# Cases and Materials on Corporations

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# Cases and Materials on Corporations

NINTH EDITION

**John C. Coffee, Jr.**
*Columbia University*

**Ronald J. Gilson**
*Columbia University and Stanford University*

**Brian JM Quinn**
*Boston College Law School*

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# *PREFACE*

With this Ninth Edition, Jesse Choper, a founder of this casebook and long-time Dean at Boalt Hall Law School in Berkeley, leaves us for retirement. We will miss him. He was our leader—always organized, always friendly, and always seeking to express a complex thought in a few less words. His succinct and fluent writing style will continue to influence us.

Joining us with this edition is Brian JM Quinn of Boston College Law School. Brian has already done many things in a short time: a teaching fellow at Stanford Law School, a legislative aide to Senator Edward M. Kennedy, in private practice with Cooley Godward in Palo Alto, a country coordinator for Harvard's Institute for International Development (where he oversaw Harvard's Vietnam-based teaching and research activities), and a specialist in merger and acquisition law.

With this edition, we have made a determined effort to shrink our size without reducing our coverage or depth. New material however has been added in all chapters. In Chapter I, recognizing that issues of race have dominated the headlines and political discourse, we examine recent efforts to increase racial and gender diversity on corporate boards, and efforts by some states and Nasdaq to require greater diversity. We also briefly review the Public Benefit Corporation, which is a new creature that is a hybrid of a profit-making corporation and a not-for-profit entity. Its recent growth has been hyperbolic. We also return to this new actor on the corporate stage in connection with corporate acquisitions in Chapter IX.

Chapter II provides an introduction to the basic management structures of the corporation as well as to the various duties of directors, including the duties of care and loyalty. New to this chapter is a focus on the emerging line of duty of good faith cases in the context of director oversight where directors have failed to monitor a critical risk. Known as the "*Caremark*" context, it had been thought that the risk of liability in this area was remote, but a new line of cases has refused to dismiss these claims and compelled defendants to settle where they overlooked a serious risk for a continuing period.

Chapter III surveys the financial economics associated with valuing corporations. Because parties create corporations to the end of creating value, Chapter III provides a framework for doing so and the role of law in accomplishing it.

Chapter IV covers important issues related to the formation of the corporation, including the effects of defective incorporation, and also addresses the occasions on which courts have "pierced the corporate veil" and subjected shareholders to liability because they misused the corporation. Chapter IV also examines the potential liability of successor corporations for the deaths of their predecessors.

Chapter V covers disclosure and the federal securities laws. New Supreme Court decisions (including Lorenzo and Omnicare) are assessed, and the continuing struggle to define insider trading is reviewed.

Chapter VI examines shareholder voting and proxy contests as basic tools of corporate accountability and gives special attention to recent efforts by activist hedge funds to influence and constrain corporate management through proxy contests. Close attention is given to the SEC's rules, which have been revised in several noteworthy respects.

Chapters VII addresses the legal issues associated with organizing and operating privately held corporations. It traces the evolution of the legal rules governing such "close" corporations, as corporate law in this area has moved from legislative formalities to becoming increasingly a matter of contract. The culmination has been a series of legislative authorizations for new types of vehicles that emphasize contract, including the highly successful limited liability company.

Chapter VIII introduces the shareholder derivative action, a critical legal device for policing management opportunism, but one not without its own faults. This chapter examines cases and standards that deal with the evolution of the demand futility standard in derivative litigation.

Chapter IX takes up the most controversial area of corporate law over the last 30 some years: the legal rules governing friendly and unfriendly acquisitions. In doing so it tracks the unique experience of Delaware law over this period and the continuing dialogue between the Delaware Chancery Court and the Delaware Supreme Court about the allocation of authority between the board of directors and shareholders.

The authors particularly want to express their thanks and appreciation to their research assistants who have worked long and hard on this edition (and have shown immense patience in dealing with the authors). These include: Henry Hagen, Jihoon Kim, and Taylor Sutton.

*John C. Coffee, Jr.*
*Ronald J. Gilson*
*Brian JM Quinn*

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# Cases and Materials on Corporations

# I INTRODUCTION

## A. THE LEGAL CHARACTER OF THE CORPORATION: FACTORS INFLUENCING CHOICE OF THE CORPORATE FORM

The number of corporations in the United States is vastly dwarfed by the number of other business organizations, particularly sole proprietorships.[1] Yet corporations account for the great majority of total business revenues and are the form of business organization chosen by most firms once the scale of the business enterprise reaches a significant level.[2]

Why is this? Generally, four distinct factors motivate the owners of a business to conduct it as a corporation: (1) limited liability of shareholders, (2) perpetual existence of the corporation, (3) easy transferability of ownership interests, and (4) centralized management. In addition, a fifth factor — tax considerations — may also loom large, depending on the tax laws then in effect and the plans and tax position of the firm's owners. Historically, these factors not only distinguish the

1. As of 2015, there were 6,119,595 corporations, 3,715,187 partnerships, and 25,226,245 sole proprietorships. See SOI Tax Stats Integrated Business Data, Selected Financial Data on Businesses (Internal Revenue Service 2015).

2. In 2015, corporations accounted for only 17 percent of the tax returns filed by all businesses, but these returns amounted to 81 percent of all business receipts. See SOI Tax Stats Integrated Business Data, Selected Financial Data on Businesses (Internal Revenue Service 2015).

corporation from other business entities,[3] such as the partnership, but they also provide a roadmap of much of the substantive content of corporate law and the recurring problems that arise within corporations. Thus, at the outset, a brief overview of these factors is useful.

"Limited liability" essentially means that investors risk only their purchase price paid for their shares and have no additional liability.[4] For most investors, this may be the most important factor leading them to incorporate, because it insulates the shareholders' personal assets from corporate debts. Also, limited liability allows corporate creditors to disregard the claims of the owners' personal creditors. In contrast, a general partner of a partnership faces unlimited personal liability for the firm's debts. Still, the advantages of limited liability can be exaggerated, both because there are substitutes for it (insurance for tort debts or the use of the limited partnership form, which also allows limited partners to avoid liability for more than their capital contributions), and because "financial" creditors are likely to demand personal guarantees from the principal owners when they lend to the firm. In this light, limited liability chiefly shelters the principal shareholders from tort creditors and "trade" creditors (i.e., suppliers of goods or services to the firm, who typically do not demand guarantees because they expect payment within a short period on a relatively small indebtedness).

The significance of the second factor—perpetual existence—stems from the greater certainty it affords both creditors and other investors, particularly in circumstances where they must commit capital to the business for a prolonged or indeterminate period. In an individual proprietorship or partnership, the death, withdrawal, or insolvency of the proprietor or of any partner (assuming there is no specific contrary provision in the partnership agreement) terminates the business organization. But the legal status of the corporation is unaffected by the death, withdrawal, or insolvency of a shareholder, and under its charter the corporation typically enjoys perpetual existence. The legal stability of the corporation may be an important factor in a financial institution's willingness to extend credit to the enterprise without requiring individual endorsements or other forms of personal guarantees.

The third major advantage of incorporation results from the use of transferable securities to represent the shareholder's interest in the common business enterprise. The general norm in the case of corporations is that these shares are freely tradable, similar for most purposes to negotiable instruments. Free transferability makes possible secondary markets—such as the stock exchanges—in which investors can trade ownership interests on a regular, continuing, and impersonal basis. Secondary securities markets enable investors to obtain greater diversification and liquidity and thus make it easier for corporations to raise capital. In contrast, partnership interests ordinarily are not transferable without the consent of all the other partners, and the sale of an interest in an unincorporated business usually involves at least a bill of sale or some other lengthy and non-negotiable instrument.

3. Some newer forms of business organizations—such as the limited liability company and the limited liability partnership—combine limited liability and certain other "corporate-like" features with a nontaxable status. In particular, the limited liability company is coming into greater use and is examined in Chapter VII.

4. The principal exceptions to this rule of limited liability are covered in Chapter IV.D; in these instances, courts will "pierce the corporate veil" and hold shareholders personally liable for corporate debts when they sense that there has been a misuse of the corporate form. But mere asset insufficiency does not imply a misuse of the corporate form or justify veil-piercing.

The final factor motivating use of the corporate form—centralized management—refers to the critical fact that the investors in a corporation delegate most of the authority to run the business enterprise to agents that they elect—namely, the corporation's board of directors. These agents are unique because they cannot be legally compelled by the shareholders to take any specific course of action and generally can be removed only for cause pending the next election of directors. In this sense, the position of directors resembles that of elected officials in a democracy, who are expected to use their own discretion and are not bound by the day-to-day preferences of the electorate. In contrast, unless the partnership agreement provides otherwise, each partner in a partnership has an equal right to manage the business and bind the firm and other partners regarding partnership property and affairs. In short, authority in a partnership tends to be shared, not centralized, whereas in a corporation, the corporation's board of directors, not its shareholders, holds the authority to exercise corporate powers and direct the business and affairs of the enterprise. This is a default rule that can be modified by special provisions in the corporation's certificate of incorporation, but courts have been generally reluctant, in the absence of a clear charter provision, to permit shareholders to exercise powers normally belonging to the board.

One characteristic that all corporations might be thought to share is a desire to make money and maximize value for their shareholders. Although this is the common denominator shared by business corporations (which still leaves room for disputes about the time frame in which value is to be maximized or the degree of support to be given to other stakeholders, such as employees and creditors), a new entity that lacks this orientation has recently appeared in the world of corporations: the public benefit corporation (sometimes called the "B Corp"). Its charter may commit it to supporting a special purpose or goal, even if unprofitable (for example, fighting a specific disease or achieving some level of environmental sustainability). As a result, its charter may provide that only a percentage of profits will be distributed to shareholders and the balance reinvested (or paid out) in pursuit of that charitable purpose. Some 35 states and the District of Columbia have enacted legislation authorizing such public benefit corporations, and it is estimated that approximately 4,000 have now been formed. Some well-known businesses (for example, Ben & Jerry's, the ice cream maker[5]) are organized as public benefit corporations. This topic is briefly surveyed at the end of this chapter.

