The Modernization of Corporate Law: An Essay for Bill Cary

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KEYNOTE ADDRESS

The Modernization of Corporate Law: An Essay for Bill Cary*

MELVIN ARON EISENBERG**

The business reality to which corporate law relates is constantly evolving. The author argues that in many critical areas, corporate statutory law has failed to evolve alongside that business reality, with the result that much of the statutory law is obsolescent and in need of modernization. After discussing some of the institutional reasons for this statutory obsolescence, he illustrates the problem by discussing the areas of corporate combinations, shareholders' informational rights, corporate distributions, and corporate structure, and describes how a few statutes have managed to deal with the underlying issues in these areas in a realistic manner. He concludes by discussing the prospects for modernizing corporate statutory law.

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I am Reporter for Parts I, II, and III of the American Law Institute's Principles of Corporate Governance: Recommendations and Analysis. This paper, however, is addressed for the most part to issues that differ from those addressed by the Principles, and even where the issues are comparable, the positions taken in this paper do not necessarily coincide with those taken in the Principles.

I am indebted for the very helpful comments of Richard Buxbaum, Jesse Choper, Harvey Goldschmid, Marshall Small, and Jan Vetter.
Bill Cary was the leading figure in corporate law from the early 1960's, when he assumed the chairmanship of the Securities and Exchange Commission, until his death. No one was his equal in seeing the large picture and in seeing the way the law was heading. With his passing a figure of remarkably clear vision and great moral and intellectual stature left the scene. I miss him inestimably as a friend and collaborator.

In the early part of this century, the statutory corporation law governing publicly held corporations entered a sort of ice age. Technical revisions continued to be made, case law principles were occasionally codified or modified, and some transactions that were once prohibited became permissible. Nevertheless, many fundamental problems and important new business developments often went unrecognized and untreated, as the statutes became hopelessly frozen in critical areas. Within the last ten years, signs have emerged that suggest that the modernization of corporate statutory law may be near at hand. This paper will discuss some of the reasons for the long freeze (part I), consider four areas in which statutory corporation law has become particularly unresponsive to the real world (part II), and finally turn to some portents of change (part III).

I. STRUCTURAL IMPEDIMENTS TO THE MODERNIZATION OF CORPORATE LAW

Historically, two clusters of institutional elements have inhibited the legislative modernization of corporate law. The first cluster is now so well-known that I need only summarize it here. Under traditional choice-of-law rules, a corporation's internal affairs are governed by the law of the state in which it is incorporated, and a corporation may incorporate even in a state with which it has no significant economic contacts. Similarly, under traditional tax rules, a state in which a corporation is incorporated may levy franchise taxes on the corporation, even though the corporation has no other significant economic contacts with the state. In most large publicly held corporations, management selects the state of incorporation: shareholders are unlikely to have sufficient information to either make or evaluate the incorporation decision, even if they were inclined to do so. A state with a small fiscal base, to whom franchise taxes may be a highly significant proportion of revenue, therefore has little financial incentive to take account of
shareholder interests.\(^1\)

The second cluster of elements inhibiting legislative modernization of corporate law concerns neutrality and information. A rule of law may be thought of as neutral if at the time of the rule's adoption it cannot be predicted whether the rule will systematically work for or against the interests of any given class of persons. For example, most rules in the body of contract law—what constitutes an offer, what causes an offeree's power of acceptance to lapse, and so forth—are neutral in this sense. In contrast, other bodies of law consist largely of rules that do predictably and systematically help or hurt a given class. This does not mean that such rules are bad: For one thing, it is often appropriate to promote the interests of a given class (say, veterans). For another, in some cases (such as labor-relations law) the very purpose of the law is to mediate between classes of persons, and it is therefore inevitable that any rule will favor one class or the other. The issue then is not whether the rule is neutral, but whether it is fair and reflects sound policy.

The body of corporate law consists largely of rules that lack neutrality. The major concerns of corporate law are the rights, powers, and responsibilities of managers, shareholders, and, to a lesser extent, creditors. Virtually every rule of corporation law, no matter how trivial, can be quickly and easily analyzed in terms of its impact on these classes.

Over the great run of transactions, of course, the interests of managers and shareholders coincide. Broadly speaking, shareholders and managers alike want the corporation to maximize profits. Therefore, it is generally in the shareholders' interest that the relevant legal rules permit managers to operate the corporation's business with the maximum feasible flexibility and that the rules do not inhibit entrepreneurial risk-taking. Nevertheless, there are some important cases where the interests of managers and shareholders may conflict. When managers are inefficient, the interest of shareholders is to change managers, while the interest of the managers is to stay in office. When managers transact business with the corporation in a self-dealing capacity, the interest of the managers may be to insulate the transaction from review, while the interest of shareholders is to have the transaction independently reviewed

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for fairness. The list could be extended, but the point is clear. Like other parties to an interdependent relationship, shareholders and managers have both coinciding and conflicting interests. Furthermore, in at least some of the areas where the interests may conflict, the shareholders' interest is coincident with the national economic interests in the efficient use of productive resources and in healthy capital markets.

Neutral legislative rules can be made from behind the veil, solely on the basis of fairness and sound policy. Nonneutral legislative rules cannot, because any class of persons that will be obviously affected by a new rule has an obvious interest in lobbying for or against it. Such lobbying may, but need not, involve political power. There are two sides to every story, and a lobbyist might do no more than articulately present to the legislature the side he or his client believes to be the right side. Serious problems can arise, however, if a class of persons significantly affected by nonneutral rules is not well-organized for involvement in the legislative process.

In many bodies of law consisting of nonneutral rules, serious problems of this type do not arise because the major classes directly affected by a body of law are all well-organized for legislative involvement. For example, both unions and management lobby actively on labor-relations law, and both shippers and carriers lobby actively on carrier law. In other instances serious problems of this type do not arise, even though a directly affected class is not well-organized for legislative involvement, because the resulting gap is largely filled by independent or countervailing government experts. For example, in the securities-law area Congress can draw upon the resources of the Securities and Exchange Commission and House and Senate committee staffs, and state legislatures can draw upon the resources of blue-sky commissioners.

In the corporate area, a major class significantly affected by corporate statutory law—the shareholder class—has traditionally not been well-organized for involvement in the legislative process. Much stock is held by shareholders whose interests are too small to justify a significant investment in the legislative process. Most of the balance is held by corporate institutional investors who have the potential for effectively organizing for this purpose, but traditionally have not done so. Nor is the resulting gap filled by other institutions. Although corporate law is technical, complex, and outside the knowledge of most individual legislators, legislatures typically do not have independent experts to draw on for advice.
Although corporate law is traditionally a state concern, few states have either executive or legislative staffs with significant corporate law expertise.

It often happens, therefore, that although an area of statutory corporate law has become badly outmoded in a manner that has an unsound impact on shareholders, and often therefore on the economy, the problem is not effectively brought to the legislature's attention. Accordingly, a legislature may fail to make needed changes to modernize its corporate law, without regard to the question of franchise-tax dollars, because of lack of sufficient information at the levels where it counts.

II. FOUR CRITICAL AREAS IN THE CORPORATE STATUTES

Part II will explore four critical areas in which most corporate statutes have fallen fifty to seventy-five years behind economic reality, due, it seems likely, to the institutional elements discussed in part I. These areas are corporate combinations, shareholders' informational rights, corporate distributions, and corporate structure.

A. Corporate Combinations

The prototypical corporate combination is a transaction that may be referred to as a classical merger. Nonlawyers often use the term merger to describe all forms of combination. To a lawyer, however, it normally means the fusion of two corporations pursuant to an agreement executed with reference to specific statutory merger provisions, under which the stock of one corporation (the "transferor") is converted into stock of the other (the "survivor"). The survivor then succeeds to the transferor's assets and liabilities by operation of law. At one time the classical merger was probably the dominant mode of corporate combination, but in modern times its scope has been reduced significantly. Among the most important modes of modern combination are stock-for-assets and stock-for-stock combinations. In a stock-for-assets combination, Corporation A issues shares of its own stock to Corporation B in exchange for substantially all of B's assets. Normally, A assumes B's liabilities, although often B's liabilities are assumed only on a selective basis. Usually, B agrees that it will dissolve and distribute its A stock to its own shareholders. Frequently, it is also agreed or understood that some or all of B's officers and directors will join A's management.

In a stock-for-stock combination, Corporation A issues shares
of its own stock directly to the shareholders of Corporation B in
exchange for an amount of B stock—normally at least a major-
ity—sufficient to carry control of B. As a result, the shareholder
groups of A and B are combined to a substantial extent, and B
becomes a subsidiary of A. Frequently, B is then liquidated or
merged into A, but whether or not this occurs, B’s assets will be
under A’s control. In theory, a stock-for-stock combination does
not require approval by B’s management, because corporate action
by B is not required. In practice, however, the managements of
both corporations often work out the terms of the exchange before-
hand. Often, it is agreed or understood that some or all of B’s man-
agement will either stay on with B in its new role as a subsidiary or
will join Corporation A.

Although stock-for-assets and stock-for-stock combinations
are probably at least as prevalent today as classical mergers, most
corporate statutes do not specifically address either of these new
forms of combination. Call the corporation that issues shares the
“survivor” and the other constituent corporation the “transferor.”
In the absence of explicit statutory provision, a stock-for-assets
combination might be viewed as a merger of the transferor and the
survivor, or as a sale and acquisition of the transferor’s assets ef-
fect through the issuance of the survivor’s stock. The rights of
shareholders will often differ sharply according to which view is
taken. For a classical merger, the traditional statutes usually re-
quire approval by a majority or two-thirds of the outstanding vot-
ing shares of both constituents, and normally give appraisal rights
to the shareholders of both constituents. For a sale and acquisition
of substantially all assets, however, the traditional statutes may
not give appraisal rights to the transferor’s shareholders, and do
not explicitly provide either voting or appraisal rights to the survi-
or’s shareholders.

Similarly, in the absence of explicit statutory provision a
stock-for-stock combination may be viewed, from the survivor’s
perspective, either as a merger with the transferor or as an acquisi-
tion of the transferor’s stock. For a classical merger, the traditional
statutes give the survivor’s shareholders both voting and appraisal
rights. For an acquisition of stock, however, the traditional statutes
do not explicitly give either of these rights to the survivor’s
shareholders.²

² For a discussion of the classical merger and the stock-for-stock and stock-for-assets
modes of combination, see M. Eisenberg, The Structure of the Corporation: A Legal
Economically, a stock-for-assets transaction is normally identical to a classical merger. Where previously there were two entities, two sets of assets, two sets of liabilities, and two sets of shareholder groups, there is now one entity, one set of assets, one set of liabilities, and one shareholder group. Similarly, from the survivor’s perspective a stock-for-stock combination is economically equivalent to a classical merger in most cases, and when followed by a preplanned liquidation of the survivor, it is virtually indistinguishable from a classical merger. The traditional corporate statutes, which explicitly cover classical mergers but not stock-for-stock and stock-for-assets combinations, may have made sense when the classical merger was the dominant form of combination, but that was long ago. In the area of corporate combinations, the traditional statutes are more than a half-century out of date.

Most courts, when called upon to determine the rights of shareholders in a corporate combination, have pierced through the form of a combination to look at its economic substance. Most legislatures, however, have failed to revise their statutes to provide a systematically integrated treatment of combinations, or even to explicitly recognize the newer modes of combination. Several statutes, most notably those of California and Ohio, are exceptions. The California statute, adopted in 1975, begins by defining “reorganization” to mean (1) a merger; (2) an exchange (stock-for-stock) reorganization, in which the survivor, through an exchange of equity securities, attains ownership of shares carrying more than fifty percent of the transferor’s voting power; or (3) a sale-of-assets reorganization, in which the survivor issues equity securities or long-term unsecured debt securities as consideration for substantially all of the transferor’s assets. A merger or sale-of-assets reorganiza-


4. CAL. CORP. CODE § 181 (West 1977); id. § 181 legislative committee comment (West 1977). The California code defines “voting power” as the power to vote for the election of directors, excluding the right to vote upon the happening of a future condition or event. Id. § 194.5 (West 1977). (An example of stock that has the right to vote only upon a future condition or event is preferred stock that carries voting rights under contractually defined conditions.) The statute defines “equity security” to include shares, securities convertible into shares, and warrants or securities representing a right to purchase or subscribe for shares or securities convertible into shares. Id. § 168 (West 1977). A transaction may qualify
tion normally must be approved by the shareholders of both constituents, unless the shareholders of one constituent, or their corporation, will end up with more than five-sixths of the voting power of the combined enterprise. (Approval by that constituent's shareholders is then not required, on the ground that the reorganization is not sufficiently significant from that constituent's perspective.) An exchange reorganization normally must be approved by the shareholders of the survivor, subject to the same exception.

In general, appraisal rights follow voting rights, but appraisal is usually not available for shares that are listed on certain major stock exchanges, or included in the Federal Reserve list of over-the-counter margin stocks, unless five percent or more of the class dissents.

The Ohio statute is comparable to that of California. It regulates stock-for-stock and stock-for-assets combinations and provides voting and appraisal rights for both combinations. A few other statutes have addressed the relevant issues, but much less adequately than the statutes of California and Ohio.

as a reorganization even though the survivor issues debt as well as equity securities, but an exchange of assets solely for debt securities that are adequately secured and mature within five years after the consummation of the transaction does not constitute a reorganization. Id. § 181(c) (West 1977).


6. Id. § 1201(b) (West 1977). Section 1201(c) provides, however, that "[n]otwithstanding the provisions of subdivision (b), a reorganization shall be approved by the outstanding shares . . . of the surviving corporation in a merger reorganization if any amendment is made to its articles which would otherwise require such approval." Id. § 1201(c) (West 1977). In addition, § 1201(d) provides that

a reorganization shall be approved by the outstanding shares . . . of any class of a corporation which is a party to a merger or sale-of-assets reorganization if holders of shares of that class receive shares of the surviving or acquiring corporation or parent party having different rights, preferences, privileges or restrictions than those surrendered.

Id. § 1201(d) (West Supp. 1983) (underscore omitted). Finally, § 1201(a) provides that, unless otherwise stipulated in the articles, "no approval of any class of outstanding preferred shares of the surviving or acquiring corporation . . . shall be required if the rights, preferences, privileges and restrictions granted to or imposed upon such class of shares remain unchanged (subject to the provisions of subdivision (c))." Id. § 1201(a) (West 1977) (emphasis added).


8. Id. § 1300 (West Supp. 1983).


A much simpler scheme—which does not, however, deal with appraisal—is provided by the rules of the New York Stock Exchange. Under those rules, approval by the issuer’s shareholders is required if a listed company issues securities to acquire a company or business property (or securities representing such interests), and either (1) the issuance of common or securities convertible into common could increase outstanding common by at least eighteen and one-half percent, or (2) the combined fair value of the common to be issued and any other consideration is at least eighteen and one-half percent of the market value of the issuer’s outstanding common. The rules of the American Stock Exchange are comparable.

The California and Ohio statutes, and the exchange rules, show that a modernized and sensible treatment of corporate combinations is both technically feasible and legislatively practicable. They therefore serve to underscore the failure of the great majority of states to modernize their corporate statutes in this important area.

11. See NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 312.00 (1983).
12. AMERICAN STOCK EXCHANGE GUIDE (CCH) § 10,198A (Apr. 1983): § 712. Acquisitions—Approval of shareholders is required . . . as a prerequisite to approval of applications to list additional shares to be issued as sole or partial consideration for an acquisition of the stock or assets of another company . . . where the present or potential issuance of common stock, or securities convertible into common stock, could result in an increase in outstanding common shares of 20% or more.

13. Another problem concerning combinations relates not so much to statutory obsolescence as to incomplete modernization. This problem is raised by the triangular merger. A conventional (or forward) triangular merger works this way: Assume that corporations Survivor and Transferor want to engage in a merger in which Survivor will be the survivor and Transferor’s shareholders will end up with 100,000 shares of Survivor. In a normal merger this would be accomplished by having Survivor issue 100,000 shares to Transferor’s shareholders. In a conventional triangular merger, Survivor instead begins by creating a new subsidiary, Survivor/Sub, and then transfers 100,000 shares of its own stock to Survivor/Sub in exchange for all of Survivor/Sub’s stock. Survivor/Sub and Transferor then engage in a statutory merger, but instead of issuing its own stock to Transferor’s shareholders, Survivor/Sub issues its 100,000 shares of Survivor stock. The net result is that Transferor’s business is owned by Survivor’s wholly owned subsidiary (rather than by Survivor itself, as in a normal merger), and Transferor’s shareholders own 100,000 shares of Survivor stock. By use of this technique, Survivor may therefore achieve the advantages of a statutory merger while insulating itself from direct responsibility for Transferor’s liabilities. (I say “may,” because a court could impose these liabilities on Survivor under the de facto merger doctrine, on the theory that in effect Survivor itself is a constituent to the merger. See M. EISENBERG, supra note 2, at 215-52.)

A reverse triangular merger proceeds like a conventional triangular merger, except that instead of merging Transferor into Survivor/Sub, Survivor/Sub is merged into Transferor.
B. Shareholders' Informational Rights

It seems self-evident that shareholders should be adequately informed about the financial results of their managers' stewardship and of material conflict-of-interest transactions between the corporation and its managers. In corporations with a very small number of owners, it can perhaps be taken for granted that shareholders will acquire such information: most or all shareholders are likely to participate in management, all shareholders are likely to have significant holdings, and the corporation is likely to operate in the shareholders' geographical backyard. In publicly held corporations, however, those conditions do not prevail:

(1) Because ownership and control are separated, shareholders typically do not participate in management.
(2) Because ownership is spread nationwide, shareholders typically are not in a position to observe managers directly.
(3) Because individual shareholders typically own relatively small stakes, an individual shareholder's transaction costs of going to court to get information are likely to be out of proportion to the gains he could derive from that information.14

The merger agreement provides that all previously outstanding Transferor shares are automatically converted into the 100,000 shares of Survivor held by Survivor/Sub, and that all shares in Survivor/Sub (which are held by Survivor) are automatically converted into shares of Transferor. When all the shooting is over, therefore, Survivor/Sub will have disappeared, Transferor will be a wholly owned subsidiary of Survivor, and Transferor's shareholders will own 100,000 shares of Survivor stock. By use of this technique Survivor may therefore achieve the advantages of a statutory merger while preserving Transferor's legal status, which could be important when Transferor has valuable rights under contracts, leases, licenses, or franchises.

The problem raised by triangular mergers is that they may allow subversion of shareholder voting and appraisal rights, because it can be argued that voting and appraisal rights on the survivor's side are vested in Survivor (as the sole shareholder of Survivor/Sub) rather than in Survivor's shareholders. A better conclusion would be that a triangular merger does trigger voting and appraisal rights in Survivor's shareholders, either on the theory that Survivor should be deemed a constituent to the merger, or on the theory that such a result is necessary to prevent subversion of the merger statutes. See M. Eisenberg, supra, at 277-307. Ideally, however, this problem should be dealt with by the statute itself. For example, under the California statute, Cal. Corp. Code § 1201 (West Supp. 1983), a merger reorganization must be approved by the shareholders of a corporation that is "in control of any constituent . . . corporation . . . and whose equity securities are issued or transferred in the reorganization." Id. § 1200(d) (West 1977).

