

Michigan Law Review

Volume 82
Issue 5 *Issue 5&6*

1984

The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law

Alfred F. Conard
University of Michigan Law School

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Business Organizations Law Commons](#), [Comparative and Foreign Law Commons](#), and the [European Law Commons](#)

Recommended Citation

Alfred F. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459 (1984).

Available at: <https://repository.law.umich.edu/mlr/vol82/iss5/23>

This Article is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

THE SUPERVISION OF CORPORATE MANAGEMENT: A COMPARISON OF DEVELOPMENTS IN EUROPEAN COMMUNITY AND UNITED STATES LAW†

*Alfred F. Conard**

TABLE OF CONTENTS

	Page
I. INTRODUCTION	1460
II. THE INDEPENDENCE OF SUPERVISION	1464
A. <i>The Theory of Independent Supervision</i>	1464
B. <i>The Effects of Independent Supervision</i>	1467
1. <i>Authoritative Supervision</i>	1468
a. <i>Dispersed holdings</i>	1469
b. <i>Concentrated holdings</i>	1471
2. <i>Advisory Supervision</i>	1472
a. <i>The passivity of independent directors</i>	1472
b. <i>The passivity of financial institutions</i>	1473
c. <i>Potential impacts of activating control by financial institutions</i>	1475
3. <i>Deferential Supervision</i>	1476
a. <i>Independent directors and derivative suits</i>	1477
b. <i>Independent directors and the validity of transactions involving conflicts of interest</i>	1478
c. <i>Effects on selection of directors</i>	1479
d. <i>Promoting effective supervision in the United States</i>	1480
III. EMPLOYEE PARTICIPATION IN SUPERVISION	1483
A. <i>The Theory of Codetermination</i>	1484
B. <i>Codetermination in the United States</i>	1485
C. <i>Employee Share Ownership</i>	1487
IV. CONCLUSION	1487

† The author acknowledges the indispensable research assistance of Michael Liffrig and Charles Yuen, the helpful critiques of Professor Michael Rosenzweig, and the guidance on German law of Professors Bernhard Grossfeld and Ulrich Immenga.

* Henry M. Butzel Professor of Law, University of Michigan Law School. A.B. 1932, Grinnell College; LL.B. 1936, University of Pennsylvania; J.S.D. 1942, Columbia University; LL.D. 1971, Grinnell College. — Ed.

The directors of such [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which partners in a private copartnery frequently watch over their own. . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

Adam Smith¹

I. INTRODUCTION

In 1971, Eric Stein published an account of the remarkable progress of the European Economic Community (EEC) toward a harmonized law of business corporations.² The progress was particularly striking from an American viewpoint, because the harmonization was achieved by moving toward the more rigorous of the various national standards, in contrast to the "race of laxity"³ or "race for the bottom"⁴ that has characterized the movement toward uniformity in the corporation laws of U.S. states.

At the time of Professor Stein's publication, most of the harmonization was in the form of proposals, rather than of laws in force. By 1984, nine directives for uniformity had been adopted in five sectors of corporate affairs.⁵ These sectors may be summarily characterized as organization, capi-

1. A. SMITH, 3 AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 124 (1796). For a contemporary correlation of organizational theory with Adam Smith's ideology, see Marris and Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 J. ECON. LIT. 32 (1980).

2. E. STEIN, *THE HARMONIZATION OF EUROPEAN COMPANY LAWS* (1971).

3. *Liggett Co. v. Lee*, 288 U.S. 517, 558-59 (1933) (Brandeis, J., dissenting).

4. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974). For a challenge to Cary's evaluation, see R. WINTER, *GOVERNMENT AND THE CORPORATION* 7-11 (1978); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982).

5. Première Directive du Conseil 68/151/CEE, tendant à coordonner, pour les rendre équivalentes, les garanties qui sont exigées, dans les États membres, des sociétés au sens de l'article 58 deuxième alinéa de traité, pour protéger les intérêts tant des associés que des tiers, 11 J.O. COMM. EUR. (No. L 65) 8 (Mar. 14, 1968), English translation reprinted in 1 COMMON MKT. REP. (CCH) ¶ 1351 (on companies); Second Council Directive 77/91/EEC, on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, 20 O.J. EUR. COMM. (No. L 26) 1 (Jan. 31, 1977), reprinted in 1 COMMON MKT. REP. (CCH) ¶ 1355 (on information of public limited liability companies); Third Council Directive 78/855/EEC, based on article 54(3)(g) of the Treaty concerning mergers of public limited liability companies, 21 O.J. EUR. COMM. (No. L 295) 36 (Oct. 20, 1948), reprinted in 1 COMMON MKT. REP. (CCH) ¶ 1361 (on mergers); Fourth Council Directive 78/660/EEC, based on article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, 21 O.J. EUR. COMM. (No. L 222) 11 (Aug. 14, 1978), reprinted in 1 COMMON MKT. REP. (CCH) ¶ 1371 (on annual accounts); Council Directive 79/279/EEC, coordinating the conditions for the admission of securities to official stock exchange listing, 22 O.J. EUR. COMM. (No. L 66) 21 (Mar. 16, 1979), reprinted in 1 COMMON MKT. REP. (CCH) ¶ 1721 (on conditions for listing on exchange); Council Directive 80/390/EEC, coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing, 23 O.J. EUR. COMM. (No. L 100) 1 (Apr. 17, 1980), reprinted in 1 COMMON MKT. REP. (CCH) ¶ 1731 (on data to be published on exchange listing); Council Directive 82/121/EEC, on information to be published on a regular basis by compa-

talization, merger, accounting, and the extra disclosure requirements of companies whose securities are traded on stock exchanges.

One major sector of corporate affairs, however, stubbornly resisted the Community's harmonization efforts. This was the area dealing with the composition and powers of the governing organs (in the United States, officers and directors) of the corporation. The same area has been the subject of debate during the past decade in the United States,⁶ provoking the radical proposals of Ralph Nader and Christopher Stone,⁷ the bold reform bills of Senator Metzenbaum and Congressman Rosenthal,⁸ and the discreet exhortations of the American Law Institute.⁹ The present Article reviews briefly the foci of debate in the Community and analyzes the responses of law to parallel problems in the United States.

In the European Economic Community, the governing structure of corporations became the subject of the proposed "Fifth Directive,"¹⁰ which retained its ordinal even though it will be, if ever adopted, not less than tenth in order of approval.

This directive, as proposed by the Commission in 1972, contained two features that aroused major opposition. One of these was the two-tier structure of governance. The upper tier was a supervisory council,¹¹ which would select and remove executives,¹² and from which executives would be

nies the shares of which have been admitted to official stock exchange listing, 25 O.J. EUR. COMM. (No. L 48) 26 (Feb. 20, 1982), *reprinted in* 1 COMMON MKT. REP. (CCH) ