charter, by-laws, stock certificate, etc., and all of the steps past and future, of incorporating, taking organic action, etc.—all invalidated for not conforming to local law.

But let us not beat this dead horse that never was. So, one proposes, let us be selective; let us pick out, say, a local provision like this one: a corporation shall not issue redeemable common shares.[28] But what busi-

[26] Steffens, "New Jersey: A Traitor State (pt. 1)," 24 McClure's Mag. 649 (1905). In the same vein are the remarks in Note, 33 Am. L. Rev. 419 (1899): "little Delaware, gangrened with envy at the spectacle of the truck-patchers, sand-duners, clam-diggers and mosquito-wafters of New Jersey getting all the money in the country into her coffers,—is determined to get her little tiny, sweet, round, baby hand into the grab-bag of sweet things before it is too late."

[27] See Currie, Selected Essays on the Conflict of Laws (1963); Latty, "Pseudo-Foreign Corporations," 65 Yale L.J. 137 (1955).

[28] Such a provision is suggested by, but not quite like, N.Y. Bus. Corp. Law § 512(c).

ness does this state have applying that provision to a foreign corporation that does one per cent, or less, of its business in this state and has one per cent, or less, of its shares held by local residents? (Never mind the further and nicer question of applying that provision to redeemable common shares already outstanding before the foreign corporation came into this state.) But suppose those percentages were ninety-nine instead of one? Enough has been said to suggest difficulties.

It should, nevertheless, be possible to survey the local corporation law's protective features, ascertain whom those features were meant to protect, and then apply those features in local courts wherever such local interests are, in the court's opinion, being jeopardized. The imagined protectees might include: creditors as against the corporation-group (shareholders, directors, officers, and the "entity" itself), shareholders and the "entity" against management, shareholders against other shareholders, and management against unsavory shareholders who harass and extort with strike suits and threats thereof. But should the local corporation law specifically make all its protective provisions govern all foreign corporations whenever *any* local resident within the to-be-protected category would have a "right" which would be protected only by the local corporation law? For example, statutory restrictions on dividends are aimed to protect creditors (among others) and very often expressly make directors liable to creditors for declaring and paying unlawful dividends. Should, therefore, the local state expressly make applicable in favor of a local creditor its *own* more protective dividend provisions to *any and all* foreign corporations? If so, directors of a corporation operating all over the country must comply with the dividend laws of every state, or of the "toughest" state, or run the risk of liability. (To make matters worse, accounting principles that frequently determine the legality of the dividend may differ among the states.) On the other hand, certain protective local provisions can feasibly be made applicable to all corporations, domestic or foreign. Examples would be the restrictions on using a misleading corporate name within the state.

The foregoing suffices to suggest that perhaps only a *high degree of localness* calls for application of *some* of the provisions of local corporation law to a foreign corporation. How difficult a problem this presents for the draftsman can be seen from the pattern of application and exclusion of local corporation law in New York, the only state that has made a serious, fruitful attempt to close the loophole to the nose-thumbing foreign corporations. New York has defined localness by excluding corporations whose shares are listed on a national security exchange and those with less than half of their business income for the past three years allocable

to New York under the tax law. In North Carolina, the only other state where the legislature seriously considered a similar plan for closing the loopholes, localness of the enterprise of the foreign corporation was likewise made the focal point for applying selected sections of local corporation law. Localness was defined in terms of being authorized to do business in the state as a foreign corporation and of doing no substantial business in the state of incorporation (a fairly typical Delaware corporation pattern) and of being "more closely identified with the business life of this State" by virtue of the place and character of its business and personnel.[29] Regardless of the reasons for the legislature's rejection of the proposed North Carolina provision, the attempt demonstrates the difficulty of drafting against evasion of local corporation law by the device of foreign incorporation.

(2) *Complexity of Protective Machinery and Simplicity of "Enablingism"*

It is difficult enough, as above shown, merely to draft a protective device. But if the purpose is to be achieved, the draftsman must draft against evasion, which leads to more complex provisions to protect the first protection; the more complex the machinery, the greater are the chances that it will not work, especially against a skillful evader. To illustrate, recall the North Carolina attempt to apply its corporation law selectively to certain foreign corporations doing business in the state. Most of this attempt could be defeated by forming a foreign holding company to own all the shares of the enterprise that is doing the local business. In that situation the holding company need never "do business" in this state and thus the legal relation between management and shareholders, and among the shareholders *inter sese*, would all be normally governed by the corporation laws of the state in which the holding company is incorporated—and at this point we are right back where we started. So, the North Carolina draftsmen, in addition to drafting for "pseudo-foreign corporations, came up with proposed provisions to define a "pseudo-foreign *parent* corporation" and to make selected sections of local law applicable to it. Even that, it was believed, did not really close the loopholes. Accordingly, this whole complex culminated in a grand-finale provision for compelling reincorporation, for sufficient cause, of those pseudo-foreigners under the local corporation act in a court action brought by a corporate creditor, shareholder, or the Attorney General.

At some point in the complicated pattern of a *really* "protective" corporation law, the game is not worth the candle, especially since there are respectable voices saying that even for protecting a general corporation statute from evasion by means of a foreign corporation, the policing can

[29] N.C. Sen. Bill 49, 1955 Sess., § 55-2(11).

only be done through administrative supervision, or under a state securities act[30]—a fortiori, then, would that be the case in protecting, for instance, against unfair recapitalization plans, unfair provisions of corporate securities, free-loading by promoters, etc.

As against the complexity and difficulty of drafting protective provisions, the drafting of enabling provisions has a beautiful simplicity, with just enough challenge to bring the "enablingism" home even to a reluctant court.[31]

(3) *Countervailing "Enablingism"*

The Model Act solves the problem of evasion through foreign incorporation by going "all out" to make sure that the corporation law of the state of incorporation, *and not local law*, governs the "organization" and the "internal affairs" of a foreign corporation. That will forestall any local court that might be tempted, especially in the light of the new look in conflict of laws, to apply some protective features of local law. This represents, of course, the very opposite of a "protective" concern; here the concern is that some court may get some protective ideas with the resulting uncertainty for management as to which law to plan by. Perhaps the underlying philosophy is that it is better to *know* that whatever protectiveness there is in local law can be evaded by outside incorporation than to be in doubt. (But, in any event, there is not really any protective feature in the Model Act that is worth defending against foreign corporate invaders.) One purpose of "enablingism," then, is to create certainty, even at the expense of other values.

(4) *Controversialness*

Almost any protective feature is "controversial"—controversial as to its need, the extent of the feared abuse, the feasibility of this or that method of control, the possibility or impossibility of preventing evasion. The more the drafting committee seeks collaboration with outside specialty experts and representatives of various segments of the interested community, the more heated the controversy. And there is always a handy rationale: the proposal is not feasible.

(5) *Composition of Drafting Committee*

Protective features are mostly aimed at abuse of power. This means that they would frequently be aimed at management—its power to make corporate decisions (even self-dealing decisions), its power to swing

---

30 Lattin & Jennings, Cases on Corporations 167 (3d ed. 1959). The suggestion has a marked California accent.

31 E.g., N.C. Gen. Stat. § 55-3.1 (1965) to "enable" a corporation to have less than three shareholders without running into the trouble which some judges have unreasonably created for such corporation.

stockholders' votes through control of the proxy machinery (and in close corporations the sheer power of majority ownership), its control over charter and by-law provisions, its "inside" knowledge. But the personnel of the corporation law drafting committees in most states are usually identified psychologically with management. The impetus for revising the existing corporation law usually comes from lawyers with sufficient knowledge and experience in corporation law to make them realize the inadequacy of the existing corporation law. The ensuing committee, be it of the state bar association, or a city or county bar association, or of "official" origin, is likely to be suggested by and chosen from those best versed and most interested in corporation law. It is not unnatural for these corporation lawyers to identify themselves with management and, in all good faith and professional rectitude, to be not overzealously on the scent of managerial skullduggery, actual or potential, or to be fired by a spirit of reform or resentment against the Establishment. You do not find beatniks on corporation law committees.