14. The third proposition may be less true for institutional shareholders. Nonetheless, even an institutional shareholder is likely to balk at expending funds to produce information that by its nature will almost certainly be public (and therefore available to the entire market) at the moment of its production. In any event, under present law smaller publicly held corporations, which are the corporations least likely to have significant institutional-investor shareholdings, are the very corporations that are often not required to distribute information. See infra p. 197.
Shareholders in publicly held corporations will, therefore, often be less than adequately informed about the financial results achieved by managers and about conflict-of-interest transactions, unless the corporation is affirmatively obliged to disseminate the relevant information to its shareholders. Nevertheless, until the 1930's, corporation law generally did not require publicly held corporations to disseminate either financial or conflict-of-interest data. Even in the 1930's, it was not the states but the federal government that filled this vacuum, through adoption of the Securities Exchange Act of 1934. Today, a corporation with securities registered under the Exchange Act must file with the Securities and Exchange Commission, and disseminate to its shareholders, extensive information on its financial condition and on material transactions between the corporation and its principal managers. These requirements, however, apply to only a fraction of all publicly held corporations, because they are applicable only if a corporation has at least 500 record holders of a class of equity securities. This number may be appropriate for determining the applicability of federal law to corporations. It is, however, well above the line distinguishing those corporations in which shareholders are likely to acquire financial and conflict-of-interest information in the natural course of events, from those in which shareholders are likely to remain uninformed unless dissemination is affirmatively required.

Accordingly, there is an obvious need to require corporations that have significant public ownership, but less than 500 shareholders, to disseminate to their shareholders information on financial results and material conflict-of-interest transactions. Only a few state statutes, however, have adequately addressed that need. California is one such state. Under the 1975 revision of the California statute, any corporation that has 100 or more record shareholders, and is neither registered under the Exchange Act nor exempted from such registration, must send its shareholders an annual report that includes a balance sheet, an income statement, and a statement of changes in financial position for the fiscal year. The financial data must be prepared in conformity with generally accepted accounting principles. The annual report must also describe any transaction during the previous fiscal year, in-

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volving an amount in excess of $40,000, in which a director, officer, or more-than-ten-percent shareholder had a direct or indirect material interest, and any indemnification exceeding $10,000 paid during the fiscal year to any officer or director. Corporations with less than 100 record shareholders must send to their shareholders an annual report that includes a balance sheet, an income statement, and a statement of financial change. The financial data must be prepared on a reasonable basis, and the accounting basis used in the preparation of the data must be disclosed. In these smaller corporations, mandatory dissemination of an annual report may be waived in the bylaws, but if it is, any shareholder is entitled to the relevant information on request. Moreover, five-percent shareholders in any size corporation are entitled, on request, to an interim statement covering the elapsed quarters of the current fiscal year.

The Model Business Corporation Act also addresses the need for dissemination of information to shareholders, although on a more limited basis. Section 52 of the Model Act, as revised in 1978, provides that every corporation must furnish to its shareholders annual financial statements, including a balance sheet and an income statement. The statements must be prepared on the basis of generally accepted accounting principles if the corporation prepares financial statements for the fiscal year on that basis for any purpose. The California and Model Act provisions demonstrate the practicability of requiring the dissemination of vital information to shareholders in smaller publicly held corporations. Nevertheless, it still appears that most statutes do not address the issue at all, and even those that do are often subject to critical limitations.

20. MODEL BUSINESS CORP. ACT § 52 (1979). Financial statements audited by a public accountant must be accompanied by a report setting forth his opinion. Financial statements that are not so audited must be accompanied by a statement of the president or the person in charge of the corporation's financial accounting records. The relevant person must (1) state his reasonable belief as to whether the financial statements were prepared in accordance with generally accepted accounting principles and, if not, describe the basis of presentation, and (2) describe any respects in which the financial statements were not prepared on a basis consistent with those prepared for the previous year. Id.
21. Under the Ohio statute, for example, the corporation must make available a balance sheet and a summary income statement to shareholders who attend annual meetings or who make a written request for the statement within sixty days thereafter. OHIO REV. CODE ANN. § 1701.38 (Page 1978). Under the Pennsylvania statute, a balance sheet and an income statement must be sent to shareholders unless the bylaws provide otherwise. PA. STAT. ANN. tit. 15, § 1318 (Purdon 1967). Some statutes require disclosure to shareholders of indemnification or advances of expenses to directors arising out of proceedings by or in the right of
C. Corporate Distributions

A corporation normally distributes funds to its shareholders in one of two ways: by paying a dividend, or by repurchasing or redeeming a portion of its stock. Corporate law has traditionally set limits on such distributions through the use of various financial tests that center on the concept of preserving legal capital.22

Most of the statutes adopt either a balance-sheet or an earned-surplus test. Under a balance-sheet test, distributions may be made only out of surplus, as opposed to legal capital. Broadly speaking, surplus falls into two basic categories: earned surplus, which is more or less equivalent to accumulated earnings; and capital surplus, which consists of a variety of sub-accounts, including paid-in, reduction, and revaluation surplus.

In apparent contrast, earned-surplus statutes begin by limiting distributions to that part of surplus that represents accumulated earnings. Typically, however, these statutes go on to permit distributions out of capital surplus under defined circumstances. In the final analysis, therefore, earned-surplus statutes, like balance-sheet statutes, turn on the preservation of legal capital.

What then is legal capital? Originally, it was the aggregate par value of issued stock. In a bygone era, all shares had a par value and most probably were issued at a price equal to par value. In that era, the concept of legal capital had a certain economic significance: legal capital was conventionally more or less equal to the economic capital created by the issue of stock. Modern statutes, however, do not require that shares have a par value, and even shares that have a par value may carry a par value much lower than the price at which they are issued. Accordingly, the economic capital generated by the issue of stock may be much greater than the corporation’s legal capital, which has become a mere legal construct determined in a wholly arbitrary manner. The excess of economic over legal capital that is created on the issuance of shares is designated as paid-in surplus. Distributions can normally be made out of paid-in surplus without violating either a balance-sheet or an earned-surplus statute. Furthermore, legal capital itself can be reduced by a shareholder vote, and the resulting reduction surplus...
can also be used as a source of distributions under either type of statute. Thus the impoverished protection afforded creditors by prohibiting distributions out of legal capital is wholly bankrupted by the warrant to reduce capital and pay dividends out of the reduction.