# B. *AN OVERVIEW OF THIS CASEBOOK*

The four defining characteristics of a corporation discussed above—limited liability, perpetual existence, free transferability, and centralized management—supply

5. Ben & Jerry's Homemade Holdings, Inc. is now a wholly owned subsidiary of Unilever, an international British-Dutch conglomerate. Under its certificate of incorporation, a portion of its earnings must go to certain charitable purposes and the wages of the CEO may not exceed that of the lowest paid worker by more than a 5:1 ratio. Thus, you can justify your next "Cherry Garcia" on the rationalization that you are doing something good for society. Other well-known public benefit corporations include Kickstarter and Patagonia. See also Dan Brown et al., Mapping of the State of Social Enterprise, 4 (Grunin Center for Law and Social Entrepreneurship, NYU Law, 2019).

a roadmap for much of this casebook. Limited liability is subject to potential abuse (such as when it is used to defraud creditors), and as a result there are important exceptions to its availability, which are considered in Chapter IV.

Perpetual existence implies that the corporation is typically a long-term venture for which it is difficult to draft a complete contract in advance that covers all contingencies and that fully specifies all the rights and relationships among the parties. In such a long-term contractual relationship, a greater need exists for a governance structure that can resolve disputes fairly and in accordance with the parties' likely expectations. Chapter II focuses on this role of the board of directors in corporate operations. Similarly, because a system of centralized management delegates great discretion from the firm's owners to its managers, issues arise as to how those agents employ that discretion. Conflicts of interest between managers and shareholders are as inevitable as death and taxes, and the law's recurrent concern has been how to minimize and monitor these conflicts. One such means has been to deem corporate directors and officers subject to certain mandatory fiduciary duties that require them to use their discretion in the shareholders' interests. Considerable debate has surrounded the question of how strict these duties should be. Chapter II examines the trends and divisions in the substantial body of case law on this issue.

Another means of controlling managerial discretion is through shareholder voting rights. Chapter VI looks at the system of corporate democracy by which shareholders elect corporate directors and vote on certain other fundamental matters. A recurring theme throughout this casebook will be the adequacy and relative efficiency of various techniques for holding corporate officials accountable to their shareholders. In this light, Chapter VIII surveys the legal remedies available to the shareholder through which fiduciary duties may be enforced.

Finally, free transferability of shares encouraged the development of impersonal trading markets for corporate securities, which in turn increased the possibility of fraud (or at least unfair informational advantages). Since the 1930s, federal law has prescribed disclosure standards applicable to the securities markets, and these standards represent another important restraint on managerial discretion. Chapter V assesses the law at both the federal and state levels applicable to the corporation's disclosure obligations, securities fraud, and insider trading. Chapter IX examines the unique forms of corporate control transactions that secondary markets make possible. These transactions, which include takeovers and hostile tender offers, represent the newest and potentially most important means of holding managers accountable to investor preferences.

The key point on which to focus at the outset is the nature of the agency relationships within the large public corporation. Because detailed contracts cannot be written between the shareholders and the corporation's managers to cover every contingency, substantial authority must be delegated to the corporation's managers. This broad delegation of authority together with the existence of inevitable conflicts of interest between the corporation's shareholders and its managers create problems of accountability with which American corporate law has struggled since the appearance of the private corporation in the early nineteenth century. The master problem of American corporate law is how to control management discretion and prevent opportunistic behavior—without chilling the efficiency and entrepreneurial style of the corporate form through excessively formalistic and confining restraints. Necessarily, this problem involves trade-offs: some controls may be too costly because they will inhibit socially desirable risk-taking. From this perspective, most of the succeeding chapters address alternative control devices: monitoring controls in the form of the board of directors; legal controls, as represented by the common law's derivative suit and the federal securities laws; market controls through takeovers and other corporate control transactions; voting controls through the proxy system; and private controls and contractual incentives set forth in executive compensation agreements (and in the case of smaller companies, shareholder agreements). Ultimately, an overriding policy question is: What mix of these controls works best in achieving accountability at the lowest cost? As will be seen, much depends on the context and the desires of the shareholders.

The remainder of this chapter focuses, first, on the political and legal debates that have attended the attempts of American law to grapple with the special status and character of the corporation; second, on the economists' perspective on this central issue of corporate accountability; and third, on the unavoidable question of corporate social responsibility—namely, to whom should the corporation and its agents be responsible?

## C. *A SCORECARD OF THE PLAYERS: PUBLIC CORPORATIONS, MANAGERS, DIRECTORS, AND SHAREHOLDERS*

### 1. A CORPORATE CENSUS

Corporations can be large or small. Only a relatively small percentage of corporations fall into the category of "public corporations." Indeed, this number has declined significantly in recent years (both as a result of industrial consolidation through mergers and acquisitions and as a result of "going private" transactions in which public companies are bought by their managements and private investors). One survey found that the number of companies listed on a securities exchange grew rapidly from 4,796 in 1976 to a peak of 7,322 in 1996 before falling even more rapidly to 3,671 in 2016.[6]

Why? Possibly, some companies can be run more efficiently as private firms, exempt from most of the regulations imposed by the Securities and Exchange Commission (SEC), the federal administrative agency with principal oversight over the securities markets and corporate disclosure. Alternatively, these private companies may simply have found it in their interest to delay before becoming public companies because they had found alternative sources of capital in private markets that could finance their growth until the point at which they considered it optimal to undertake a public offering. Becoming a public company is still typically the long-term goal of most companies (in order to provide needed liquidity for their shareholders), but start-ups have more discretion today in determining when to make this transition. In any event, the transition from private to public is

6. See Michael Mauboussin et al., The Incredible Shrinking Universe of Stocks (Credit Suisse 2017).

no longer a simple linear progression for a profitable firm and can be delayed (or even reversed) so long as alternative sources of capital can be found.

Although public corporations are proportionately fewer in number, they are typically much larger in terms of assets, revenues, employees, and scale of operations. Particularly important is that shareholders in public corporations possess liquidity,[7] while those in private corporations seldom do. This means that public-corporation shareholders who are either dissatisfied with the firm's management or simply doubt that their shares are likely to increase much in value can exit by selling their shares in deep secondary markets, while shareholders in private corporations seldom have this opportunity. Locked in by the absence of a secondary market, shareholders in private companies logically may have a greater desire to participate in corporate governance (that is, to exercise "voice," rather than "exit," in the standard terminology) or to pursue litigation remedies. Chapter VII examines the special problems of privately held companies and the alternative business forms used to structure relationships within such firms.

## 2. THE INDIVIDUAL PARTICIPANTS

Corporations require three necessary participants: executive officers, directors, and shareholders. Although one person may occupy all of these positions and a corporation can be organized and staffed by a single person, it is useful to understand who typically occupies these roles in the public corporation.

*Executives*. The day-to-day management of the American public corporation is entrusted to officers[8] who are appointed, and can be removed at any time, by the board of directors. The authority of the principal corporate officers is detailed in the corporation's bylaws, as supplemented from time to time by specific board resolutions. At the top of the managerial hierarchy is the chief executive officer (CEO), who in most cases (but far from all) will also serve as chairman of the board. This is in marked contrast to the European and English pattern, where a nonexecutive outside director almost always serves as chairman in order to ensure that the chief executive will not be able to dominate the board or control its agenda. Increasingly, many U.S. corporations also separate the roles of chief executive and board chairman, but this is a new trend that still does not characterize the majority of public corporations.

Beneath the chief executive officer will typically be a chief financial officer (CFO) and possibly a chief operating officer (COO). They too are likely to serve on the board of directors, but generally no more than two corporate officers serve on the board (although other officers may be invited to attend board meetings to advise the board on particular matters).

7. *Liquidity* technically means the ability to sell one's shares in the market without thereby affecting the price. In many less-liquid markets, a large shareholder cannot sell its stake without thereby driving down the price.

8. Many corporation statutes provide that there be at least four officers of the corporation: president, vice president, treasurer, and secretary. Typically, one person can hold multiple offices, except that these statutes sometimes require the roles of president and secretary to be separated. In contrast, New York permits a sole shareholder to hold all corporate offices. See, e.g., N.Y. Bus. Corp. Law §715(e) (2020).

The executives of a publicly held corporation rarely own sufficient stock in their firm to have a controlling influence through stock ownership. Their control over the firm and their tenure in office likely depend on their satisfying the board. This in turn is likely to hinge on the firm's profitability and share price relative to other firms in its industry. More independent boards, increased institutional investor activism, global competition, and deregulation have all combined to shorten CEO tenure in office and to increase the frequency of CEO turnover.[9]

Three generalizations about senior executives at U.S. public corporations need to be understood at the outset:

First, their employment status has become riskier, and their tenure in office has shortened.

Second, compared to executives elsewhere, U.S. senior executives at public corporations (and particularly the CEO) receive extraordinary compensation. Similarly, the pay ratio between the CEO's compensation and that of the lowest-paid full-time worker can be as high as 500 to 1.[10] This has raised concerns among many that these compensation practices are increasing income inequality in the United States.

Third, U.S. senior executives at public corporations receive the majority of their compensation in the form of stock options, equity awards, or other incentive-based pay. Obviously, such a system focuses their attention on their company's stock price and its quarter-to-quarter earnings (at least in comparison to an executive who is paid a fixed salary).

The most recent data on the average tenure of a CEO of a company in the Standard & Poor's 500 (which is a leading market index often used as a proxy for large public companies) found that CEO average tenure had decreased from ten years in 2000 to five years as of the end of 2017.[11] Seemingly, if the firm lags its peers in its industry, the CEO's job is increasingly at risk.

Concomitantly, as the CEO's tenure has become riskier, the CEO's income has soared.[12] The compensation paid to chief executives is a combination of annual salary, incentive awards, stock options and other forms of equity compensation, and

9. See, e.g., Dan Marcec, CEO Turnover Rates (Equilar, Inc. 2018); Rick Geddes & Hrishikesh D. Vinod, CEO Tenure, Board Composition and Regulation, 21 J. Reg. Econ. 217 (2002); Rick Geddes & Hrishikesh D. Vinod, CEO Age and Outside Directors: A Hazard Analysis, 12 Rev. Indus. Org. 767 (1997).

