Protections for Corporate Shareholders: Are Major Revisions Needed?

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I. INTRODUCTION

On May 21, 1982, the membership of the American Law Institute ("ALI"), an organization normally concerned with producing
restatements of the law, was asked to consider Tentative Draft No. 1 of a document entitled Principles of Corporate Governance and Structure: Restatement and Recommendations. That draft created widespread controversy. The Reporters are revising the proposals contained in Tentative Draft No. 1 and preparing another proposal entitled “Duty of Loyalty,” which covers aspects of corporate law not treated in Tentative Draft No. 1. Like the earlier draft, the new draft will engender controversy and opposition.

Both drafts seem to be based upon the proposition that the present law of corporations is unsatisfactory. In fact, the attitude of the ALI Reporters seems to be that United States corporations are not performing adequately, either for their shareholders or for society. This premise has led the Reporters to propose major reforms in the corporate regulatory system. Their proposals include:

1. establishment of a category called “significant relationship,” which restricts the definition of directors having desirable characteristics of independence for certain purposes;
2. permitting corporations to devote resources, within reasonable limits, to public welfare, humanitarian, educational, and philanthropic purposes, "even if corporate profit and shareholder gain are not . . . enhanced"; 4

3. for large publicly held corporations, urging a board composed of a majority of independent directors and three independent committees—audit, nominating, and compensation; 6

4. codification and expansion of the well-recognized business judgment rule, with an addition that would require directors to have "a rational basis" for their business judgments; 6

5. extensive revision of longstanding principles associated with derivative actions, providing more judicial control over dismissals and settlements; 7

6. restatement and codification of fiduciary principles falling under the category "duty of loyalty." 78

This article is descriptive in nature. It provides a survey of protections for shareholders, highlighting areas that are sometimes ignored by the corporate critics. In doing so, this article addresses a question that the ALI Reporters do not explore adequately: Does the present system of state and federal regulation of corporate internal affairs function well in the public interest? The fundamental premise of the article is straightforward: The primary obligation of corporate managers is the production of profits for the benefit of shareholders in an efficient manner, with due regard to societal needs. The conclusion is that the current system for regulating cor-

tained by the corporation, or acted as a managing underwriter in an issue of the corporation's securities, within the two preceding years, or was so affiliated with such a law or investment-banking firm when it was so retained or so acted.

For purposes of [this section], the term "the corporation" includes any corporation that controls . . . the corporation, and any subsidiary or other business organization that is controlled by the corporation.

Id. (citations omitted).

4. Id. § 201:

Corporate law should provide that the objective of the business corporation is to conduct business activities with a view to corporate profit and shareholder gain, except that, even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business

(c) may devote resources, within reasonable limits, to public welfare, humanitarian, educational, and philanthropic purposes.

Id. (emphasis added).

5. Id. §§ 3.03, 3.05-.07.

6. Id. § 4.01.

7. Id. pt. VII.

8. See supra note 2.
corporate internal affairs provides a well-balanced mixture of restrictions and freedom of action and therefore does not require major revision.

II. SEPARATION OF POWER AMONG SHAREHOLDERS, DIRECTORS, AND OFFICERS

A starting point for any meaningful analysis of corporate regulation is the recognition that corporations are business entities. In the rush to dissect the corporate form, it is possible to forget that the modern corporation arose in response to the need of businesses for risk capital. Two aspects of corporate utilization of capital are important. First, the corporate form permits large numbers of investors to combine their resources in a single business entity, with capital vastly exceeding the resources of one individual or a small group. Companies in the automotive, energy, defense, aeronautical, and mineral industries are obvious examples. Second, the corporate form offers limited liability, providing entrepreneurial risk-takers with limits on the losses they may incur in business activity. By establishing a ceiling for economic loss, the corporate form encourages risk-taking, thereby increasing possibilities for gain by the individual and society.

Although aggregation of capital is an important reason for development of the corporate form, the more important purpose is to provide limited liability for entrepreneurs desirous of engaging in risk enterprises. Limited liability is important for small corporations owned and managed by shareholders, and it is essential for large corporations owned by shareholders who are merely passive investors.

Although state incorporation laws regulate the conduct of a corporation's internal affairs, these state laws are relatively uniform. This results, in part, from the Model Business Corporation Act ("Model Act"). For over thirty years the Committee on Corporate Laws of the American Bar Association's Section of Corporation, Banking and Business Law has engaged in continuous anal-

9. The Model Act currently is undergoing an extensive revision, including a renumbering. Although this article primarily cites the 1979 version of the Model Act, it includes secondary citations to an exposure draft of the 1983 version of the Act. 1983 Revised Model Business Corp. Act (Exposure Draft, Mar. 1983) [hereinafter cited as Exposure Draft]. The Committee on Corporate Laws has submitted the Exposure Draft to the American Bar Association's membership for comment.

10. Membership of the Committee on Corporate Laws includes active members of the corporate bar, lawyers who represent plaintiffs in actions brought against corporations, and
ysis and revision of the Model Act, which is a major point of reference in the continuing revision of state corporation laws. More than twenty-five states have adopted in substance the Model Act; others have adopted portions of it. In addition, the Delaware General Corporation Law\textsuperscript{11} controls the internal affairs of many of this country's largest corporations because they have chosen to incorporate in Delaware and to be governed by the Delaware statute. The Model Act and the Delaware statute have created considerable uniformity in the laws applicable to corporations in the United States.

A similar general pattern regulating ownership and control of corporations exists in virtually all states. The corporation, an artificial entity with limited liability, comes into existence by complying with the provisions of the state of incorporation and commences its operation through the acts of "incorporators." The statute of the state of incorporation, the corporation's articles of incorporation, and its bylaws govern the corporation. Together, these three documents define the powers vested in the shareholders, the directors, and the corporate officers.

At the inception of a corporation, shareholders possess the power to adopt articles of incorporation and bylaws and to elect directors. The shareholders retain the power to elect directors and to vote on a limited number of matters regarded as fundamental to the corporation, including amendment of the articles of incorporation and the bylaws, merger, sale of assets, and voluntary dissolution.