A related lack of economic reality is found in the statutory treatment of a repurchase by a corporation of its own shares.\textsuperscript{23} From the perspective of creditors, a repurchase is economically indistinguishable from a dividend. Under most statutes, however, a repurchase of shares, unlike a dividend, may not irreversibly decrease surplus, because repurchased stock is conceived of as "treasury stock" and retains the status of issued stock until cancelled or reissued. The rationale of this treatment is that repurchased shares resemble an asset, because they can be resold. In modern corporations, however, authorized shares normally far outnumber issued shares, or easily can be made to do so by certificate amendment. Accordingly, a repurchase of shares normally enables a corporation to do nothing more than it could have done without the repurchase. Economically, therefore, repurchased shares are no more of an asset than are authorized but unissued shares.

In sum, the traditional statutory provisions concerning distributions bear virtually no relation to economic reality. Involuntary creditors, trade creditors, and short-term lenders must normally take this law as they find it. Institutional lenders and preferred-stock underwriters, however, have the power to impose contractual restrictions on distributions beyond those imposed by corporation law, and they normally do so.\textsuperscript{24} The contractual restrictions commonly employed in long-term and preferred-stock underwriting agreements tend to demonstrate what kinds of limits on distributions are economically significant and workable. Under the most common pattern found in long-term loan agreements, for example, the corporation promises not to make a distribution to shareholders unless the proposed distribution, plus all other distributions after a given date, would be less than earnings accumulated after that date plus the proceeds of new stock issues. The relevant date, known as the "peg date," is usually the beginning of the fiscal year in which the debt is issued.\textsuperscript{25} This requirement may be supple-

\begin{footnotesize}
\textsuperscript{23} For a general discussion of corporate stock repurchases, see W. Cary & M. Eisenberg, supra note 22, at 1423-31.

\textsuperscript{24} For a general discussion of the ways in which creditors protect themselves against excessive corporate distributions, see B. Manning, supra note 22, at 91-107.

\textsuperscript{25} During the initial period after the agreement is made, the corporation might not
\end{footnotesize}
mented by a provision that working capital (current assets minus current liabilities) will not fall below a designated level, thereby helping to preserve the quality as well as the quantity of net worth.

In 1975, California modernized its statute along lines comparable to those of long-term loan agreements. To begin with, the California statute drops the concepts of "legal capital" and "surplus"; classifies dividends, repurchases, and redemptions as "distributions"; and treats all distributions under a common set of rules. To oversimplify slightly, a distribution to shareholders is permitted only if (1) retained earnings equal or exceed the proposed distribution, or (2) immediately after the distribution, the corporation's assets will be at least one-and-one-quarter times its liabilities, and current assets will equal or exceed current liabilities. In addition, the statute includes an equity insolvency test, and it prohibits any distribution to holders of a junior class if, following the distribution, the excess of assets over liabilities would be less than the aggregate liquidation preferences of senior classes. Finally, reacquired shares revert to the status of authorized but unissued stock. Thus the building blocks of the California statute are not empty legal concepts, like legal capital and treasury stock, but economic realities, like retained earnings, asset-liability ratios, and liquidation preferences.

In 1979, the Model Act was revised along similar lines. Prior to that time, the Model Act had become a wastebasket of dividend

accumulate earnings or issue new stock. To permit distributions in that event, the agreement often provides the corporation with a cushion, either by setting the peg date back into the past, or by adding to the funds available for dividends a specified amount known as the "dip." The dip frequently approximates the corporation's net income for the fiscal year before the loan or one or two years' dividends at the corporation's established dividend rate.

27. See id. § 166 (West 1977).
29. Id. § 500 (West Supp. 1983). If the corporation's earnings before taxes and interest expense have not been covering its interest expense, current assets must be at least equal to one-and-one-quarter times current liabilities. Id. § 500(b)(2) (West 1977 & Supp. 1983).
30. Id. § 501 (West 1977). A corporation may not make a distribution if the corporation is, or as a result of the distribution would be, unable to meet its liabilities as they mature. Id.
31. Id. § 502 (West Supp. 1983).
32. Id. § 510 (West 1977).
tests—allowing dividends out of earned surplus, out of current income without regard to earned surplus, out of amortization of wasting assets without regard to either earned surplus or current income, out of paid-in surplus, out of reduction surplus, and, according to an official comment, out of revaluation surplus. As revised, the Model Act, like the California statute, drops all references to par value, capital, and surplus; treats dividends and repurchases under the common heading of distributions; and provides that reacquired shares revert to the status of authorized but unissued stock. The commentary accompanying the adoption of these provisions states that "insolvency in the equity sense . . . is] the most important and fundamental test for the permissibility of distributions."

There are a number of important differences between the Model Act and California provisions. For example, as long as liquidation preferences are protected, the California statute permits a distribution if the corporation either has sufficient retained earnings or satisfies both a total and a current assets-to-liability ratio. The Model Act provides only a total assets-to-liabilities test, together with an equity insolvency test and protection of liquidation preferences. In calculating asset-liability ratios, the California statute excludes exotic items such as goodwill, capitalized research and development expenses, and deferred credits. The Model Act does not. The California assets-to-liability tests are based on values determined under generally accepted accounting principles. The Model Act requires only that determinations be based upon accounting principles and practices, or a fair valuation method, reasonable under the circumstances. For present purposes, however, the important point is not which statute is preferable, but that the new Model Act provisions, like those of California, are economically meaningful. This cannot be said of the vast majority of distribution provisions on the statute books.

D. Corporate Structure

Under our national economic system, substantial control over the factors of production and distribution, and over a large share

35. See 1 Model Business Corp. Act Ann. § 2 comment at 36 (2d ed. 1971) ("[w]here directors revalue assets upward, the corresponding credit is to capital surplus").
36. See sections 2, 6, 18, and 45 of the revised Model Act, in Committee on Corporate Laws, Changes in the MBCA, supra note 33.
37. Id. at 1881.
of the resources of individuals and financial intermediaries, is vested in the hands of the privately appointed corporate managers of 2000 or so large publicly held corporations. The legitimacy of this system rests on three fundamental premises: (1) Placing control of the factors of production and distribution in the hands of privately appointed corporate managers who are accountable for their performance, and who act in the interest and subject to the ultimate control of those who own the corporation, achieves a more efficient utilization of economic resources than that achievable under alternative economic systems, without entailing unacceptable costs. (2) Corporate managers are in fact accountable for their performance. (3) Corporate managers act in the interest, and subject to the ultimate control, of the shareholders, who are the owners of the corporation.

Given these premises, the legal system must insist on some institution of accountability, external to the managers, that provides reasonable assurance that efficient utilization of the corporation's resources is forthcoming. One such institution would be direct review of managerial performance by the body of shareholders. In the large publicly held corporation, however, this body cannot be relied upon to conduct the kind of scrutiny required, because of its disparate and shifting nature and the complexity of modern management issues.

Another such institution would be the market. Three types of market mechanisms are potentially relevant. The first consists of the product markets in which the corporation operates, with their attendant sanction of business failure. This mechanism, however, is inadequate to the purpose. A large publicly held corporation can often remain in business for a protracted period of time even with minimal returns, or may earn acceptable returns only because it is coasting on programs that prior managers put into place.

The second relevant market mechanism is the capital market.

38. This right is often challenged on the grounds that share ownership is frequently short-lived and almost invariably derivative in that shareholders typically purchase and sell stock on the market instead of contributing funds directly to the corporation's capital. This challenge is difficult to understand. It might equally well be said that a middleman has less right in his inventory than does a manufacturer, or that a person who buys a house has less right to its control than a person who builds one. There are other problems with the concept of ultimate shareholder control—not least, whether the shareholders are interested in exerting control. For present purposes, however, it is sufficient to note that, in our society, control solely by virtue of ownership—hands-on or hands-off—is a fully legitimating principle. Furthermore, managing the corporation in the interest of shareholders is socially desirable because their interest coincides with society's interest in efficiency.
Inefficient managerial performance will increase the cost of equity capital by decreasing the price at which the corporation's equity capital sells. A corporation with a large cash flow, however, may be able to meet its capital needs for a long period of time through internal and even external financing, although its profits are lower than good management would produce.

The third relevant market mechanism is the market for corporate control. If the corporation's assets are utilized inefficiently, its shares may sell at a price low enough to tempt outsiders to acquire control through a takeover. The takeover mechanism, however, also provides excessive leeway for managerial inefficiency, because of the high transaction costs imposed by the inherent mechanisms of takeover bids, the requirements of relevant statutes, the wide array of available defensive techniques, the incentives to take over well-run instead of poorly run companies, and the time-lag that the public often experiences in ascertaining lack of managerial efficiency.

Finally, because self-interested transactions are typically not sufficiently material in dollar terms to have a significant impact on share prices, market mechanisms, even if fully effective in holding corporate management accountable for efficiency, are unlikely to be effective in regulating managerial conflicts of interest. Such conflicts have public as well as private consequences. Even when these transactions are economically immaterial, they tend to sap the public's confidence, and therefore its willingness to participate, in capital markets.

A constraint beyond the market is therefore required as a check on managerial efficiency, as well as on conflicts of interest. The implicit model of accountability in the traditional corporate statutes was one in which the directors managed the business of the corporation and were accountable to the shareholders. Perhaps this model was accurate 100 years ago, but management by the board and direct accountability to shareholders has long since ceased to be the norm in the large publicly held corporation. Today, it is clear that the business of such a corporation can be managed, in the normal sense of that term, only by full-time executives, and that the shareholders of such a corporation cannot be expected to monitor (i.e., oversee) the management. In effect, the management and monitoring functions have each dropped down one step in the corporate pyramid. The management function has dropped down from the board to the executives; the monitoring function has dropped down from the shareholders to the board.
Accordingly, the primary function of the board should not be to manage the business of the corporation, as the traditional statutes prescribe. Instead, it should be to select the chief executive officer and three or four other top managers (such as the chief financial and accounting officers), and to monitor or oversee their overall conduct of the business—primarily to determine whether the top managers’ conduct of the business is efficient, but also to keep an eye on whether their behavior is consistent with law, generally accepted ethical principles, and standards of humane behavior. Although the board may play a wide variety of other roles, such as participation in strategic planning and approval of major actions and plans, the monitoring or oversight function is paramount.

Performance of this function, however, has two critical prerequisites: directors who can monitor objectively, and an accurate and reliable flow of information to the board. To achieve the first prerequisite, a majority of the directors of a large publicly held corporation should be free of significant relationships to the senior executives, such as familial ties, employment by the corporation, or significant professional or economic relationships with the corporation. In addition, the nomination of directors in these corporations should originate in a nominating committee consisting entirely of directors who have no significant relationships with the corporation’s senior executives. Such a committee helps assure board objectivity in two ways. First, it provides an independent locus of responsibility for the composition of the board. Second, it can screen out candidates who lack objectivity toward the senior executives by virtue of elements that cannot be adequately captured by an objective test, such as particularly close personal relationships or significant interlocking directorships.

That the issue of board composition is easily susceptible of statutory treatment is evidenced by a number of sources. For example, the Investment Company Act provides that no more than sixty percent of the directors of a registered investment company may be “interested persons,” the Canadian and Ontario business corporations acts require companies that issue shares to the public to have at least two outside directors, and the New York Stock Exchange requires listed companies to have at least two di-

40. Id. § 80a-10(a) (1982).
rectors who are independent of management. At present, however, no state corporation statute requires that even a single director be free of significant relationships with the senior executives.

Even a board with a majority of directors who have no significant relationships with the senior executives cannot perform its monitoring function without objective data on the financial results of the managers' stewardship. Under present practice, the power to select the accounting principles used in preparing a corporation's financial statements often lies in the hands of the executives. Virtually the only limit placed on executives is that the accountant must deem the principles selected by the executives to be "generally accepted." But the accountants' standards for determining whether a given principle is "generally accepted" are often very soft.

Furthermore, the accountant's only mechanism for enforcing

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44. For example, a 1982 article in Fortune, concerning Aetna Life Insurance Company, reports:

At a roundtable discussion staged by the Wall Street Transcript last May, five insurance analysts all lamented Aetna's property and casualty troubles, yet went on to predict that the improved first-quarter results already reported would be followed by improved results for the year. One analyst, Donald Franz . . ., framed his prediction memorably. Recalling that Aetna's chairman, John H. Filer, had recently made some positive statements about 1982, Franz said that earnings would quite likely rise "to ensure that the chairman will not be called a liar."

Some of the statements Franz had in mind appeared in Aetna's first-quarter report, in a letter signed by Filer and William O. Bailey, the company's president. They spoke of "increased balance and stability," of earnings improvements over the last three quarters, and of "our belief that Aetna will maintain reasonable and improving profits this year."

The remarkable thing about that letter, about a second-quarter letter that followed, and about the analysts' forecasts to boot is that none of these declarations about Aetna mentioned the overwhelming and extraordinary reason why its 1982 earnings are up. The reason, made visible only by a terse footnote to Aetna's financial statements, is tax benefits that the company has been plugging into its earnings even though at best it will not realize the benefits until sometime in the future.