10. For the 350 largest corporations, the ratio between CEO compensation and that of the median employee was 320:1 in 2019 (up from 61:1 in 1989 and 21:1 in 1965). See Lawrence Mishel & Jori Kandra, CEO Compensation Surged 14% in 2019, at 1 (Economic Policy Institute 2020). In 2018, for all publicly traded companies, the same ratio of CEO pay to that of the median employee was 144:1. See Deb Lifshey, The CEO Pay Ratio and Perspectives from the 2018 Proxy Season (Pearl Meyers & Partners, LLC 2018).

11. For the ten-year figure as of 2000, see The Conference Board, 2011 CEO Succession Report: Key Findings. For the five-year figure as of 2017, see Theo Francis & Yan Wu, CEO Pay for the S&P 500, Wall Street Journal, June 3, 2020. For another, but earlier, study finding a seven-year average CEO tenure at Fortune 100 companies, see Denis B. K. Lyons, CEO Casualties: A Battlefield Report, Directors & Boards (June 1999) at 43.

12. Executive compensation levels grew only modestly from the Second World War to 1970, but then experienced dramatic growth. During the 1990s, the annual growth rate in median pay was around 10 percent, rising from a median CEO compensation package of $2.3 million in 1992 to $7.2 million in 2001. See Carola Frydman & Dirk Jenter, CEO Compensation, 2 Ann. Rev. Fin. Econ. 75, 78 (2010). As a percentage of corporate earnings, the top five senior executives at each firm earned on average 9.8 percent of aggregate corporate earnings during 2001 to 2003 (up from 5 percent in the period from 1993 to 1995). See Lucian Bebchuk & Yaniv Grinstein, The Growth in Executive Pay, 21 Oxford Rev. Econ. Pol'y 283, 297 (2005).

perquisites. In 2020, the median compensation for a CEO of an S&P 500 company had risen to $13.1 million.[13] The composition of executive compensation has also changed significantly in recent years. Typically, in the case of the 350 largest firms, only 7 percent of this compensation now comes in the form of salary, with various kinds of equity awards and stock options accounting for another 77 percent.[14]

Perhaps the most striking statistic about executive compensation is its constant rate of increase—both in good times and in bad. Professors Lucian Bebchuk and Jesse Fried estimate that the average real (i.e., inflation-adjusted) pay of chief executive officers of firms in the S&P 500 more than quadrupled between 1992 and 2000.[15] Increases in option-based compensation were responsible for most of this increase and jumped ninefold over this period.[16] Another more recent survey found that the median CEO's realized compensation rose by 36.5 percent for S&P 500 CEOs in just the period between 2009 and 2010 (a time of low profits and much economic turbulence).[17] Finally, a study that looked to the values actually realized on stock options issued to CEOs found that CEO pay grew 940.3 percent from 1978 to 2018.[18] Yes, it is good to be a CEO.

Behind the shift from cash-based compensation to equity compensation lie a variety of factors: (1) the desire of institutional investors to use stock options to make senior management more sensitive to the market and less bureaucratic and resistant to change; (2) the impact of the tax laws, which deny the corporation a tax deduction for very high cash compensation to a senior executive but do not similarly penalize stock options;[19] and (3) the sense of many boards that executives who create significant stock price gains for shareholders deserve to share in those gains through the award of generous stock options.

At the same time, however, the growth in executive compensation has attracted public attention and drawn a legislative response. Some are concerned simply that the new levels of executive compensation are staggeringly high in a time of high unemployment and economic stagnation; others believe that disparities as great as 500 to 1 between the compensation of the chief executive and that of the average employee are unjustified and are increasing income inequality in the

13. See Theo Francis & Yan Wu, CEO Pay for the S&P 500, Wall Street Journal, June 3, 2020. For earlier studies showing the rapid growth, see Eric Dash, Executive Pay: A Special Report: Off to the Races Again, Leaving Many Behind, N.Y. Times, Apr. 9, 2006, at 3-1 (reporting survey by Pearl Meyer & Partners, an executive compensation consultant). For the CEOs of the United States' 500 largest companies, average compensation was even higher at $15.2 million in 2006. See Scott DeCarlo, Executive Pay: Big Paychecks, Forbes, May 21, 2007. In 2019, the highest-paid CEO at a U.S. public company was Sundar Pichai, the CEO of Alphabet (and its subsidiary, Google), who received a total compensation package that year of $280.6 million. See Theo Francis & Yan Wu, supra.

14. See Lawrence Mishel & Jori Kandra, supra note 10. For an earlier study by Pearl Meyer & Partners, see Behind the Numbers: New York Times 2006 CEO Pay Survey at 7.

15. See Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 1 (2004).

16. Id.

17. See GMI's 2011 CEO Pay Survey at 3. Moreover, this annual increase was even higher (38.4 percent) if one looked at the increase for CEOs in the Russell 1000 (an index twice as large as the S&P 500 and thus containing smaller companies).

18. See Lawrence Mishel & Julia Wolfe, CEO Compensation Has Grown 940% Since 1978; see https://www.epi.org/publication/ceo-compensation-2018/.

19. See Internal Revenue Code §162(m) (providing that, in a publicly held corporation, tax deductions for annual compensation are capped in the case of the CEO and the next four highest-paid officers at $1 million each). This provision does not apply to certain performance-based compensation, and hence performance-based bonuses have become more prevalent.

U.S. workforce.[20] More recently, still other critics contended that high short-term compensation incentivizes management to accept excessive risk and may have created a "moral hazard" problem that helps explain the high leverage and eventual failure of major financial institutions in 2008.[21] After all, this argument runs, if the CEO can make $100 million through bonuses in years 1 and 2 by entering into risky transactions, such a CEO need not worry much that these transactions may later fail and cause insolvency in years 4 and 5. This concern motivated Congress to seek to restrict incentive compensation at large financial institutions by passing the Dodd-Frank Act of 2010,[22] and it further caused Congress to require that the compensation committees of public corporations be entirely composed of independent directors.[23] Still, much of this legislation on executive compensation was never implemented under the Trump Administration, and few, if any, controls on executive compensation today exist under federal corporate or securities law.

The high rate of increase in executive compensation continues to date. Some attribute this to management "capture" of the board, while others believe that it has more to do with the process by which independent compensation committees set CEO compensation. Typically, such committees establish a "peer group" of similar companies with which their firm would like to be compared. Then, the committee sets their CEO's compensation at a level equal to some percentile (usually between the 50th and 90th percentiles) of CEO compensation paid within this peer group.[24] The result is an automatic escalator effect, and to the extent their firm is, in turn, included in other firm's peer groups, this effect is extended.

The critical point here is simply that the setting of executive compensation is one of the most important, most debated, and most unresolved issues in corporate governance.

*Directors.* Corporate law delegates the corporation's power and authority to its board of directors, who in turn delegate much of this authority to the chief executive officer and other senior managers pursuant to the corporation's bylaws and board resolutions. In every state, there is a statutory provision paralleling the following language in the American Bar Association's Revised Model Business

20. There have been a number of estimates of this ratio. For the 500 to 1 estimate (as of 2003), see Bebchuk & Fried, footnote 15 supra, at 1. For another estimate, of 400 to 1, see Editorial, Atonement in the Boardroom, N.Y. Times, Sept. 21, 2002, at A-14 (noting comments by the president of the Federal Reserve Bank of New York that chief executives' compensation had risen to 400 times the compensation of the average employee, up from 42 times in 1980). A more recent study, based on 2005 data, by the Economic Policy Institute places the ratio of the average CEO's earnings to that of the average worker at 262 to 1. See Lawrence Mishel, CEO-to-Worker Pay Imbalance Grows, Economic Snapshots, available at http://www.epi.org/publications/webfeatures_snapshots_20060621/. Finally, the AFL-CIO estimates this ratio at 380 to 1. See http://.aflcio.org/2013/3/4/working-america-wealth-inequality-much-worse-you-think-and-congress-just-made-it-worse. For even more recent data, see notes 15 to 17.

21. See Lucian A. Bebchuk & Holger Spamann, Regulating Bankers' Pay, 98 Geo. L.J. 247, 255-274 (2010).

22. Section 956 of the Dodd-Frank Act (codified at 12 U.S.C. §5641) broadly authorized financial regulators to limit excessive compensation, but to date this provision has only been implemented in an equivocal fashion with few substantive restrictions.

23. Section 952 of the Dodd-Frank Act added new Section 10C to the Securities Exchange Act of 1934, which requires compensation committee members to meet standards of independence specified by the stock exchanges. The Dodd-Frank Act also mandated advisory, nonbinding votes by shareholders of public companies on executive compensation (so-called say on pay votes), which are discussed in Chapter VI.

24. See Charles Elson & Craig Ferrere, Executive Superstars, Peer Groups, and Over-Compensation: Cause, Effect and Solution, 38 J. Corp. L. 487, 493 (2013).

Corporation Act (RMBCA, 3d ed.): "All corporate powers shall be exercised by or under authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors. . . ."[25]

Given that directors exercise the authority and power of the corporation, who are these directors? In a small, closely held or family business, the directors will probably be the corporation's principal shareholders (many of whom will probably be employee-managers as well). In large publicly held corporations, however, a substantial majority of the board will be composed of "outside" directors having no employment or economic relationship with the corporation (and usually holding in the aggregate only a small percentage of the firm's shares). This trend toward majority independent boards is accelerating, along with a concomitant trend for boards to become smaller and to have fewer insider or "affiliated" members. For example, a 2010 study of the boards at the companies included in the S&P 500 found that 84 percent of directors qualified as independent.[26]

Along with the trend toward fewer inside directors, a concomitant trend has arisen toward a smaller board size. In 2019, the size of the average board of a corporation included in the S&P 500 index was 10.7; in 1992 it had been 15.[27] Of these 10.7, 9.1 were independent, and 1.6 were affiliated directors. The rationale underlying both of these trends is that a smaller board with fewer inside directors is less likely to be dominated by the CEO and hence can better protect shareholder interests.