(6) *The Federals Move in—And Current Complacency*

The great corporation finance scandals of the first third of the current century led to a vast takeover by the federal government of areas that had been left to, and largely neglected by, the states. This takeover was implemented with an administrative supervision that is constant, alert, and knowledgeable. The great stock promotion scandals of old have been rendered if not impossible at least highly improbable under the Securities Act of 1933, by the basically simple concept of disclosure: when you sell securities to the public tell the truth, the whole truth, and nothing but the truth, or the SEC (or some aggrieved private party) will get you. The scandalous stock market manipulations antedating the Securities and Exchange Act of 1934 are no more, or so most believe. Nor, with that act in effect, does a stockholder have to go through years of litigation and frustration, as did Mr. Richard Reid Rogers some thirty-five years ago, before he could even find out what salaries, bonuses, stock options, special "credits," etc. management of the corporation in which he held shares was bestowing upon itself.[32] Again, that same act throws a bit of a damper on one of the old abuses: management using its inside knowledge for playing the market in the corporation's shares.[33] Furthermore, under Chapter X of the Bankruptcy Act of 1938, no longer does the

---

[32] See Rogers v. Hill, 289 U.S. 582 (1933); Rogers v. Guaranty Trust Co., 288 U.S. 123 (1933); and those same cases in the lower courts.

[33] But see stories currently in the news on the SEC's suit against Texas Gulf Sulphur management. U.S. News & World Report, May 10, 1965, pp. 96-99. See also leading newspapers of April 20, 1965.

distress reorganization lend itself to most of the bitter barbs of 1933,[34] nor could a John T. Flynn today, with the Investment Companies Act of 1940 on the books in addition to legislation already mentioned, write a contemporary diatribe like *Investment Trusts Gone Wrong* (1931). So too, comparable dragons in the world of utility holding companies have been slain by the Public Utility Holding Company Act of 1935.

Now, all this federal legislation and administrative implementation may not have created a perfect world of corporate finance with liberty and justice for all, but at least many people believe the situation is much, much better. And whether justice actually *be* done or not, what is really important is that people *believe* that justice is being done. True, an occasional legal scholar does not share the prevailing complacency; for example, the late Professor Dodd called the pattern of preferred shares arrearage elimination a "recapitalization racket" and a "reproach" to a "civilized system" of law.[35] But recapitalization, eliminating preferred shares' arrearages, is a phenomenon of a period of recovery after a great economic depression, more a problem of the 1940's than of today. And as for the dangerous features that state laws permit in securities, concededly "noncumulative" preferred is a distress-issue security, hardly ever issued (so far as I have been able to ascertain) except in salvage-operation reorganizations; and these days such reorganization plans are under the many safeguards of Chapter X of the Bankruptcy Act with its machinery for weighing, presumably, any imperfection in securities that are issued in a reorganization.

In any event, all this federal legislation and activity has gone far to create the belief that the "bad" parts of the old corporate machinery have been pretty well replaced, to the further complacency of the draftsmen of state corporation laws, to which complacency is perhaps also added the uncomfortable suspicion that what they are doing is not so important anyhow.

(7) *The Brooding Omnipresence of Common Law and Equity*

In the area of fiduciary duties of corporate officers, directors, and dominant shareholders, the lack of concern in state legislation may be due to the assumed adequacy, more or less, of the common law and of the ability of equity to meet new situations. Legislators may feel, for example, that there is no need for a statutory provision that might put limits to the limited liability of shareholders who create creditor-proof corporate set-

34 See Lowenthal, The Investor Pays (1933), purporting to tell the story of the 1920's reorganization of the Chicago, Milwaukee and St. Paul Railroad.

35 Dodd, "Recapitalization Plans Involving Funding of Accrued Dividends," ABA Proceedings of the Section of Corporation, Banking and Mercantile Law 26, 39 (1945).

ups and traps for unwary creditors by inadequately capitalized corporations. And, arguably, courts have done a pretty good job of meeting the problems.