The most significant aspect of the corporate form, other than limited liability, is the fact that corporate statutes prevent shareholders, who are the owners of the corporation, from managing the ordinary affairs of the corporation. For example, section 35 of the Model Act provides: "All corporate powers shall be exercised by or under authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors except as may be otherwise provided in this Act or in the articles of incorporation."\textsuperscript{12} Similarly, section 141 of the Delaware General

\textsuperscript{11} The Delaware provisions are similar to provisions of the Model Act.

\textsuperscript{12} See also Exposure Draft, supra note 9, § 8.01.
Corporation Law states: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." Management of the corporation is the responsibility of the board of directors, not the shareholders.

The primary tasks of the board of directors are the establishment of corporate policy, the appointment of operating officers, and the review of corporate performance. In addition, the directors exercise certain powers not afforded to shareholders and officers. Only the board of directors may declare dividends, issue stock, enter into extraordinary contracts, and recommend to the shareholders fundamental changes in the corporation.

Although the board of directors manages the corporation's business and affairs, it is the officers who carry on the daily operations of the corporation. The officers develop plans for long-term operation of the corporation, which are usually presented to the directors for approval. The officers also have authority to deal with third parties on behalf of the corporation. There are two limitations on the authority of corporate officers: 1) they may not bind the corporation in extraordinary situations in which authority is reserved to the directors, and 2) they may not, even with board approval, accomplish fundamental changes requiring shareholder approval.

This system of corporate governance permits corporate management to function without shareholder interference. Directors and officers, not the shareholders, control corporate operations during periods between elections of directors.

In the large corporation owned by many shareholders, separation of ownership from operational control reflects a statutory policy that the corporate enterprise will function better when professional business people are the managers. Business decisions require professional expertise, and the law recognizes that professional managers must have sufficient flexibility to meet changing conditions without submitting each decision to a shareholder vote. There are, however, certain restraints on managerial behavior. The

13. Del. Code Ann. tit. 8, § 141 (1983). An important exception to the rule that the shareholders may not manage the corporation is in the "close corporation" provisions of the various state statutes. See, e.g., Del. Code Ann. tit. 8, §§ 341-356 (1983). For instance, under § 351 of the Delaware General Corporation Law, "[t]he certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors." Id. § 351 (1983).
managers are subject to scrutiny when elections for directors occur. They are subject also to the discipline of the market, where poor management usually results in lower share prices.

Despite significant differences between small and large corporations, significant analogies exist. Although in a small corporation the same persons usually have both ownership and control, separation between the two frequently exist. For example, some owners of new corporations may have no desire to manage, although they wish to provide capital. In a maturing corporation, shares may have been transferred to family members not interested in management. Exclusion of nonmanaging owners can also result when one shareholder or a group of shareholders owns sufficient stock to control the corporation. Thus in both small and large corporations, there may be "minority shareholders" who have no voice either in the election of directors or in the operation of the corporation.

Control of a corporation means the ability to elect directors, who in turn will appoint the corporate officers. Control of the voting process will determine who controls the corporation. A single shareholder, or a group of shareholders acting together, may own a majority of the shares and thus have the power to elect a majority of the board. Control of a corporation may also result when no one owns a majority of shares. In those situations, ownership of less than fifty percent of the shares of a corporation will be sufficient to ensure control. The phrase "minority shareholders" thus may include a majority of shareholders who are not members of the control group.

Many corporations are now so large that shareholder control is no longer a meaningful concept. Writing in the 1930's, Professors Berle and Means identified the fact that some corporations were so large, and their ownership so diverse, that no single shareholder or group of shareholders could control the corporation through stock ownership.14 They observed that boards of directors control those corporations by determining the identity of persons named as the holders of powers of attorney in the proxies submitted by shareholders. Their observations are correct today. Shareholders in large corporations typically do not exercise independent judgment when voting their shares. These shareholders usually will empower representatives of management to cast their votes for them. Accordingly, control of the proxy machinery means control of the corporation. It is in this sense that the concept of separation of ownership

from control is most clear. The shareholders consistently vote in favor of management's nominees for directors, and they usually affirm management's suggestions for fundamental changes.

Many characterize the inability of shareholders in large corporations to influence the election of directors as a lack of "shareholder democracy." Nevertheless, the inability of most shareholders to control the election of directors is similar in both large and small corporations. In the largest corporations, persons owning an extremely small amount of stock may exercise control. In small corporations, only those owning a majority of shares are able to exercise control.

Since the inability of shareholders to affect the daily operations of the corporation is inherent in the modern day corporate structure, the separation of ownership from control in the largest corporations raises problems differing only in degree from those of smaller corporations. In all corporations, except those operated by owner-managers, owners of the corporation have no power to scrutinize corporate managers on a day-to-day basis.

Given the absence of direct shareholder control in the contemporary corporation, the ability of a regulatory system to provide other controls is crucial. The existing state and federal corporate regulatory system provides these controls.

III. CORPORATE OBJECTIVES

Any effort to rationalize the regulation of corporate internal affairs must identify the purpose of that regulation. As early as the 1930's, Professors Dodd and Berle engaged in a debate under the topic "for whom are corporate managers trustees?" Professor Dodd asserted that managers of the corporation are "guardians of all the interests which the corporation affects and not merely servants of its absentee owners." Professor Berle considered corporate powers exercised by managers as powers held in trust for shareholders and not for other persons affected by the corporation. Although the debate over management objectives persists,

15. Professor Berle initiated the debate in Berle, Corporate Powers as Powers in Trust, 44 HARV. L. REV. 1049 (1931) [hereinafter cited as Berle, Corporate Powers]. For the reply, see Dodd, For Whom Are Corporate Managers Trustees?, 45 HARV. L. REV. 1145 (1932). For the rejoinder, see Berle, For Whom Corporate Managers Are Trustees: A Note, 45 HARV. L. REV. 1365 (1932).


18. See, e.g., Address by SEC Chairman Harold M. Williams, Fifth Annual Securities
the law continues to hold corporate managers responsible to the shareholders of the corporation and not to its employees, customers, or the general public.