Of course, an "outside" director should not be automatically equated with an "independent" director; other economic or personal relationships may exist. For example, the director may be associated with a law or investment banking firm that provides services for the corporation. Although the number of such "interested" outside directors appears to be in decline,[28] one recent study finds 11 percent of all directors as falling into the intermediate category of "affiliated directors"—that is, directors who are not insiders but have some economic relationship with the firm, such as that of a consultant, attorney, or investment banker.[29] This shift over time toward an independent majority and the declining presence of "affiliated" directors is well illustrated in Figure 1.1, prepared by Professor Jeffrey Gordon.[30]

Since Professor Gordon's study (which ended with data for the year 2005), this trend has continued. In 2019, 85 percent of S&P 500 board members were classified as independent.[31]

25. RMBCA §8.01(b) (2002).

26. See Spencer Stuart 2011 Board Index: The Changing Profile of Directors (2012).

27. See Spencer Stuart 2019 Board Index, at 14.

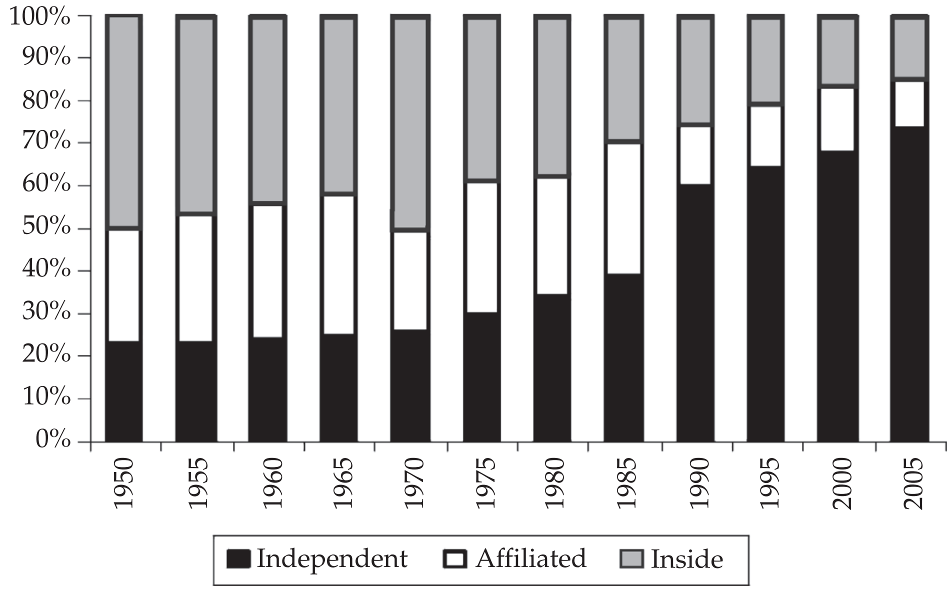
28. To illustrate this trend, it is noteworthy that a 1979 SEC study found that 35 percent of directors in its sample were directly employed by the corporation, and another 29 percent had economic relationships with the corporation that necessitated disclosure in the corporation's proxy statement (for a total of 64 percent). See SEC Staff Report, Corporate Accountability 432-436, 591-597, and Table 2 (1979). By 1983 this percentage was beginning to decline, and a study in that year found that 61 percent of the directors on the boards surveyed were "independent of the senior management of the corporation." See Heidrick & Struggles, The Changing Board 3 (1983).

29. See Jeffrey Gordon, The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices, 59 Stan. L. Rev. 1465, 1565 (2007); see also Biao Xie, Wallace N. Davidson III & Peter J. DaDalt, Earnings Management and Corporate Governance: The Roles of the Board and the Audit Committee, 9 J. Corp. Fin. 295, 303 (2003).

30. See Gordon, supra footnote 29, at 1474.

31. See 2019 Spencer Stuart Board Index at 8 (Spencer Stuart 2020).

*Figure 1.1*
**BOARD COMPOSITION, 1950-2005**




Who today serves on the board of a publicly held corporation? The simple answer is that the largest constituent group is chief executives and chief financial officers of other corporations,[32] with a smattering of university presidents, foundation executives, former public officials, academics, and others to add diversity. In the case of the largest public corporations, an effort has typically been made within the last decade to add women and minority representatives, but the corporate board is far from a microcosm of American society generally and still remains populated primarily by white male business executives[33] (as we will discuss shortly).

How hard must directors work? Boards of S&P 500 companies meet on average between eight and nine times a year, with their audit committees also meeting on average nine times a year.[34] In 2006, a survey by a leading consulting firm found that the majority of the directors at Fortune 1000 companies spend at least 16 hours per month on board matters (or approximately 192 hours a year)—up from 159 hours in 2004.[35] The National Association of Corporate Directors more recently has

32. In 2019, 30 percent of newly appointed directors were active or retired CEOs and another 10 percent were CFOs. See 2019 Spencer Stuart Board Index. An earlier study had found that 63 percent of outside directors in its sample were chief executives of other corporations. See Jay W. Lorsch & Elizabeth MacIver, Pawns or Potentates: The Reality of America's Corporate Boards 18 (1989). Seemingly, recent studies have found some reductions in the percentage of directors who are active or former CEOs.

33. The pace of social change in the boardroom has been slow but noticeable. As of 2011, one survey found that 91 percent of Fortune 1000 corporations had at least one woman on the board, 78 percent had at least one African American director, 45 percent had at least one Hispanic/Latino director, and 16 percent had at least one Asian director. See Spencer Stuart, footnote 26 supra, at 8 and 20. We will shortly see that these percentages have increased very recently.

34. See 2019 Spencer Stuart Board Index, supra note 31.

35. See Korn/Ferry International, 32nd Annual Board of Directors Study (2006) at 53-54.

estimated that directors work an average of 245 hours a year.[36] The job seems to be getting more time-consuming.

Not surprisingly, board compensation has risen commensurately. Typically, directors receive an annual retainer fee, a per-meeting fee, and—increasingly—stock grants or options. Looking at the S&P 500, one consulting firm has estimated the median total remuneration package for the individual independent director rose to $305,000 in 2019.[37] Of this amount, 57 percent was paid in stock and only 38 percent in cash (with the balance being other perquisites).

Currently, the character and operation of the American corporate board are undergoing a significant transition, with the most important changes relating to (1) the separation of the roles of the CEO and the Board Chairman; (2) the introduction of the "lead director" concept; (3) the new role and duties of the audit committee, as established by the Sarbanes-Oxley Act of 2002; (4) new independence requirement for the boards of publicly listed firms; and (5) an intensifying search for gender and racial diversity:

1. *The separation of the board chair and the CEO*. Until very recently, the CEO of a U.S. public company typically also served as its board chair. Although this structure was favored by CEOs (who believed there could only be "one captain to a ship"), institutional investors wanted board structures to resemble those of boards in the United Kingdom, where the two positions were almost always separated. Investors believe that separation of the two roles gives the independent directors greater ability to monitor the CEO and control the board's agenda. Over time, they brought increasing pressure on boards to separate the positions, and the trend is moving in favor of such separation. In 2019, 53 percent of S&P 500 companies split the two positions,[38] but they did not necessarily appoint an independent director as board chair, often instead appointing the recently retired CEO as chair.[39] As a result, only 34 percent of S&P 500 companies had an independent chair in 2019.[40] The tide is clearly shifting, but gradually.

2. *The "lead director*." Where the board permits the CEO to also serve as board chair, the standard pattern has become to appoint a functional substitute for the nonexecutive chairman: the "lead director."[41] The lead director (sometimes called the "presiding director") will be an experienced, independent director elected by the independent directors, whose primary function will be to chair an annual review of the chief executive's performance.[42] This procedure contemplates one

36. See 2016-2017 NACD Public Company Governance Survey at 2 (National Association of Corporate Directors 2017).

37. See 2019 Spencer Stuart Board Index, supra note 31, at 8. For an earlier study, see Pearl Meyer & Partners, 2006 Director Compensation Report: Study of the Top 200 Corporations (2006) at 3-4.

38. See 2019 Spencer Stuart Board Index at 22.

39. For example, a 2011 survey found that although 41 percent of S&P 500 companies then had a formal policy requiring the separation of the CEO and chair roles (up from 33 percent in 2006), only 21 percent required an independent chair (as compared with 10 percent in 2006). See 2011 Spencer Stuart Board Index at 22.

40. See 2019 Spencer Stuart Board Index. This 34 percent figure was up substantially from only 16 percent in 2009—in effect, doubling in a decade.

41. The lead director position was originated by the General Motors board in the early 1990s after it discharged its chief executive officer following a long and difficult internal process, which convinced them that the independent directors needed a focal point on the board.

42. Under GM's guidelines, the independent directors meet without management's presence at least three times a year to evaluate the CEO. The lead director also sets the board's agenda on these issues. For an overview of the concept, see Gordon, supra note 29, at 1494-1495.

or more meetings at which the board, in the absence of the chief executive and other insiders, will assess the chief executive's performance and consider succession issues. This compromise was mandated in 2002 by the NYSE and Nasdaq for their U.S. listed companies.[43] Proponents of this system believe that other outside directors who have concerns about the chief executive's performance will contact the lead director and treat him as the natural leader of any board effort to restrain or remove the CEO. Corporations can implement this concept in a variety of ways, ranging from strong to weak. Some appoint one senior director as the lead director for a term; others rotate the position among the chairs of various board committees, thereby avoiding the institution of any permanent lead director. The NYSE requires only that the outside directors meet by themselves to review the chief executive's performance and does not require that the board elect a lead director.

3. *The enhanced role of the audit committee.* Boards of directors typically operate through committees. Of particular importance is the audit committee; the board of every large publicly held corporation has such a committee, whose role is to maintain oversight over the company's accounting and financial reporting processes. This obligation involves the audit committee both in supervising internal control functions, which are designed to protect the corporation from diversion or misappropriation of its assets, and in guarding the integrity of the company's financial statements. Increasingly, audit committees have also assumed responsibility for the corporation's compliance with legal and regulatory obligations. Beyond simply monitoring the independence and performance of the company's outside and internal auditors, the audit committee must review the company's financial disclosures, meet with the auditors, and ask probing questions of both management and the auditors. In particular, the committee is expected to understand and evaluate the company's critical accounting policies, respond to whistle-blowers, analyze its major financial risks and its policies for managing those risks, and assess the quality of the company's disclosures to the market. Not surprisingly, the audit committee tends to meet more frequently than other committees (or the board as a whole), and corporations increasingly pay audit committee members more than other directors.