The effects on the company's 1982 earnings have been dramatic. In the first six months of the year, Aetna took $138 million of these anticipated tax benefits into its earnings, an amount accounting for no less than 62% of reported operating earnings of $222 million. Without this boost, the company's operating earn-
Typically, the accountant is dependent on

ings would have been 60% lower than in 1981. Had they been reported in this

And just how unusual are Aetna’s tactics? Extremely and undeniably so, to

The problem is addressed in Opinion No. 11, a pronouncement issued by a pre-

A company might pass this test, the opinion then says, if three conditions,

Some accountants, among them Aetna’s auditors, Peat Marwick Mitchell,

In a letter, a CPA responded to the Fortune article:

More than anything else, your article illustrates that the much ballyhooed

Fortune, Jan. 24, 1983, at 20. Eventually, Aetna agreed, under pressure from the Securities

45. A clean certificate is an unqualified opinion stating that the financial statements

fairly present the firm’s financial condition in accordance with generally accepted account-

ings to withhold a clean certificate from the corporation’s

financial statement. Typically, the accountant is dependent on

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ings would have been

There. It is not that oper-

ating tax-loss carry-forwards are scarce: lots of companies have them and would

no doubt be delighted to convert them immediately into current earnings. But
generally accepted accounting principles come close to prohibiting the practice.
The problem is addressed in Opinion No. 11, a pronouncement issued by a pre-

decessor of the profession’s self-regulatory body, the Financial Accounting Stan-

ards Board. The opinion declares that realization of the tax benefits ordinarily

is not “assured” because a company can’t know with absolute certainty that it

will have taxable profits in the future against which the loss carry-forwards can

be used. Therefore, says the opinion, tax benefits arising from loss carry-for-

wards should not be recognized in profits until they are realized, except in un-

usual circumstances when realization is assured “beyond any reasonable doubt.”

A company might pass this test, the opinion then says, if three conditions,

each and all, are satisfied. The first concerns the character of the loss being car-

ried forward: it must have resulted from “an identifiable, isolated, and nonrecur-

ring cause.” The second concerns the character of the company: it must have

been continuously profitable over a long period or have suffered occasional losses

that were more than offset by taxable income later on. The third concerns the

character of the taxable income expected: it must with near certainty be large

enough to offset the loss carry-forward and must come along fast enough to de-

liver the tax benefits within the carry-forward period.

Some accountants, among them Aetna’s auditors, Peat Marwick Mitchell,

have interpreted this listing of conditions as providing “such as” guidance; that

is, if a company can meet tests “such as” the ones stated, it may consider its tax

benefits to be realizable beyond a reasonable doubt. The problem with this in-

terpretation is that the accounting office of the Securities and Exchange Com-

mission doesn’t agree with it. The SEC regards the conditions as absolute re-

quirements that must be met.

Loomis, Behind the Profits Glow at Aetna, FORTUNE, Nov. 15, 1982, at 54, 54-55.

In a letter, a CPA responded to the Fortune article:

Aetna’s inclusion of $138 million in unrealized tax benefits from tax loss

carry-forwards . . . is the most flagrant case of earnings management I’ve ever

seen. When John Shad took over as chairman of the SEC, he said that his goal

was to move away from what he called an excessive emphasis on enforcement,

making it easier for corporations to raise capital. If the SEC has missed too

many cases like Aetna’s, it will reach his goal but at the expense of investors who

rely on what are thought to be accurate financial reports.

More than anything else, your article illustrates that the much ballyhooed

self-regulation of the accounting profession is a grisly joke.

Fortune, Jan. 24, 1983, at 20. Eventually, Aetna agreed, under pressure from the Securities

and Exchange Commission, to eliminate $203 million in “tax benefits” from its 1982 earn-

ings, thereby reducing earnings for that year from $522 million to $319 million. N.Y. Times,

July 8, 1983, at D1, col. 3.
the executives for his tenure in office, and this dependence may result in an almost irresistible pressure on the accountant to go along with marginal principles. A leading student of accounting has said that the accountant “can swallow his convictions or he can qualify his opinion, or he can resign. Usually the latter two courses are one and the same.”

Objective reporting on executives’ financial results cannot be assured in an institutional structure that combines power of selection among competing accounting principles by the very executives whose activities are being accounted for, wide discretion in the executives in making that selection, and auditing of executives’ financial performance by persons whom the executives hire and can fire. To achieve an objective flow of information on the financial results achieved by the executives, the accountant must be truly independent of the executives. Toward that end, publicly held corporations should be required to have an audit committee composed of directors who have no significant relationships to the senior executives. This committee should be vested with the power to select and dismiss the independent accountant (or recommend its selection and dismissal), set the terms of its engagement, and generally oversee the independent auditing process. Again, however, the statutes fall short. Although the need for an audit committee in publicly held corporations is widely recognized, and the New York Stock Exchange rules require companies listed on that

46. D. Ladd, Contemporary Corporate Accounting and the Public 163 (1963) (quoting Leonard Spacek); see also R. Sterling, Presentation made at Oklahoma State University, Distinguished Lecture Series (Mar. 16, 1972), reprinted in Statement in Quotes: “Accounting Power”, J. ACCT., Jan. 1973, at 61-62 (discussing conflicts of interest confronting auditor when faced by domineering executive); cf. Andrews, Fewer Companies Get Auditors’ Full Okay on Financial Reports, Wall St. J., Apr. 17, 1975, at 1, col. 6 (auditors risk discharge when they issue qualified opinions); Andrews, Why Didn’t Auditors Find Something Wrong with Equity Funding?, Wall St. J., May 4, 1973, at 1, col. 6 (a too-intimate relationship between auditor and company may have been, in part, responsible for Equity Funding collapse); Metz, Market Place: Real and Ideal in C.P.A. Audits, N.Y. Times, Nov. 18, 1972, at 52, col. 3 (questioning independence of auditors).

47. See, e.g., Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, Corporate Director’s Guidebook, 33 Bus. LAW. 1591, 1626-27 (1978) [hereinafter cited as Corporate Director’s Guidebook]; Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, The Overview Committees of the Board of Directors, 34 Bus. LAW. 1837, 1853-61 (1979) [hereinafter cited as Committee on Corporate Laws, Overview Committees]; The Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 Bus. LAW. 2083, 2108-10 (1978); see also Principles of Corp. Governance and Structure: Restatement and Recommendations § 3.05 comment a, at 85-87 (Tent. Draft No. 1, 1982) (a high percentage of corporations have audit committees) [hereinafter cited as Principles].
exchange to have such a committee, only Connecticut requires an audit committee by statute. In short, in the area of corporate structure, as in the areas of combinations, distributions, and dissemination of information, the corporate statutes speak to conditions of the nineteenth instead of the late-twentieth century. Most of the statutes literally require management by the board, which is virtually impossible in the publicly held corporation. Almost none speak to the critical issues of board independence and the need for nominating and audit committees in large publicly held corporations.