The impact of large corporations on the economy cannot be denied. Even small corporations may have extensive influence within their communities. Nevertheless, a shift of corporate focus from shareholder profits to the public interest would create problems in regulating corporate internal affairs. I have stated my views on this subject as follows:

Rejection of the profit motive as the guiding principle for corporate behavior and substitution of the public interest carries significant and extensive legal consequences. The traditional legal notion that the corporate manager owes fiduciary obligations to the shareholder-owners of the corporation is based on profit maximization. Historically, the shareholder-owner has had the power by means of a set of well developed legal rules to force the corporate manager to account to him for the use of his property. Corporate power exercised in the pursuit of profit for the benefit of shareholders has been subject to the control established through these developed legal rules. If the underlying profit theory upon which these rules of control are based is discarded, however, it is inevitable that a new set of rules will be established which will be designed to control the exercise of corporate power in the pursuit of public obligations. Consideration of whether society wishes to discard an entire system of controls based upon profit maximization for business must be accompanied by consideration of what the new control rules will contain.19

Despite many statements that corporations have obligations to the public, there is no legal theory justifying the use of corporate resources solely in the public interest. This does not mean that the absence of a theory should bar business activity designed to fulfill public obligations. Corporate activities motivated by concern for society can in the long run maximize corporate profits.

There are at least three categories of business activity that fulfill public obligations: "activity carried on in conformity with legislative standards, activity carried on in response to government pressure, and activity carried on in pursuit of community welfare

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needs which also benefits the corporation.\textsuperscript{20} If a corporation can satisfy public obligations in a manner consistent with profit-maximization objectives, then the establishment of separate standards for judging the activities of corporate directors and officers is unnecessary. Their activities would simultaneously fulfill their obligations to the public and to the corporation and its shareholder-owners. The ALI Reporters' emphasis on the use of corporate resources without reference to "corporate profit and shareholder gain\textsuperscript{21} ignores the reality that profit maximization and activities in the public interest are compatible.

IV. THE ADEQUACY OF CURRENT PROTECTION FOR CORPORATE INTERESTS

Considering the separation of ownership from control noted above\textsuperscript{22} and the corporation's ability to satisfy public obligations while pursuing profit objectives, the corporate regulatory system should and does concentrate on protecting shareholders. The present system does so by 1) protecting shareholder voting rights; 2) requiring corporate officers and directors to manage the corporation with care; 3) preventing conflict-of-interest transactions between the corporation and its directors and officers; and 4) safeguarding against overreaching by corporate officers, directors, and controlling shareholders in securities transactions.

A. Protection of Shareholder Voting Rights

As noted earlier,\textsuperscript{23} shareholders generally do not have the power to manage the business and affairs of the corporation. Instead, their power lies in their ability to vote for directors and to vote for or against certain fundamental changes in the corporation, such as mergers, sale of assets, dissolution, article amendments, and authorization for additional shares.

Before examining the legal protections afforded shareholders in the area of fundamental changes, it is important to note that state corporate statutes, together with the corporation's articles of incorporation and bylaws, constitute a contract between shareholders and their corporation. A unique aspect of the corporate contract is its provisions for amendment. In adopting the articles and

\textsuperscript{20} Id. at 221.
\textsuperscript{21} See supra note 4.
\textsuperscript{22} See supra pp. 247-50.
\textsuperscript{23} See supra text accompanying notes 12-13.
bylaws, the shareholders agree that certain fundamental changes in the corporation will require a specified percentage of votes. If a proposal receives the required number of votes, the contemplated action will occur despite the objection of some shareholders. The partnership law concept of unanimous voting or veto over business action is not a part of corporation law.\textsuperscript{24}

1. PROXY VOTING

The most important aspect of shareholder voting is the right of the shareholder to vote by proxy. Proxy voting allows shareholders to vote without requiring their presence at meetings. Instead, shareholders may authorize agents to vote their shares for them. Shareholders located far from a corporate meeting may protect their voting rights by voting in absentia.

Although all states grant the right to vote by proxy, few states regulate the solicitation of proxies. The Securities Exchange Act of 1934 ("Exchange Act")\textsuperscript{26} addresses the gap in state regulation and regulates proxy solicitations of larger corporations.\textsuperscript{26} Section 14\textsuperscript{27} of the Exchange Act gives the Securities and Exchange Commission ("SEC") the power to promulgate rules regulating the solicitation of proxies with respect to any security registered under section 12\textsuperscript{28} of the Act—i.e., any security listed on a national stock exchange or any security of a company that has total assets exceeding $3 million and is held of record by 500 or more persons.\textsuperscript{29}

\textsuperscript{24} Shareholders of small corporations often agree to require unanimity in the election of directors. Moreover, articles of incorporation or bylaws of a corporation of any size may provide voting requirements that are greater than a majority, even up to 100%. The corporate form does not, however, lend itself well to these high voting requirements, because minority vetoes have the effect of stifling corporate enterprise and initiative.


\textsuperscript{26} See Exchange Act §§ 14(a), (c), 15 U.S.C. §§ 78n(a), (c) (1982).

\textsuperscript{27} 15 U.S.C. § 78n(a) (1982).


The federal proxy regulations are extremely broad. Anyone soliciting votes must furnish shareholders with written proxy statements containing information specified by the SEC. The regulations dictate the form of proxy and the manner of presentation. Extensive provisions exist concerning the amount and type of information that must be included in the proxy material. In addition, proxy solicitation in a contested election triggers special rules that apply to management or to others soliciting proxies.

One of the most important proxy rules is rule 14a-9 of the Exchange Act. The rule provides that no solicitation may be made by means of a communication that is false or misleading with respect to any material fact or that fails to correct an earlier communication that has become false or misleading. This rule promotes full disclosure in proxy solicitations. Rule 14a-9 has produced extensive litigation by both the SEC and by individuals asserting that proxy solicitations contained misleading information.

2. CUMULATIVE VOTING

Most states permit cumulative voting for directors. The typical statute provides that the number of votes each shareholder is entitled to cast for the election of directors will be multiplied by the number of directors to be elected, and that the shareholder may cast all of his votes for a single director or may distribute his votes among the nominees. Cumulative voting enables shareholders without a controlling block of the corporation's shares to elect one or more directors, thus permitting the minority shareholders to elect at least one representative to the board of directors.

3. FINANCIAL INFORMATION

The federal securities laws ensure the availability of corporate
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financial information. Federal proxy rules require corporations that register securities under section 12 of the Exchange Act to send their shareholders an annual report containing certified financial statements for at least the last two fiscal years of the corporation. They must also file with the SEC annual and quarterly reports containing financial information. The latter information is available directly to shareholders upon request and reaches the marketplace through analysis by professionals.

State law is increasingly providing similar protections for smaller corporations. In 1978, an amendment of the Model Act added the requirement that "[e]ach corporation shall furnish to its shareholders annual financial statements, including at least a balance sheet as of the end of each fiscal year and a statement of income for such fiscal year." This provision was included because federal law does not require small, closely held corporations whose securities are not registered under section 12 of the Exchange Act to send financial statements to shareholders. Amendment of the Model Act closed a gap in the federal regulatory system.

4. SHAREHOLDER NOMINATIONS

Despite the existence of a federal mechanism mandating extensive disclosure, shareholders seldom vote against management. Shareholders seem remarkably uninterested in seeking change through the voting procedures, except for situations in which a large and well-financed shareholder group owning substantial shares in the corporation creates a contest.

Shareholder lethargy and management control of the proxy

39. See supra notes 28-29 and accompanying text.
42. See 34 Bus. Law. 1616 (1979).
43. MODEL BUSINESS CORP. ACT § 52 (1979); see also Exposure Draft, supra note 9, §§ 16.01-04.
45. Most states give shareholders the right to examine the corporation’s list of stockholders; in many jurisdictions the right includes the examination of books and records. Examination and copying of the stockholder list provides the possibility of changing the management of the corporation through voting procedures or purchase of shares. Also, the right to examine books and records provides shareholders with information regarding the conduct of the corporation’s affairs and information pertinent to share valuation.
46. See supra pp. 249-50.
apparatus in the large corporation often make the election of management’s nominees a foregone conclusion, prompting the suggestion that control of the director-nomination process should lie in the hands of independent groups instead of with management. One proposal would remove from the board of directors the right to nominate candidates for election and would give that right to a special committee of directors. Only independent directors, those not employed by the corporation and having no direct or indirect financial connection with the corporation, would compose the committee. This change would transfer the nomination process and the ultimate control of the corporation from the current management group to an outside, independent group.

These proposals for shareholder input into the nominating process thus raise a question of great significance: Should the board of directors have the opportunity to control the identity of the nominees presented to the shareholders as “management” nominees? This question affects the all-important concept of corporate control. Control of the corporation will not shift if the board of directors has the ultimate power to determine the identity of those for whom proxies will be voted. Removal of the nominating power from the full board of directors in order to place it solely in the hands of an independent nominating committee would result in taking corporate control away from corporate management.

The approach of the ALI Reporters is not so drastic. They suggest that a nominating committee composed exclusively of independent directors should have the responsibility for recommending candidates for the board. The Reporters’ proposal allows the board to submit its own nominees for elections, but it also permits the nominating committee to list the names of its nominees in solicitation materials.

Suggestions for change in the nomination process are probably the most important made by those interested in corporate reform. Although the board of directors is viewed by many as being responsible for the nomination process, in fact corporate chief executive officers (“CEO’s”) usually control director nominations. The

49. Tentative Draft No. 1, supra note 1, § 3.06.
50. Id. § 3.06 comment d, at 103-04.
rationale for this arrangement is a managerial philosophy that the CEO cannot manage a highly complicated business if he does not have the confidence of the board of directors. The board of directors is not only expected to support and counsel the CEO, but also to monitor his performance and to discharge him when he manages badly.

The premise that the corporation cannot function well if the CEO and the board of directors constantly disagree seems sound. Nevertheless, the presence of independent directors on the board provides an important method for monitoring management.51

5. SHAREHOLDER PROPOSALS

Despite state law reluctance to allow shareholder control of corporate operations, federal proxy rules permit a limited amount of shareholder input. Rule 14a-8,52 promulgated pursuant to the Exchange Act, permits a shareholder to present proposals for corporate action at shareholders’ meetings. The rule requires management to include shareholder proposals in its proxy statement but permits omission of proposals under certain circumstances.53

Despite the rule 14a-8 mechanism for shareholder input, almost all proposals made under the rule fail to carry the requisite number of shareholder votes for adoption. Failure of the shareholder-input mechanism reinforces the proposition that shareholders are not interested in controlling corporate operations. The great likelihood is that the individual shareholder, like the large institutional holder, will sell his shares when he becomes dissatisfied with the performance of the corporation. The real voting process occurs in the marketplace, not in director elections or in debates over policy questions submitted by shareholders.

51. See, e.g., Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, Corporate Director’s Guidebook, 33 Bus. Law. 1591, 1619-28 (1978) [hereinafter cited as Corporate Director’s Guidebook].
53. Rule 14a-8(c) provides that an issuer may omit a shareholder proposal, for example:
   (1) If the proposal is, under the laws of the issuer’s domicile, not a proper subject for action by security holders;
   (4) If the proposal relates to the enforcement of a personal claim or the redress of a personal grievance against the issuer, or any other person;
   (5) If the proposal deals with a matter that is not significantly related to the issuer’s business.
B. Fiduciary Duty Standards

Federal disclosure regulations provide extremely important and effective protection of shareholder voting rights in contested director elections, in shareholder votes on fundamental changes in the corporation (such as a sale of assets or a merger), and in other circumstances affecting shareholders' fundamental economic interests in the corporation. Nevertheless, because of inertia or disinterest, shareholders usually do not control the voting process, and, as noted above, state law prevents them from exercising control over day-to-day operations. No substantial gap in regulation occurs, however, because an extensive body of state and federal law imposes fiduciary obligations upon corporate officers and directors in managing the corporation. Although the ALI Reporters apparently believe that the law of corporate fiduciary relations needs major revision, an examination of the current law in this area indicates that major changes are unnecessary.

C. Duty of Care

1. MODEL ACT SECTION 35

All states treat the obligations of corporate directors as fiduciary in nature. The corporate director owes both a duty of care and a duty of loyalty to the corporation and to the shareholders.

Section 35 of the Model Act articulates the director's obligation to act with care:

A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.\textsuperscript{54}

2. GOOD FAITH

The duty of care standard requires the director to act in good faith.\textsuperscript{55} If a director engages in a conflict-of-interest transaction, he will be unable to meet the good faith requirement of section 35.

\textsuperscript{54} Model Business Corp. Act § 35 (1979); see also Exposure Draft, supra note 9, § 8.30(a).

\textsuperscript{55} Primarily, it is state law that regulates the duty of care; federal regulation focuses on fraud. See, e.g., Securities Act of 1933, §§ 11-12, 17, 23, 15 U.S.C. §§ 77k-77l, 77q, 77w (1982).
3. DIRECTORS' DILIGENCE

Under the duty of care standard, a director acting in good faith must exercise diligence concerning corporate affairs. The duty of diligence requires him to participate in meetings of the board and of board committees, to be informed about the corporation, and to monitor delegated activities. The diligence requirement derives from the rule that a director should use "such care as an ordinarily prudent person in a like position would use under similar circumstances." Litigation brought to recover damages from directors who have failed to exercise adequate diligence has been the primary method of enforcing the duty of care standard.

Section 35 of the Model Act deals with the diligence question as it relates to the duty to become informed by providing affirmatively that a director may rely upon others with respect to information. Section 35 states:

In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

(a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,
(b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or
(c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation or the by-laws, as to matters within its designated authority, which committee the director reasonably believes to merit confidence, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

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56. Corporate Director's Guidebook, supra note 51, at 1602-03 (discussing directors' duty of attention).
57. Model Business Corp. Act § 35 (1979); see also Exposure Draft, supra note 9, § 8.30(a)(2).
58. Although few cases on duty of care exist, liability for failure to exercise diligence is regarded as well established. See, e.g., Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924).
59. Model Business Corp. Act § 35 (1979); see also Exposure Draft, supra note 9, § 8.30(b).
The Model Act provides a safe harbor against claims of lack of diligence to directors acting in good faith who rely on information from the articulated sources. At the same time, however, section 35 of the Model Act indirectly emphasizes that directors must be informed about corporate affairs. The requirements that directors pay attention to their duties and become informed protect shareholders by inducing directors to gather adequate knowledge before making business decisions.

4. BUSINESS JUDGMENT RULE

Also encompassed within the duty of care standard is a protection for directors when they make business judgments. As the state system of corporate governance has developed, state courts uniformly have decided that directors should be able to take risks for the corporation without fearing that their judgments will be questioned later. Under the business judgment rule, if a director is diligent in the performance of his duties, becomes fully informed, and acts in good faith, he may make a poor or unreasonable decision (but not an extremely bad decision) without being subject to liability.

The policy behind the business judgment approach seems sound. The main purpose of the corporate form is to pursue profits. Holding corporate directors liable for business losses resulting from mistakes made in good faith in the pursuit of profits would stifle business initiative.

Two other factors support the logic of the business judgment rule. First, if a negligence standard were applied to directors' business decisions, the activities of the directors in making these decisions would frequently be judged in light of subsequent events unknown to the directors at the time the original decisions were made. Such after-the-fact evaluation would be unfair. Second, constant litigation over the propriety of business decisions would force judges and juries to make business decisions, a role for which they

60. Courts imposing liability in duty of care cases require that the director's lack of diligence or failure to become informed be causally related to a measurable damage. See, e.g., Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924) (finding a breach of duty, but declining to impose liability because of failure to show a causal relation).

61. See, e.g., Auerbach v. Bennett, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979) ("[t]hat doctrine bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes").
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Finally, under current law the business judgment rule does not entirely immunize directors' judgments. If a director acts recklessly, or in a grossly irrational manner, his business judgment may subject him to liability.63

5. SHAREHOLDER DERIVATIVE SUITS

A shareholder derivative suit is an action brought by a shareholder on behalf of his corporation against third parties or against officers or directors of the corporation. In recent years, many have questioned whether the exercise of business judgment by a board of directors acting in good faith should be sufficient to terminate derivative litigation. Contrasting views have resulted, with New York deciding the question in the affirmative,64 and Delaware permitting judicial scrutiny of a board's good faith decisions.65

The ALI Reporters would extensively revise the law of derivative suits.66 The furor over the suggested changes is great, and the problem is too complex to address in this survey.

6. INDEMNIFICATION

Related to the operation of the business judgment rule is in-

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62. Litigation over directors' business judgments occurs in several circumstances. For example, the trustee in bankruptcy or the receiver of a defunct corporation inevitably seeks to find assets for the creditors of the corporation. The trustee may bring suit against the former directors alleging poor business judgment. Another example is the derivative suit. A disgruntled shareholder may sue the board of directors, alleging that business judgment has been poor. In both cases, the motivation of the party bringing suit is to recover damages from the directors.

63. The ALI Reporters use the phrase “had a rational basis” to describe the non-egregious decision. Tentative Draft No. 1, supra note 1, § 4.01(d). Section 4.01, in articulating the business judgment rule, provides:

   (d) A corporate director or officer shall not be subject to liability under the duty of care standards . . . with respect to the consequences of a business judgment if he:

   (1) informed himself and made reasonable inquiry with respect to the business judgment;
   (2) acted in good faith and without a disabling conflict of interest; and
   (3) had a rational basis for the business judgment.

Id. (emphasis added). This articulation provides less protection for directors than do other articulations of the business judgment rule.

65. See Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). The ALI Reporters adopted the view of the Zapata court. See Tentative Draft No. 1, supra note 1, § 7.03 comment a, at 304.

66. For the derivative suit provisions, see Tentative Draft No. 1, supra note 1, §§ 7.01-.08 (§ 7.08 is not included in this draft).
demnification for corporate officers and directors. The principle of indemnnification is that if a director acts in good faith on behalf of the corporation, he should not be subject to liability to third parties, and he should not be required to bear litigation expenses incurred in successful defense of suits brought against him because of his status as a director. The Delaware General Corporation Law gives a corporation the power to indemnify any officer or director "if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation." 67

These indemnification provisions are consistent with the business judgment rule. A director protected against liability for making an error in business judgment should not be subject to an indirect form of liability by paying litigation expenses or third party claims.

7. COMMITTEES

Most large corporations have established committees of directors to help their boards discharge their responsibilities. These committees have two key functions. The first function is to assist in both the short-range and long-range operation of the company. The committees carrying out this function may include the long-range or strategic-planning committee, the public-policy committee, the finance committee, and the executive committee. The executive committee will also be responsible for performing the tasks of the board of directors when the board is not in session. The second function of board committees is to provide independent judgment on transactions by or with officers and directors. The committees established to carry out the latter function normally are the audit committee and the compensation committee, with the nominating committee providing independent review of the nominating process. 68

67. Del. Code Ann. tit. 8, § 145(a), (b) (1983); see also Model Business Corp. Act § 5(a), (b) (1979) (same language as quoted); Exposure Draft, supra note 9, § 8.51(a) (similar language). In 1980, § 5 of the Model Act was amended, see Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, Changes in the Model Business Corporation Act Affecting Indemnification of Corporate Personnel, 36 Bus. Law. 99 (1980), to remove ambiguities in the section and to resolve certain questions regarding the specific implementation of indemnification procedures. Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, Changes in the Model Business Corporation Act Affecting Indemnification of Corporate Personnel, 34 Bus. Law. 1585, 1595 (1979).

68. For a discussion of the audit, compensation, and nominating committees, see Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, The Overview Committees of the Board of Directors, 35 Bus. Law. 1335 (1980) (hereinafter cited
SHAREHOLDER PROTECTIONS

Section 42 of the Model Act is illustrative of the power provided by statute for the creation of board committees, especially the executive committee. The authorizing legislation permits a committee to "exercise all the authority of the board of directors," with certain articulated exceptions. The board normally entrusts decisionmaking authority of that magnitude only to the executive committee, not to other board committees.

The official comment on the amendments to Model Act section 42 suggests that a noncommittee director attempting to meet the standard of care set out in section 35 of the Model Act should use care in delegating matters to a committee and in surveillance of the activities of a committee exercising responsibilities: "Care in delegation and surveillance would include appraisal of the capabilities and diligence of the committee directors in light of the subject and its relative importance, and would be facilitated, in the usual case, by review of minutes and receipt of other reports concerning committee activities."

8. EVALUATION OF THE DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

The duty of care standard requires directors and officers to act in good faith, use diligence in attending to corporate affairs, and take reasonable steps to inform themselves fully when making business decisions. Fulfillment of these duties permits directors and officers to make business judgments free from fear of liability when their judgments prove to be erroneous, unless their judgments are poor enough to be treated as gross derelictions of duty. Bad business judgments will expose officers to termination by the board and will subject members of the board to sanctions in the form of defeat by shareholders in elections. Shareholders who are unable to

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as Committee on Corporate Laws, The Overview Committees]; see also Corporate Director's Guidebook, supra note 51, at 1625-27.

The existence of board committees is important to good business practice. Committees can assist the full board of directors in establishing compensation, in reviewing the performance of the chief executive officer and other officers of the corporation, in reviewing the corporation's financial disclosures, in planning long- and short-range strategy, in reviewing the corporation's compliance with various laws, in anticipating the corporation's impact upon society, and in assisting in the efficient operation of the corporation.

68. Model Business Corp. Act § 42 (1979); see also Exposure Draft, supra note 9, § 8.25.


71. Id.
influence elections are likely to sell their shares, causing fluctuations in stock prices that will be likely to have the same effect as changing management through the voting process.\(^72\)

The legal standards governing the conduct of directors and officers acting in good faith permit the corporation to function well in its primary activity—business. The duty of directors and officers to be diligent and to obtain knowledge regarding the corporation should lead to good management. Any suggestion that directors should be held to a duty of care higher than the standard of the existing business judgment rule misses the point. The imposition of liability for bad business judgments would inevitably cause directors to refrain from making risky decisions. If directors do not take risks, business initiative will be stifled. No state or federal intervention is needed in the duty of care area.

D. Conflict-of-Interest Transactions Involving Directors and Officers

The foregoing discussion has examined the principles applicable to conduct by officers and directors who act in good faith. Different principles apply when the action of an officer or director lacks good faith. The \textit{Corporate Director's Guidebook} explains:

By assuming his office, the corporate director commits allegiance to the enterprise and acknowledges that the best interests of the corporation and its shareholders must prevail over any individual interest of his own. The basic principle to be observed is that the director should not use his corporate position to make a personal profit or gain other personal advantage.\(^78\)

Conflict-of-interest transactions will subject an officer or director to liability. An officer or director may not steal or embezzle from his corporation. He may not use the corporation for personal benefit,\(^74\) he may not use corporate funds and facilities to develop a product that would increase his own personal profit,\(^75\) and he may not use the corporate mechanism to purchase or issue stock for the purpose of perpetuating his controlling group in office.\(^78\)

\(^72\) Bad management may also turn a corporation into an attractive takeover target. \(^73\) \textit{Corporate Director's Guidebook}, supra note 51, at 1599. \(^74\) Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Del. 1939). \(^75\) See id. \(^76\) Bennett v. Propp, 41 Del. Ch. 14, 25, 187 A.2d 405, 411 (Del. 1962). In a parent-subsidiary relationship, the parent may not use its dominant position to the detriment of the subsidiary's minority shareholders. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).
Another doctrine, related to conflict-of-interest principles, bars a director or officer from taking an opportunity belonging to his corporation. Under the "corporate opportunity" doctrine, a director who receives information about a favorable business opportunity because of his relationship to the corporation must first offer the opportunity to the corporation. Only after a disinterested decision by the corporation to refuse the opportunity may the director pursue the matter for his own account.\(^7\)

Executive compensation also may be an area of conflict of interest. Modern corporate practice has resulted in high compensation at the senior management level. Responding to charges that extravagant executive compensation bears no relation to executive performance, many corporations have established a system for independent review of executive compensation. Most corporations use a compensation committee composed exclusively of independent, nonmanagement directors.\(^7\)

In lawsuits challenging director transactions with the corporation, the burden of demonstrating the fairness of the transaction is usually placed on the director. If he meets this burden, the transaction will not be set aside.\(^7\)

Modern corporate theory accepts the notion that an independent majority of directors or shareholders, acting in good faith, may authorize or ratify directors' and officers' transactions with their corporation and thereby eliminate problems associated with participation of the director and the officer on the corporate side of the transaction. Both the Delaware General Corporation Law\(^8\) and the Model Act\(^8\) reflect this theory. Both statutes provide that if there is independent approval, a contract or transaction between a corporation and a director or officer will not be void or voidable solely because the director or officer has been present at, or participated in, the meeting of the board authorizing the contract or be-

\(^7\) See Corporate Director's Guidebook, supra note 51, at 1600.

\(^7\) See Committee on Corporate Laws, The Overview Committees, supra note 68, at 1347-51.

\(^7\) See Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 298, 93 A.2d 107, 110 (Del. 1952). The rule that allows directors to justify a transaction with the corporation by showing the transaction's fairness is more favorable to directors than was the rule's legal predecessor. The prior rule was that every contract between a director and his corporation was voidable without regard to fairness. See Marsh, Are Directors Trustees? Conflict of Interest and Corporate Morality, 22 Bus. Law. 35, 36-39 (1966).

\(^7\) DEL. CODE ANN. tit. 8, § 144 (1983).

\(^8\) MODEL BUSINESS CORP. ACT § 41 (1979); see also Exposure Draft, supra note 9, § 8.31.
cause his votes contributed to the board’s approval.\textsuperscript{82} Independent approval requires disclosure of material facts and a good faith vote either by a majority of the disinterested directors or by a majority of the shareholders. Underlying these statutes is the policy that an officer or director may provide a benefit to his corporation by entering into a contract with it.

At least in Delaware this approach still leaves open the question of fairness. The Delaware rule provides that when the shareholders or an independent majority of directors have approved a contract with a director or officer, the burden of showing unfairness shifts to the person attempting to set aside the contract.\textsuperscript{83} Thus, disinterested approval has two effects. First, it overcomes the presumption that the contract in which the director has a financial interest is void or voidable. Second, it causes the burden of proof to shift back to the party alleging the unfairness.

A key point in analyzing conflicts of interest involving directors is the concept of independence. The most usual approach is that a director will be independent only when he has no financial interest in a transaction involving his corporation. The interest may be direct, or it may arise indirectly from a family, corporate, business, or professional relationship.\textsuperscript{84}

The theory that independent directors can protect the corporation and its shareholders from overreaching by management is extremely important. Independent directors may protect the corporation and its shareholders by acting either as an independent majority of the board or as members of board committees established to deal with conflict situations.\textsuperscript{85}

Although state regulation of director and officer conflict-of-interest transactions is well-developed, a detailed federal system has not emerged. This lack of federal regulation does not mean that existing protections are inadequate. State law provides a good blend of protecting the corporation against these conflicts of interest, while at the same time making it possible for the corporation to benefit from good faith transactions with directors and officers.

\textsuperscript{82} The Delaware statute applies to corporate-opportunity transactions by both directors and officers; the Model Act provision applies to directors' transactions only.


\textsuperscript{84} The ALI Reporters use the term "significant relationship" in defining the independence of directors. See supra note 3. The Reporters' expansive definition of the term has given rise to considerable controversy.

\textsuperscript{85} See supra note 78 and accompanying text.
E. Overreaching in Securities Transactions

Under both federal and state laws, protection exists for shareholders when they sell securities to or purchase securities from officers, directors, or controlling shareholders. Officers and directors of the corporation, as well as persons able to elect the majority of the corporation’s board, control assets owned by all shareholders, and as such they occupy positions of trust and confidence.

The corporate officer, director, or majority shareholder may not act in an arms-length manner with shareholders. One of the frequently cited statements of the fiduciary principle is that of Judge Cardozo in Meinhard v. Salmon:

Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

Special doctrines have developed under both federal and state laws to govern insider purchases and sales of securities made without adequate disclosure. Under state law, corporate officers and directors breach a fiduciary duty to disclose when they purchase shares from shareholders without disclosing material corporate information available to them as insiders. The federal doctrine relating to insider trading adopts the theory that officers, directors, and controlling shareholders have the obligation not to engage in securities transactions with shareholders without disclosing material corporate information, and extends that obligation also to other persons having access to information available only for corporate purposes. The federal doctrine of insider trading is en-

86. Both federal and state laws condemn misrepresentations made in connection with the purchase or sale of securities. See Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U.L. Rev. 627, 661-62 (1963). The law requires no special status or fiduciary obligation for the shareholder to receive judicial relief. Id.
87. 249 N.Y. 458, 164 N.E. 545 (1928).
88. Id. at 464, 164 N.E. at 546, quoted in Perlman v. Feldman, 219 F.2d 173, 176 (2d Cir. 1955).
89. See Ruder, supra note 86, at 661-62.
92. Id. at 3263; Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976
forced under SEC rule 10b-5, and has been subject to extensive interpretation.

An additional area of concern is the question whether majority shareholders may sell a controlling interest in a corporation at a premium price without sharing that premium with minority shareholders. Although the prevailing doctrine allows consummation of the sale without such sharing, the doctrine is subject to several important exceptions. If a sale of a controlling block of stock is accompanied by looting of the corporation, prospective looting, sale of corporate office, or misuse of corporate office, liability may be imposed upon the selling shareholders. Although the majority shareholders may sell their shares to third parties at a premium over current market prices, they may not do so if the transaction injures the corporation or the minority shareholders.

Fiduciary duty doctrines apply also to overreaching by controlling shareholders in transactions involving fundamental changes in the corporate structure. In reorganizations, mergers, sales of assets, and related transactions, shareholders in control of a corporation have the opportunity to force unfair transactions upon minority shareholders. These transactions usually involve purchases or sales of securities, and frequently invoke both federal and state law doctrines condemning misrepresentation and nondisclosure.

Some observers have characterized the United States Supreme Court decision in Santa Fe Industries v. Green as an indication of a reduced federal interest in protecting minority shareholders in corporate transactions. In the Santa Fe case the parent corporation in a short-form merger forced allegedly unfair merger terms upon minority shareholders of its subsidiary. The Supreme Court


100. 430 U.S. 462 (1977).
held that since the merger terms had been revealed to the minority shareholders, no claim was stated under rule 10b-5. It held that mere breach of a fiduciary duty was not enough, stating that rule 10b-5 required either deceptive or manipulative conduct. The Supreme Court's decision was less a philosophical change in the protection of shareholders than an effort by the Supreme Court to remain faithful to statutory language. The federal securities law continues to provide substantial protection of shareholders in cases involving misrepresentation and nondisclosure in securities transactions.\(^{101}\)

Federal regulation in cases involving fully disclosed overreaching is desirable, but is probably not needed because state law provides adequate remedies. For instance, the Delaware courts require majority shareholders dealing with minority shareholders in a corporate transaction to show fairness to the minority.\(^ {102}\) This Delaware position is typical of the law of other states to the effect that officers, directors, and controlling shareholders owe a fiduciary obligation to minority shareholders in major corporate transactions.