A basic rationale underlying the audit committee is that, if the corporation's management were to employ overly aggressive or otherwise inappropriate accounting policies, the corporation's auditors could quietly report this to the audit committee, which is staffed exclusively (at least in theory) by independent directors. By design, the audit committee is a back channel or safety valve by which the auditors can report their concerns to the independent directors without directly confronting the company's management. For this reason, the NYSE in the late 1970s required all its listed companies to maintain an audit committee composed solely of directors independent of management.[44]

Still, the flurry of accounting irregularity cases that arose from 2000 to 2002 showed that the board was often not aware of how risky or aggressive its

43. The 2011 Spencer Stuart Board Index finds that 97 percent of the corporations in its survey had a "lead" or "presiding" independent director. Id. at 24. This 3 percent shortfall (from 100 percent compliance) is probably explained by the fact that the NYSE and Nasdaq policies on lead directors do not apply to companies with controlling shareholders.

44. For the current audit committee rule, see NYSE Listed Company Manual §303A.00 (2004).

management's financial reporting policies were. As a result, a principal goal of the Sarbanes-Oxley Act,[45] which Congress passed by overwhelming margins in 2002, was to enhance the authority of the audit committee and rewire the internal circuitry of reporting within the corporation to ensure that any doubts or concerns held by the auditors reached the audit committee. To this end, the Sarbanes-Oxley Act specifies federal independence standards for audit committee members,[46] mandates that the audit committee "be directly responsible for the appointment, compensation, and oversight of the work" of the independent auditor, and specifies that such audit firm "shall report directly to the audit committee."[47] Control over the auditor's compensation was assigned to the audit committee because Congress feared that otherwise management might "bribe" the auditor with high fees and lucrative consulting work into acquiescing in risky or dubious accounting policies. Congress also prohibited the auditors of publicly held firms from performing certain defined consulting activities for their audit client—again to preserve the auditor's independence. Effectively, Congress's mandates regarding the audit committee override state corporation law (for listed firms) and transfer authority from the board and the shareholders to the audit committee. Further, the Act grants the audit committee the authority to hire independent counsel and other advisers, whose fees must be paid by the corporation.[48] In addition, the Act expands the role of the audit committee from simple supervision of accounting and financial reporting to a broader watchdog role under which it must establish procedures for the receipt and evaluation of anonymous submissions by employees of concerns regarding "questionable accounting or auditing matters."[49]

4. *New independence requirements.* In the wake of Enron and related scandals, the SEC asked the NYSE and Nasdaq in 2002 to review their corporate governance listing standards. After much study and debate, the two exchanges agreed on new and closely similar listing standards, which include the following principal new standards:[50]

a. *Listed companies must have a majority of independent directors.* While a majority independent board was already the norm prior to Sarbanes-Oxley, a significant percentage of listed companies did not comply. Now, a public company that is listed on a major exchange must have a majority independent board.[51]

b. *Listed companies must have an audit committee, a nominating committee, and a compensation committee, each composed exclusively of independent directors.* The nominating

45. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

46. The statutory requirements are contained in §301 of the Sarbanes-Oxley Act (codified as §10A(m) of the Securities Exchange Act of 1934) but have been implemented by SEC rules that are now set forth in Rule 10A-3 under the Securities Exchange Act of 1934. In addition, the exchanges have adopted their own requirements. See NYSE Listed Company Manual §§303A.02, 303A.06, and 303A.7 (2007). Rule 10A-3 precludes the audit committee member from receiving "directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof," other than a fee for service as a director or committee member.

47. See §301 of Sarbanes-Oxley Act of 2002 (codified as §10A(m)(2) of the Securities Exchange Act of 1934).

48. See §301 (codified as §10A(m)(5)-(6) of the Securities Exchange Act).

49. Id. (codified as §10A(m)(4) of the Securities Exchange Act).

50. In the case of the NYSE, the new standards are codified in §303A of the Exchange's Listed Company Manual.

51. For the NYSE's rule, see NYSE Listed Company Manual, §303A.01. The NYSE's definition of "independence" is set forth in NYSE Listed Company Manual, §303A.02 and requires the board to "affirmatively determine that the director has no material relationship with the listed company."

committee must both recommend to the entire board the director nominees for the next annual meeting of shareholders and specify written criteria for the selection of directors and the regular evaluation of the board and management.[52] The compensation committee reviews the compensation of the corporation's executives and recommends to the full board the terms of incentive compensation and equity-based stock plans.[53] In 2010, the Dodd-Frank Act further enforced the stock exchanges' rules by statutorily requiring that compensation committee members of listed companies meet certain standards of independence.[54]

c. *The definition of "independent director" has been tightened.* In particular, the new definition adopted by the NYSE excludes any person having a material relationship with the company (including an officer or shareholder of another company that does business with it), as well as former employees who are within three years of their departure or retirement from the company. Stock ownership, even of a significant amount, was not, however, seen as a material relationship that made the director less than independent, but rather was regarded as a factor that naturally motivated the director to be more vigilant. Each board of a listed company is expected to develop its own categorical standards for determining director independence and to disclose in the corporation's annual proxy statement its basis for determining that a particular relationship did not materially affect director independence.

d. *An assessment.* How important are these new changes? Some evidence indicates that boards and committees today meet more frequently and spend more time at their tasks than in the past.[55] But what benefits have resulted from the emergence of a more active and independent board over the last two decades? Here, there is controversy. Some believe that the new emphasis on the independence level of the board does not adequately respond to the accountability problems demonstrated by Enron, WorldCom, and the failure of various financial institutions in 2008 because the boards of these companies fully satisfied even the new, enhanced independence requirements.

In general, a number of studies have focused on the effect of board composition on firm performance, but they have taken very different approaches. One group of studies has examined discrete board tasks and functions (such as replacing the CEO or responding to a takeover bid), while a second group has sought to relate board composition to overall company performance—that is, does an independent board improve the "bottom line"?[56]

52. See NYSE Listed Company Manual, §303A.04 ("Nominating/Corporate Governance Committee").

53. See NYSE Listed Company Manual, §303A.05 ("Compensation Committee").

54. See §952 of the Dodd-Frank Act (codified at §10C of the Securities Exchange Act of 1934). However, Congress left it to stock exchange rules to define "independence."

55. See discussion supra at footnotes 34-36. Board meetings now appear to take six hours or more (up from a previous level of four to six hours). See 2011 Spencer Stuart Board Index at 28. But this does not prove that the quality of the decisions made are better.

56. For an overview of the evidence on the effect of board composition on corporate performance, see Gordon, supra note 29, at 1500-1509. For an earlier and more skeptical assessment of whether independent boards improve corporate performance, see Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Bus. Law. 921 (1999) (finding little correlation between board independence and firm performance and even some signs of a negative correlation).

The first group of studies has produced clearer results. An independent board does seem better at resisting financial fraud and probably replaces a poorly performing CEO more quickly.[57] Independent boards may be less likely to overpay in making an acquisition and may be less likely to resist a lucrative hostile offer for the company, but the evidence here is in dispute.[58] However, the second group of studies found little evidence to link board composition to superior company performance.[59] That is, a corporation whose board is 80 percent independent does not seem to outperform a corporation whose board is only 60 percent independent. In general, these empirical studies have not been able to find any significant relationship between the percentage of independent directors and company performance.

How should these inconsistent findings be interpreted? They could suggest that outside directors do better at discrete, specific tasks (e.g., monitoring conflicts, replacing an inferior CEO, restricting defensive takeover tactics) than at improving the firm's competitive strategy or overall efficiency. Alternatively, these findings could mean that even outside directors are not sufficiently independent to have a strong impact on the firm's management (given that the firm's management typically selects, or at least approves, the nomination of outside directors). Finally, some skeptics doubt that independence really matters that much at all, in part because outside directors are usually chosen (or at least approved) by the chief executive officer and have little incentive, time, or ability to resist the CEO.[60]

Some critics of the current system argue that the only truly independent directors are professional ones — that is, persons who serve full-time as directors of no more than a few corporations.[61] A cadre of such director candidates, they argue, could be identified and recruited by institutional shareholders and would be primarily loyal to them, rather than to management. This proposal remains controversial because some fear that full-time directors would become rivals to the CEO, and others fear that directors would primarily be loyal to the particular constituency of shareholders that nominated them. As a result, little movement in this direction is discernible.

Finally, why do outside directors serve? Most surveys find that the financial rewards are of only secondary significance and that directors are primarily motivated by the hope that they will learn from service on a "quality" board or because of the honor in being selected.[62] Against these nonpecuniary rewards, outside directors must weigh both the risk of liability (from derivative and securities litigation often based on negligence theories) and the growing time demands. The policy issue, discussed further in Chapter VIII, is obvious: If one believes outside

57. See Gordon, supra note 29, at 1501-1505; Michael Weisbach, Outside Directors and CEO Turnover, 20 J. Fin. Econ. 431 (1988); Jerold B. Warner, Ross L. Watts & Karen H. Wruck, Stock Prices and Top Management Changes, 20 J. Fin. Econ. 461 (1988). For an overview, see Sanjai Bhagat & Bernard Black, The Non-Correlation Between Board Independence and Long-Term Firm Performance, 27 J. Corp. L. 231 (2002).

58. See Gordon, supra note 29, at 1502-1503; Bhagat & Black, supra note 57, at 930.

59. See Bhagat & Black, supra note 57; see also Benjamin E. Hermalin & Michael S. Weisbach, The Effect of Board Composition and Direct Incentives on Firm Performance, 20 Fin. Mgmt. 101, 102 (1991).

60. For a classic critique of independent directors as an illusory reform, see Victor Brudney, The Independent Director — Heavenly City or Potemkin Village, 95 Harv. L. Rev. 597 (1982).

61. For such a proposal, see Ronald Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863 (1991).

62. Lorsch & MacIver, supra note 32, at 26.

directors are the key to corporate accountability, exposure to liability may chill their willingness to serve. Conversely, if one is skeptical about the capacity or motivations of outside directors, an even greater threat of liability may be necessary to maintain their loyalty and vigilance.

e. *The search for diversity*. Let's start with some data: From 2014 to 2019 the percentage of board seats held by women rose from 19 percent to 27 percent at S&P 500 companies and from 12 percent to 19 percent for companies in the Russell 3000.[63] Ethnic diversity has increased at a slower rate, with the number of Russell 3000 board seats held by African Americans increasing from 3.6 percent in 2008 to only 4.1 percent in 2019. However, for the top 200 companies in size, African Americans made up 10 percent of directors in 2019.[64]

In terms of new director appointments, both women and minorities did substantially better. The percentage of new directorships filled by women increased from 27 percent in 2014 to 46 percent in 2019 for the S&P 500 and from 21 percent to 45 percent for the Russell 3000. In the case of ethnic minorities, the percentage of new directorships received by African Americans increased from 15.3 percent in 2008 to 21.1 percent in 2019 for the S&P 500 and from 9.1 percent to 13.3 percent for the Russell 3000. Obviously, much like the proverbial half-filled glass of water, reasonable people can disagree about whether these statistics show progress or only reflect a slow and inadequate rate of change. Larger corporations do appear to be showing greater responsiveness toward diversity concerns, and all corporations appear to be focusing new appointments on diversity candidates. The blunt truth, however, is that simply using new appointments to increase diversity implies a slow rate of progress. The alternative is either to expand the board's size or to request some incumbent directors to retire.

Legislatures and regulators have also recently acted to mandate board diversity. California has led the way, acting first in 2018 to require boards of corporations headquartered in California to have at least one female director (and in later years more), even if the corporation is incorporated in a different state.[65] Then, in 2020, it followed up by enacting an additional statute requiring public companies headquartered in California to have board members representative of "underrepresented communities" by the end of 2022.[66] Such "communities" are defined to include "an individual who self identifies as Black, African American, Hispanic, Latino, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self identifies as gay, lesbian, bisexual, or transgender." The number of required directors from such communities will depend on board size.

These statutes (and similar ones in other states that have followed California) raise issues under both the Equal Protection Clause and the "internal affairs

63. These statistics are derived from Kosmas Papadopoulos, U.S. Board Diversity Trends in 2019, 2 to 3 (ISS Analytics 2019). Note that the Russell 3000 excludes all S&P 500 companies and thus is a measure of smaller companies.

64. See 2019 U.S. Spencer Stuart Board Index, supra note 31, at 21 (2019). Because the typical board is comprised of 10.7 directors, this means that at the top 200 corporations there was on average one African American director.

65. See 2018 Cal. Legis. Serv. Ch. 954 (SB 826) (West) (2018).

66. See AB 979 (2020). By the end of 2022, AB 979 would require a California-headquartered public company with nine directors on the board to have not less than three representatives of "underrepresented communities."

doctrine." The latter long-recognized, but under-examined, doctrine holds that the law of the jurisdiction of incorporation governs as to all matters of internal corporate governance.[67] It is estimated that several hundred corporations incorporated in Delaware are headquartered in California, thus setting the stage for legal conflict. No prediction is here made as to how such litigation will be solved, as it is also possible to view increased board diversity as a remedy for past discrimination that occurred in the jurisdiction in which the company was headquartered.

In late 2020, Nasdaq asked the SEC to approve as a required listing condition for companies seeking to list on it that they have both a minority director and another director who identifies with approximately the same "underrepresented communities" as specified in California legislation.[68] Interestingly, the Nasdaq proposal noted that at least 75 percent of its presently listed firms would not be in compliance with this new requirement. To date, neither the SEC nor the NYSE has responded publicly to the Nasdaq proposal, and some fear the possibility that some issuers might switch their listings to the NYSE to avoid mandatory diversity requirements.

A final source of pressure on boards to increase diversity has been the major institutional investors. In 2017, the three largest institutional investors began such a campaign and had immediate success. According to one study, in 2019 alone, this campaign more than doubled the largest number of women directors appointed in any prior year.[69] In short, those who hold the votes can be very persuasive.

*Shareholders.* Three basic features characterize the share ownership of U.S. public corporations: First, ownership is dispersed, with relatively few publicly held corporations having a controlling shareholder or an identifiable control group. Second, approximately 70 percent of the stock in U.S. public corporations is today owned by institutional investors, and, in the case of the 1,000 largest U.S. public corporations, this percentage rises to the mid-70s range.[70] Viewed in historical perspective, the rise of institutional investors was an epic transition, as only 6.1 percent of all equities in 1950 were owned by institutional investors.[71] The growth from that level to over 50 percent by 1970 spurred a variety of changes in institutional investor behavior, including their insistence on a variety of reforms (e.g., more independent directors, more diversity on the board, and, most recently, substantive measures to curtail climate change).

67. In Edgar v. MITE Corp., 457 U.S. 624, 645 (1982), the Supreme Court held that the internal affairs of the corporation, which it defined as "the matters peculiar to the relationship among and between the corporation and its current officers, directors, and shareholders," must be governed by the laws of the state in which the company is incorporated. Under such a definition, the composition of the board of directors would seemingly be controlled by the internal affairs doctrine.

68. See Chip Cutler, "Pressures Rise to Diversify Boards," The Wall Street Journal, December 8, 2020.

69. See Todd Gormley, Vishal R. Gupta, David A. Matsa, Sandra C. Mortal & Lukai Yang, The Big Three and Board Gender Diversity (available on SSRN at https://ssrn.com/abstract=3722653 (2020)).

70. The Conference Board, Institutional Investment Report found that 73 percent of the stock of the largest 1,000 corporations was owned by institutions as of 2009 (at 26). Institutional investors are reluctant to invest in smaller or mid-sized companies because they fear that they will have inadequate liquidity if they wish to sell. Thus, the percentage that they own of a company's stock increases with the company's size.

71. Id. at 26. The Conference Board estimates, at the top 1,000 corporations, the latest percentage of institutional ownership was 73 percent (as of the end of 2009). Id. at 27. Historically, the leading reason for the increased size of institutional ownership after 1950 was the appearance of private pension funds shortly after World War II (with General Motors being the leading corporation that established its own pension plan).

The third basic factor about institutional share ownership may be even more important: institutional ownership has not only grown, but has greatly concentrated. Today, five to eight such investors will often hold sufficient shares to be able to exercise de facto control (i.e., 25 percent to 40 percent). This greatly economizes on the time and costs that these investors must expend to influence management, and it induces management to listen.

The first two factors partially cancel each other out. That is, dispersed ownership means that in most U.S. corporations there is not a single shareholder owning 10 percent of the stock (and in many companies not even 5 percent). As a result, prior to the growth of institutional investors, collective action by shareholders to resist a management plan or proposal, or to elect a new board that would replace the incumbent management, was both difficult and costly. However, increased shareholder concentration has greatly reduced cost. Although a typical institution will seldom hold more than 5 percent of any corporation's stock, the top five institutional owners today collectively hold around 20 percent (and sometimes more), and the top 25 institutional investors typically will own a majority of the stock, implying that the coordination costs associated with shareholder activism have declined and that shareholders may as a result be more able than in the past to resist management. Increasingly, institutional investors do in fact act collectively and can force changes on reluctant corporations. However, as next discussed, different types of institutional investors behave differently and show characteristically different approaches toward shareholder activism.

Who are the principal institutional investors? The "Big Three" of institutional investors—BlackRock, Inc., State Street Global Investors, and the Vanguard Group—now hold over 20 percent of the shares (on a value-weighted basis) in the S&P 500 (and vote approximately 25 percent at shareholder meetings).[72] On some issues, as few as six institutional investors have forced giant oil companies to change their position on climate change issues, reversing earlier stances that the oil companies had long held.[73]

In terms of categories, the two dominant groups of institutional investors are: (1) mutual funds, which are regulated by the Investment Company Act of 1940 and overseen by the SEC, and (2) pension funds, many of which are regulated by the Employee Retirement Income Security Act of 1974 ("ERISA"), which is overseen by the U.S. Department of Labor. Other significant groups of institutional investors include insurance companies, hedge funds (which are largely exempt from the Investment Company Act of 1940), university endowments, and bank trust departments. More important than these formal differences are their approaches to investing. Many large mutual and pension funds are "indexed"; that is, they invest in broad market indexes that seek to match the market. Thus, they seek less to beat the market than to assure investors of the market return. In contrast, other mutual funds and most hedge funds are seeking to outperform the market and tend to invest in a much smaller number of stocks. In 2019, for the first time, the

72. Lucian Bebchuk & Scott Hirst, The Specter of the Giant Three, 99 B.U. L. Rev. 721, 724 (2019).
73. Madison Condon, Externalities and the Common Owner, 95 Wash. L. Rev. 1, 10-11 (2019) (discussing six institutions, including The Big Three, that forced Royal Dutch Shell to reverse its policy on emissions).

assets managed by "indexed" mutual funds exceeded the funds held by "actively managed" mutual funds.[74]

Because they invest in a large number of stocks, indexed investors are less able to supervise every stock in their portfolio. From a cost/benefit perspective, these indexed investors doubted that they could justify the cost of research and monitoring of a large portfolio of companies.[75] As a result, indexed investors historically have been more "passive" in their approach to corporate governance than stock-picking mutual and hedge funds, which are frequently characterized as "activists." This active/passive distinction can be overstated, however, as increasingly investors from both groups form coalitions that can place irresistible pressure on corporate managements—often with a result that directors favored by these institutions are added to the board. Procedurally, "activist" funds sometimes circulate a lengthy and carefully researched memorandum to other institutional investors, including their more "passive" colleagues, in the hopes of convincing them that a particular company's strategy is flawed and should be improved. Based on this memo, they may seek support to nominate a slate of candidates to the criticized company's board. Sometimes they are successful; sometimes not.