Perhaps it is believed that the common law can be counted upon to invalidate contracts, by charter and by-law provisions, that purport to exculpate even for fraud, gross negligence, unintentional wrong-doing, etc. Courts can be pretty ingenious at this.

So too in that most sensitive area of corporation law, the fiduciary area, courts have a long tradition of subjecting strategic power-wielders to trustee-like duties.

(8) *Managerial Ethics and Status*

Finally, the "public be damned" attitude of big corporate enterprise of the turn of the century has undergone something of a revolution. In part as a result of disclosure requirements of the various federal laws previously mentioned, management in publicly-held corporations virtually lives in a glass house. In consequence it is extremely sensitive not only of its image with the public but even more of its standing "in the club." What each corporation does is soon known to management in other corporations. In such light-of-day even mere overreaching may lead to loss of status. Students of deterrence may argue whether the raised eyebrow is as effective as the jail sentence, but "acceptance" by the group is at least one determinant of behavior. This does not mean that shady dealings are a thing of the past; news in the past few years has told us of absconders to Brazil with millions of dollars of shareholders' money, of competition-squelching shenanigans in the electrical industry, and other doings promoted with high hopes of not getting caught. But in matters of salary, bonuses, stock options, holdings, etc., management in publicly-held corporations has felt new restraints.

Indeed, it is probably in close corporations that the darkest deeds are being done. Here management's power comes not from being in control of the proxy machinery but from owning outright the control block of shares. Here management is supreme, and not subject to publicity requirements. Hence in the close corporation management operates without fear of shareholders or of public opinion. Curiously enough, in close corporations it has often been the *lack* of "enablingism" that has led to unfettered majority stock domination. In many states, the small group of partners in the venture could not get together by contract, either in the charter or elsewhere, and prescribe what management or majorities could or could not do; they were hemmed in by restrictions in corporation laws which applied to all corporations but which had *actually* been drafted for

the publicly-held corporation. New York at one time was one of the worst offenders; its new law, following a precedent set by North Carolina, should clear up many difficulties.[36] But more than "enablingism" is needed in the case of the close corporation, with its entrenched power and secrecy (and consequent lack of extra-legal restraints), to protect against power-wielders' oppression of minority interests. Very little has been done in corporation laws in this direction, in part because only recently has the close corporation been recognized as sui generis, with its own problems that call for attention.[37]

SOME CLOSING OBSERVATIONS

Perhaps many of those inclined to seek protection against corporate abuses are beginning to sense that the great problems of the day with respect to enterprises (whatever be the corporate or noncorporate form of the business organization) are not internal corporate affairs but problems of the impact of the enterprise upon the world that it affects economically, politically, and sociologically. Against the really great problems (fairness in employment, for example), internal corporate protective regulation begins to lose significance. To one with the current spirit of challenge of traditional values and of reform and revolt, there is no great appeal in, say, a longer and more complicated corporation-law provision purporting to protect minority shareholders by an appraisal remedy, even if such protective remedies can be shown to be needed or to work well outside of close corporations.[38] One concerned with protective features inclines to lose zest once he finds himself in that fantastic statutory pattern which we have come to know as corporation law, with its over-preoccupation with legal conceptions which grow into monstrous shapes as they feed upon themselves. (Witness the usual provisions relating to "stated capital," with their ramifications into dividends, distribution, etc.) It is difficult to work up concern for protective features while tilting at windmills.

---

[36] See, by the scholar in whose honor this issue is published, Stevens, "Close Corporations and the New York Business Corporation Law of 1961," 11 Buffalo L. Rev. 481 (1962).

[37] Much of the spadework in this field has been done by my colleague, Professor F. Hodge O'Neal, in his numerous writings in addition to his treatise, Close Corporations (1958).

[38] Justifiable doubts have been voiced about the need or contribution of appraisal remedies. Manning, "The Shareholder's Appraisal Remedy: An Essay for Frank Coker," 72 Yale L.J. 223 (1962).