III. PROSPECTS FOR THE MODERNIZATION OF CORPORATE LAW

Within the last ten years or so, there has been a remarkable amount of ferment in the area of corporate law. For the moment, the American Law Institute's Principles of Corporate Governance: Analysis and Recommendations is at center stage, but the ferment precedes that project. In 1977, the Business Roundtable issued its statement on The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation. In 1977 and 1978, the ALI, the American Bar Association's Section of Corporation, Banking and Business Law, and the ALI-ABA Committee on Continuing Professional Education, jointly convened four important regional conferences on corporate law. In 1978, the American Assembly issued a report on Corporate Governance in America, and the ABA Section issued the Corporate Director's Guidebook. In 1979, the ABA Section issued a follow-up guidebook, The Overview Committees of the Board of Directors.

This ferment appears to have been precipitated in large part by several developments in the mid-1970's. One was the general reexamination of our institutions that followed in the wake of Watergate. An element of Watergate was the revelation that some of our largest corporations had been engaged in widespread viola-

48. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303.00 (1983).
50. Tentative Draft No. 1 of this project, PRINCIPLES, supra note 47, was approved by the ALI Council in 1982, but was not submitted to the membership for a vote. It is now being extensively revised.
51. The Business Roundtable, supra note 47.
53. CORPORATE GOVERNANCE IN AMERICA (1978) (54th American Assembly).
54. Corporate Director's Guidebook, supra note 47.
55. Committee on Corporate Laws, Overview Committees, supra note 47.
tion of domestic law, and some others had paid bribes to persons at the highest levels of foreign governments and thereby recklessly endangered our national security by putting at risk the political stability of our closest allies. In the short term, these disclosures led to the Foreign Corrupt Practices Act of 1977. In the long term, they needlessly shook the public's confidence in one of the pillars of legitimacy of the American corporate system—the premise (which I regard as correct) that placing control of the factors of production and distribution in the hands of privately appointed managers maximizes our national wealth without entailing substantial nonfinancial costs.

A second development precipitating the current reexamination of corporate law appears to have been a growing realization by the profession that such a reexamination was needed sooner or later, and was best conducted now, in an atmosphere of relative calm. The priority of this need was accentuated by the publication in 1974 of Bill Cary's article Federalism and Corporate Law: Reflections Upon Delaware, which delineated a new concept of federal corporate law. For half a century or more, the idea of federal incorporation has been floated as a response to the defects in corporate statutory law. The name under which that idea passes is somewhat misleading. Usually, corporations may choose the law under which

56. For example, a 1983 Wall Street Journal article reports:

Lockheed Corp. is resisting a fresh attempt to unseal some still-untold secrets about its overseas payoffs, which touched off a scandal in the 1970s that shook governments around the world.

In fact, says a Lockheed lawyer in papers filed in federal court here, disclosure could have a "devastating impact upon the reputations and careers of a number of foreign officials, some of whom hold positions of importance to the foreign relations of this country."

Lockheed's known payoffs were indeed embarrassing when disclosed. Prince Bernhard of the Netherlands, who allegedly received $1 million, resigned official duties. Former Prime Minister Kakuei Tanaka of Japan is still on trial on the charge he took $2 million, and a verdict is scheduled to be handed down Oct. 12. Several Italian officials, including a former defense minister, were convicted in 1979 in connection with alleged bribes of $2 million.

To settle an SEC suit, Lockheed admitted making as much as $38 million in questionable payments overseas in countries including Taiwan, Malaysia, Mexico, Morocco, Kuwait, Argentina, Colombia, Spain, Saudi Arabia, Peru and Venezuela.


they wish to become incorporated. Under the traditional idea of federal incorporation, however, all or certain classes of corporations would be required to incorporate under a federal statute that would govern their internal affairs. That idea never got off the ground, for at least two reasons. First, statutory corporation law is filled with an enormous amount of trivia concerning such matters as what goes into the certificate of incorporation and how much notice must be given for meetings. These are matters with which Congress would not appropriately be concerned. Second, there is an extremely strong tradition in this country that regulation of corporate internal affairs is a matter for the states.

Against this background, Cary proposed that Congress should adopt an act that would set minimum standards in selected areas of corporation law to govern publicly held corporations, but would leave everything else to the states. The effect of this concept was to make federal corporate law appear more feasible: Because a minimum standards act would cover only selected corporate areas, Congress would not have to legislate on trivia. Because of the structure and coverage of such an act, all corporations would still be incorporated under state law, all but a few thousand corporations would be entirely regulated under state law, and even these few thousand corporations would be entirely regulated by state law in the areas not covered by the act.

In 1980, Cary's concept was given tangible expression. Senator Metzenbaum introduced a federal corporate minimum standards bill in the Senate, and the late Congressman Rosenthal introduced a companion bill in the House. This expression of the concept turned out, perhaps not surprisingly, to be short-lived—the bills did not go forward. The more fundamental effect of the concept, however, was to help move the reexamination of corporate law to a high position on the legal agenda, and therefore, somewhat ironically, to increase the likelihood that state corporation law will be modernized and revitalized in a manner that would render the concept moot. To the extent that the problems in statutory corporation law have arisen out of a legislative concern with franchise-tax dollars, the relevant state legislatures will undoubtedly prefer

modernizing their own statutes to the threat of losing control to Congress. To the extent that the problems in statutory corporation law have arisen out of lack of information about the obsolescence of some critical statutory provisions, the current reexamination of corporate law will bring much-needed information to state legislative attention. Accordingly, there is now reason to hope that state legislatures will respond to the present reexamination of corporate law by modernizing their statutes in a manner that deals fairly and efficiently with both management and shareholder interests, so that the problems a federal statute would entail can be avoided.

Whatever factors have motivated the present reexamination of corporate law, it is clear that the reexamination is long overdue. The American corporate system is a complex economic machine, and statutory corporate law is one of the important subsystems on which the machine is based. Some components of that subsystem are badly in need of modernization. Modernization always entails some present costs, but typically they are much less than the future costs of obsolescence.