For other reasons, many institutional investors do not seek to participate in the "control" of public corporations and are reluctant to nominate their officers or employees to positions as directors. Multiple reasons can explain this reluctance, including: (1) fear of insider trading liability if, while holding a seat on the board, they came into possession of arguably material, nonpublic information, (2) doubt that they could outperform professional management, and (3) possible liability as a director or controlling person and insufficient time to perform their fiduciary responsibilities. Above all, a basic control/liquidity trade-off complicates institutional investor participation in corporate governance: The more institutions that become involved in governance and hold large equity stakes, the more they might be forced to sacrifice their liquidity.[76]

One dramatic exception to this generalization about the limited interest of many institutional investors in corporate governance must be recognized: hedge funds.

74. In 2019, indexed funds (here, meaning funds that tracked a broad market index) for the first time exceeded the assets of traditional mutual funds, holding $4.27 trillion in assets in comparison to $4.25 trillion in assets for traditional, stock-picking mutual funds. See Dawn Lin, "Index Funds Are the New Kings of Wall Street," The Wall Street Journal, (September 18, 2019). See also Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, The New Titans of Wall Street: A Theoretical Framework for Passive Investors, 168 U. Pa. L. Rev. 17 (2019). Essentially, the American retail investor has decided that it would prefer to match the market with diversified index funds than to beat it with stock-picking funds (which have much higher fees and risks).

75. See Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863 (2013) (these authors do note, however, that mutual and hedge funds that hold smaller portfolios and take greater stakes in portfolio companies have a greater incentive to engage in costly research and monitoring). Indexed investors can, however, easily take positions on "generic" or recurring issues that arise at many companies (such as diversity, climate change, and board independence). Recently, they have been much more active on these issues than have been the mutual funds and hedge funds.

76. See John Coffee, Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277 (1991). For example, if institutions place their own employees on the board of a company in which they are shareholders, they may come into possession of material nonpublic information and thus be restricted from trading by the laws against insider trading. Or they may become subject to §16(b) of the Securities Exchange Act of 1934, which precludes such persons from making "short-swing" trading profits (both of these restrictions are discussed infra in Chapter V). The barrier here is that many institutional investors value their ability to sell immediately more than they value any right to a greater voice in corporate decisionmaking.

Although far fewer in number and smaller in size than mutual funds, hedge funds are very active traders that typically account for over half the daily trading on the New York and London stock exchanges, and thus they can "move the market."[77] Legally, hedge funds are unregulated mutual funds; that is, they are pooled investment funds, typically organized as limited partnerships, that hold securities and possibly other assets for their owners and are managed by professional investment advisers, but they are exempt from most of the provisions of the Investment Company Act of 1940, which regulates mutual funds.[78] This exemption enables hedge funds to remain undiversified and thus to take concentrated positions in portfolio companies (which most mutual funds cannot do and must remain diversified).

Ordinary retail investors do not have access to hedge funds (because they are regarded as a high-risk investment that should not be offered to unsophisticated investors). Hedge funds are not permitted to market or sell interests in themselves to the general investing public and must either (a) have 100 or fewer beneficial owners,[79] or (b) sell their securities only to high net-worth individuals.[80] Given their ability to hold an undiversified portfolio, hedge funds often take large equity positions in their portfolio companies (typically up to 10 percent).[81] One of their preferred strategies is to seek out underperforming companies that they believe are poorly managed in order to organize a coalition of investors (often called a "wolfpack") to change their policies and possibly their managements. Frequently, in order to boost these companies' stock prices, they seek to force divestiture of non-core divisions, encourage stock buybacks, and push for increased leverage. This is a risky strategy, but hedge funds are motivated to take on risk by a compensation structure that typically pays their investment adviser 20 percent (or sometimes more) of the profits that the fund makes. Thus, their advisers accept high risk in exchange for a high return.

A final word about individual shareholders: today, they hold less than 25 percent of the shares in U.S. public corporations, but even this level of participation by individuals in the U.S. equity markets is higher than in any other country. One survey found that slightly over 91 million U.S. citizens owned stocks (either directly, through ownership of mutual funds, or through employer-sponsored retirement plans).[82] Hence, a broad decline in stock market levels may have political consequences in the United States that it does not have elsewhere. Although many individual shareholders are wealthy and have large portfolios, the American middle class has increasingly invested its retirement income in equity securities, largely through diversified mutual funds. This extensive participation by the middle class in the stock market in the United States, which is not paralleled in Europe

77. For an overview, see Cary Martin, Private Investment Companies in the Wake of the Financial Crisis, 37 Del. J. Corp. L. 49 (2012).

78. Title IV of the Dodd-Frank Act of 2010 required larger hedge funds to register under the Investment Advisers Act of 1940 but left them exempt from the Investment Company Act (which regulates the conduct and structure of mutual funds).

79. See §3(c)(1) of the Investment Company Act of 1940, 15 U.S.C. §80a-3(c)(1).

80. See §3(c)(7) of the Investment Company Act of 1940, 15 U.S.C. §80a-3(c)(7) (requiring that these "qualified" purchasers own at least $5 million in investments).

81. For a focus on the new role of hedge funds in corporate governance, see Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021 (2007).

82. See Investment Company Institute and Securities Industry Association, Equity Ownership in America, 2005, at 44.

or elsewhere, helps explain why issues of market fairness find their way onto the national political agenda in America.

## D. *HISTORY AND EVOLUTION OF THE BUSINESS CORPORATION*

Between the eighteenth and early twentieth centuries, corporate law in the United States moved from a form of public law used to regulate legislatively chartered entities formed for a quasi-public purpose (such as organizations formed to build canals or turnpikes or to establish banks or insurance companies) to an almost entirely private body of law, available to all and much more enabling than mandatory. This transition never, however, reached the point where corporate law lost all its mandatory features and became simply a model form contract. Indeed, one feature of corporate law has remained constant: only the state can create a corporation and confer limited liability on its shareholders.

At the time of the American Revolution, the established English doctrine was that only the king in Parliament could create a corporation.[83] Such royal charters had been important because they often bestowed a de facto monopoly on the recipient and also enabled their recipients to undertake the range of public functions performed by the early trading companies, such as setting up local governments and conducting negotiations with the indigenous peoples of a colonial territory. English law had sought to constrain the use of the corporate form in order to preserve the political authority of the Crown to grant charters. But private business organizations, established as joint ventures or partnerships, were still regularly formed to conduct overseas trading operations, and by the mid-eighteenth century, judicial decisions had begun to protect their right to compete with chartered corporations.

Then, in the early eighteenth century, a famous financial panic—the "South Sea Bubble"[84]—changed and colored the English view of the corporation, associating it with a speculative mania in which shares in worthless or overvalued firms were traded at steadily escalating prices until the inevitable collapse of the financial markets resulted in scarce credit and business failures throughout the economy. The legacy of this scandal was the Bubble Act, passed by Parliament in 1719, which barred unchartered joint stock companies from selling their securities to the public in the hope of restricting market trading to those more stable companies chartered by the Crown.[85] To evade this statute, promoters developed a functional substitute: the trust became a device for holding business assets for the benefit

83. For the best overview of the early development of American corporate law, see J. Willard Hurst, The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970 (1970).

84. For a history of this period, see John Carswell, The South Sea Bubble (1960); Virginia Cowles, The Great Swindle: The Story of the South Sea Bubble (2002).

85. The Bubble Act, 1719, 6 Geo. 1, ch. 18, §§18-29, was largely repealed in 1825. Many believe it had little effect and did not restrict speculative syndications. Still, the corporate form acquired such a stigma in the eyes of British investors that it was used only sparingly, for a limited number of quasi-public businesses, such as canals, turnpikes, insurance companies, and banks. Yet, truly speculative syndications continued to be offered to investors through the trust or deed-of-settlement device and joint stock associations, even though they lacked complete limited liability. See A. B. DuBois, The English Business Company After the Bubble Act, 1720-1800 (1938).

of investors, thus forming a substitute for the corporation, one whose beneficial interests could be traded. Although the beneficiaries of this device enjoyed limited liability as a practical matter, the trustee did not. Whether this device really overcame the Bubble Act's prohibition on unincorporated business entities assuming corporate powers was never really tested, but it did link the development of corporate law with basic concepts of trust law, such as that of fiduciary duty.

### 1. THE EARLY AMERICAN EXPERIENCE

The foregoing reasons for skepticism about the corporate form may have had less relevance in the American context, but they did establish the starting point for American lawmaking after the Revolution. At the beginning of the nineteenth century, the American political context furnished independent reasons for hostility to the corporate form. Basically, the Jeffersonians were reluctant to encourage industrialization because they feared the consequences of large amounts of capital being assembled in any private enterprise; thus, they saw liberalized access to the corporate form as part of the Federalists' political program, to which they were generally hostile. In consequence, use of the corporate form was subjected to a host of restrictions, and the corporation was often regarded as a quasi-public entity.

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". . . Corporations were not that common, before 1800. Few of them were business corporations. Almost all colonial corporations were churches, charities, or cities or boroughs. New York City was a chartered corporation. In all of the eighteenth century, charters were issued to only 335 businesses. Only seven of these were issued in the colonial period; 181 were granted between 1796 and 1800. Banks, insurance companies, water companies, and companies organized to build or run canals, turnpikes, and bridges made up the overwhelming majority of these early corporations. A mere handful, notably the New Jersey Society for Establishing Useful Manufactures (1791), were established for manufacturing purposes.

* * *

Until about the middle of the century, the corporation was by no means the dominant form of business organization. Most commercial enterprises were partnerships. They consisted of two or three partners, often related by blood or marriage. The partnership was "used by all types of business, from the small country storekeepers to the great merchant bankers." But as the economy developed, entrepreneurs made more and more use of the corporation, especially for transport ventures. The corporate form was a more efficient way to structure and finance their ventures. But the special charter system was clumsy and cumbersome. And it wasted a legislature's time as well—or would have, if the legislature actually scrutinized each charter, and wrote charters to order, case by case. In fact, except for projects of special importance, charters became stylized, standardized, matters of rote, or were dictated by the promoters. General incorporation laws, as we will see, finally replaced the special charter system.