Appraisal or dissenters' rights also protect shareholders when there is a fundamental change in the corporation. Under state law, shareholders dissenting from certain corporate actions have the right to have their shares appraised and to obtain payment in cash from the corporation.\(^ {103}\) In 1978, an amendment of the Model Act clarified this right.\(^ {104}\) As amended, section 80 entitles shareholders to dissent and obtain payment in the event of certain corporate actions: 1) a plan of merger or consolidation; 2) a sale or exchange of all or substantially all of a corporation's assets; 3) a plan of exchange involving acquisition of the corporation's shares; 4) an

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101. The question of whether the United States Supreme Court is turning away from protecting minority shareholders may be answered if the Court ever decides a case factually similar to one that the United States Court of Appeals for the Second Circuit decided in Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978). In Goldberg, a parent corporation failed to disclose to the minority shareholders of its subsidiary the unfairness of a transaction. The Second Circuit distinguished *Santa Fe*, positing that the parent's failure to disclose its overreaching provided the element of deception required in a rule 10b-5 action.


104. See Conard, *Amendments of Model Business Corporation Act Affecting Dissenters' Rights (Sections 73, 74, 80, and 81)*, 33 Bus. Law. 2587 (1978).
amendment of the articles of incorporation materially and adversely affecting the shares of the dissenting shareholders in certain ways; and 5) corporate action in which a shareholder or board resolution directs that dissenting shareholders shall have the right to obtain payment for the shares. The theory underlying appraisal and dissenters' rights is that a shareholder who disapproves of change in the basic characteristics of his corporation should have the opportunity to object and to receive fair payment for his shares.

The appraisal remedy is not without flaws: Compliance with the prerequisites for appraisal is sometimes difficult and questions exist concerning the fairness of the valuation of the shareholders' securities under the appraisal procedures. Nevertheless, the appraisal remedy fulfills an important function by giving shareholders the right to have their shares appraised and to receive cash payment when they object to a corporate action involving fundamental change.

V. THE FOCUS OF FEDERAL LAW

This article has focused on state law regulation of corporate internal affairs in the United States, and has also noted that federal securities laws protect shareholders through proxy rules, mandatory financial disclosures, and antifraud rules applicable to securities transactions.

The disclosure system of the federal securities laws also has important effects on corporations. The Securities Act of 1933 requires extensive disclosure when corporations distribute securities to the public. The Exchange Act imposes comprehensive annual and periodic reporting requirements on moderate- and large-sized

105. Model Business Corp. Act § 80 (1979); see also Exposure Draft, supra note 9, § 13.02.

106. Section 81 of the Model Act defines "fair value" of the securities as "their value immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of such corporate action unless such exclusion would be inequitable." Model Business Corp. Act § 81(a)(3) (1979); see also Exposure Draft, supra note 9, § 13.01(3). The 1978 amendment added the phrase "unless such exclusion would be inequitable" to provide for consideration of value that existed in the corporation, but was not recognized by the market. According to Professor Conard, author of the comments to the 1978 Model Act amendments, "[t]he exception is inserted to deal with 'squeeze out' situations in which the dissenter is excluded against his will from continued participation in the altered enterprise, by some method such as a 'cash merger.'" Conard, supra note 104, at 2600-01.

companies\textsuperscript{108} and also requires reports of beneficial ownership of securities.\textsuperscript{109} Federal securities legislation dealing with corporate tender offers contains disclosure provisions\textsuperscript{110} designed to give information to the shareholders about the identity, purposes, and resources of persons obtaining five percent of the corporation's shares or making tender offers.

The federal securities laws also regulate corporate conduct directly, through other means unrelated to disclosure. The Foreign Corrupt Practices Act of 1977\textsuperscript{111} prohibits domestic corporations from bribing foreign officials or other persons in the furtherance of business abroad. It requires corporations to keep books and records "accurately and fairly" reflecting corporate transactions, including the disposition of a corporation's assets. The tender offer legislation regulates tender offers made for corporate shares.\textsuperscript{112} Section 16(b),\textsuperscript{113} the short-swing profit section of the Exchange Act, prevents insiders from profiting on purchases and sales of shares within a six-month period.

Despite this imposing array of federal securities laws affecting corporations, officers, and directors, the federal securities laws do not focus on the regulation of corporate internal affairs. Regulation of internal corporate affairs is incidental to the regulation of the securities markets.

VI. Conclusion

This article's description of state and federal laws regulating corporate internal affairs provides a background for consideration of the question whether new state or federal regulation of corporations is necessary. The inquiry should be whether this state and federal corporate law provides adequate regulation. Those seeking change should bear the burden of proving the inadequacy of existing regulation.

As noted earlier, a perceived need to force corporations to follow desirable social policies is not proper justification for governmental intervention pursued at the expense of short- or long-range profits. A plan of corporate regulation motivated by concern for social policy is laden with regulatory problems and would cause a

\textsuperscript{108} See supra notes 28-29, 41 and accompanying text.
\textsuperscript{110} Id. §§ 13(d), 14(d), 15 U.S.C. §§ 78m(d), 78n(d) (1982).
\textsuperscript{111} 15 U.S.C. §§ 78a note, 78m, 78dd-1, 78dd-2, 78ff (1982).
\textsuperscript{112} Exchange Act §§ 13(d), (e), 14(d), (f), 15 U.S.C. §§ 78m(d), (e), 78n(d), (f) (1982).
\textsuperscript{113} 15 U.S.C. § 78p(b) (1982).
major shift in the corporate structure in the United States.

Proper analysis of the ALI corporate governance project should question whether the ALI Reporters are correct in their perception that corporations and shareholders need increased protections. The conclusion reached here, after examination of the current combined state and federal regulatory system, is that extensive changes in the regulation of corporate internal affairs are not necessary. The present system strikes a proper balance between facilitating corporate business decisions without undue interference and protecting corporations and minority shareholders against injury by officers, directors, and controlling shareholders.

114. The power to cause major shifts in corporate activity already exists within the federal securities law system, particularly through accounting policies, disclosure regulations, the Foreign Corrupt Practices Act, proxy rules, antifraud rules, and the rules of the stock exchanges and other self-regulatory agencies. See Ruder, Corporate Governance: An Analysis of Duties, Attacks, and Responses, 4 DEL. J. CORP. L. 741, 750 (1979).