From the standpoint of modern corporation law, the early charters seem quite odd. Today, almost all corporations have no expiration date; they can last (in theory) forever. In the early nineteenth century, charter terms of five, twenty, or thirty years' duration were quite common. In New Jersey, every manufacturing company (except one) had a limited term of life before 1823; perpetual duration was rare before the Civil War. In Maryland, a general law of 1839 limited corporate life (for mining or manufacturing companies) to a maximum of thirty years. Early charters also often departed from the principle of one vote for each share of stock. It was not the rule in Maryland, for example, until after 1819. In New Hampshire, under the charter of the Souhegan Nail and Cotton Factory (1812), each of the fifty shares of capital stock was entitled to a vote, but no member was entitled to more than ten votes, no matter how many shares he owned . . .

* * *

The main line of development in corporation law seems fairly clear. Variations were leveled out; practice moved in the direction of a kind of common law of corporations; business custom and the needs of entrepreneurs fixed the basic shape. Between 1800 and 1850, the essential nature of the corporation changed. The corporation was, originally, a kind of monopoly. It was a unique, ad hoc creation; it tended to vest exclusive control over a public asset, a natural resource, or give a business opportunity to one group of favorites or investors or segments of the public. This was what the charter of a town or a hospital was like—or a turnpike, a bank, or a bridge company. The monopoly aspect made the corporation odious to Jefferson's followers. But then the corporation became something different: a general form for organizing a business, legally open to all, and with few real restrictions on entry, duration, and management. In a sense, this democratized the corporation, or at least made it open to competition, to the free market, to the battle of businesses for a share of the trade. Business practice led the way, in many regards. The living law on proxy voting, general and special meetings, inspection of books, and the transfer of stock, gradually created demands (which were met) for standard clauses in corporate charters. These norms ultimately found their way into the statute and case law of corporations. . . .

* * *

Fear of unbridled power is a constant theme in American history—mostly government power, but also, at times, large landowners, big businesses, dynastic wealth. Fear also, of corruption; money was an acid that could corrode the rule of law. Legislatures could hand out charters and franchises. Bribery was always a danger. People associated corporations with franchises and monopolies. This was not a fantasy. Franchises *were* monopolies. Banks were aggregations of capital; they seemed to represent the "few" against the "many." Unlike farms and stores and textile mills, they did not make anything, at least nothing real. At least this is what people thought. Banks, and maybe all corporations, were too powerful, and they were parasites, not producers. The more corporations, the bigger the danger. James Sullivan, attorney general of Massachusetts, warned in 1802 that "The creation of a great variety of corporate interests . . . must have a direct tendency to weaken the power of government."

Corporations were "soulless," as the phrase went. Of course, as everybody knew, human beings ran corporations. But, unlike people, corporations did not necessarily die. There was no limit to their size, or their greed. They could aggregate the worst impulses of the men who ran them. Profit was their only emotion.

In theory, the special charter system was a form of control. But the process could be infected with corruption. And, by the 1840s and 1850s, the demand for charters threatened to swamp the legislatures of the states. State session laws bulged with special charters. In the first half of the century, Pennsylvania issued nearly two thousand special charters, mostly to transportation companies, a "time-consuming and cumbersome" process. This was a colossal waste of time. Moreover, there was no real supervision. The logical step — which was taken — was to pass general corporation acts. One carefully considered law could save time and make rules for all corporations. And the corporate form would no longer be a privilege of the few.

* * *

In the famous case of *Dartmouth College v. Woodward* (1819),[79] the U.S. Supreme Court seemed to face the issue of control over corporations squarely. By the terms of the federal Constitution, no state could impair the obligation of a contract. But what was a "contract"? Dartmouth College was, like many colleges and other institutions, in form a corporation, with a charter in its home state of New Hampshire. The New Hampshire legislature passed a law, making major changes in the way the college was to be run — increasing, for example, the number of trustees and giving the state more control. All this contradicted the terms of the college's charter. The Supreme Court, speaking through Chief Justice John Marshall, struck down the statute. A corporate charter was "a contract made on a valuable consideration," a "contract for the security and disposition of property." It followed that the legislature could not change the terms of a charter. To do so would "impair" the charter, that is, the contract between the state and the corporation.

Dartmouth College was no business corporation; but the court, and the newspaper-reading public, well understood that this was an important decision. Its significance went far beyond the question of a small college and the way it was governed. A howl of protest followed from some quarters. This was from people who felt that the case was a blow to popular sovereignty; it took away from "the people and their elected representatives" a "large part of the control over social and economic affairs." That was one way of looking at the case. The court and its defenders saw it differently. This decision, and others like it, protected investments and property interests. It shielded them from shifting, temporary winds of public opinion. It promoted legal stability, which in turn promoted economic growth. It encouraged risk- taking in business.

*Dartmouth College* had a far less sweeping impact than one might have guessed. In a concurring opinion, Justice Joseph Story hinted, perhaps deliberately, at a simple way to get around the new rule. If the legislature, Story said, really wanted to alter corporate charters, it ought to reserve the right to do so when it issued these charters. Then the right to change the terms of the charter would be, legally speaking, part of the "contract" between the state and the corporation, and when the legislature passed a law amending the charter, there would be no "impairment." In later years, legislatures routinely inserted a clause in each charter, reserving to the state the right to alter, amend, and repeal. This right was also a common feature of

79. 4 Wheat. 518 (1819).

general incorporation laws. Finally, the right was inserted in state constitutions. The New York Constitution of 1846 provided that "all general laws and special acts" about corporations "may be altered from time to time or repealed" (art. 8, sec. 1).

* * *

At first, the courts treated corporate powers rather gingerly. There was a "general and well settled principle" that corporation only have the powers that were "specifically granted" or were "necessary for the purpose of carrying into effect the powers expressly granted." If you thought of a corporation as a single venture, or capital to be used for a single purpose — a bridge, a factory, a bank — then this principle made sense. Chief Justice Roger Taney built on this principle in the famous case of the Charles River Bridge (1837).[82] Massachusetts had chartered a company in the late eighteenth century to build a toll bridge over the Charles River. Many years later, the state granted another charter, to a new group of entrepreneurs. The second bridge, to be built very close to the first one, was to be (after a brief period) completely free. This would, of course, ruin the investment in the original bridge. The owners of the old bridge sued. They argued that the new charter violated the constitution, in that it impaired the obligation of a contract (their charter). Cases like *Dartmouth College* seemed to support their case.

But the Supreme Court held against them. There was no impairment of the contract (the charter). A charter had to be narrowly interpreted. The state never promised not to charter a competing bridge. The Supreme Court (speaking through Chief Justice Roger Brooke Taney) insisted on reading the original charter quite literally, insisting that, in interpreting a charter, nothing can be implied or read into it. The case, however, reflects beautifully the ethos of the times: the worship of growth, progress, development; the impatience with old, vested rights; the idea that an economic omelet cannot be made without breaking eggs. The old bridge, like the old turnpikes, had to give way to what-ever was more dynamic, more modern, and more progressive . . .

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## 2. NINETEENTH-CENTURY EFFORTS TO CONTROL THE CORPORATION

The *Dartmouth College* and *Charles River Bridge* cases involved the controversial political question of the degree of freedom that private corporations should have from legislative control (the Federalists won a partial victory under Marshall in *Dartmouth College,* but suffered a temporary setback in *Charles River Bridge* when Taney, a Jackson appointee, read corporate powers very narrowly). A related concern during this period, however, united Federalist and Jeffersonian judges: the status of creditors. If creditors advanced money or goods to the corporation and the shareholders then withdrew their capital, creditors seemed to be left without legal recourse. Although the law on fraudulent conveyances could easily have been stretched to deal with this abuse, a distinctly American solution was instead devised that, although lacking

82. *Proprietors of the Charles River Bridge v. Proprietors of the Warren Bridge*, 11 Pet. 420 (1837); on the background and meaning of the case, *see* Stanley I. Kutler, *Privilege and Creative Destruction: The Charles River Bridge Case* (1971).

any clear precedent in English law, responded directly to this perceived attempt by those who hid behind the "soulless" corporation to exploit creditors.

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The business corporation was an economic animal. It existed to make profits. It was managed by officers and directors, and it had stockholders, who in theory owned the company. Then there were the corporation's creditors. The case law had to struggle with new questions: What rights and duties did these have with regard to each other? One answer was the so-called trust-fund doctrine, which Joseph Story gets credit for inventing. The leading case was *Wood v. Drummer* (1824).[83] Stockholders of the Hallowell and Augusta Bank, of Maine, which was winding up its corporate existence, declared dividends amounting to 75 percent of the capital stock of $200,000. The bank thus became a hollow shell. Not all of the capital stock had actually been paid for. The plaintiffs held bank notes that became worthless. The stockholders, Story felt, could not distribute capital to themselves, defrauding the creditors (that is, the holders of the bank notes). The capital stock of banks was "to be deemed a pledge or trust fund for the payment of the debts contracted by the bank." Creditors could "follow" the funds "into the hands of any persons, who are not innocent purchasers," and recover it from them. The stockholders, who had lined their pockets with bank money, were liable to the creditors. Later cases picked up this doctrine and applied it to more broadly. Slowly, courts built up a body of rules to regulate the internal life of corporations, and the relationships between corporations and the outside world.

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In effect, Wood v. Drummer held that at least a portion of the capital contributed to a corporation by its shareholders was irrevocably committed and could not be withdrawn to the prejudice of creditors. From this "trust fund" concept, our contemporary law on dividends and watered stock (discussed in Chapter III.D) eventually developed. The "trust fund" doctrine acquired special prominence toward the end of the nineteenth century when the famous robber barons of that era (Jay Gould, Jim Fisk, Commodore Cornelius Vanderbilt) recurrently sought to exchange overvalued or worthless property in return for shares of a solvent corporation that they controlled (typically, a railroad) in order to dilute the interests of the other shareholders. Such stock was called "watered stock," after the practice of feeding salt to cattle in order to make them thirsty enough to consume large quantities of water and thereby increase their weight just before they were sold by the pound. Professor Friedman discusses the uncertain response of American courts and legislatures to these recurrent frauds and their first attempts to establish rules and remedies for the protection of investors.

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Some of the vultures were truly spectacular. In the 1860s and 1870s, men like Vanderbilt, Jay Gould, and Jim Fisk fought tawdry battles over the stock market, the economy, and the corpses of railroad corporations. The investing public

83. 3 Mason C.C. Rpts. 308, Fed. Cas. No. 17,944 (1824).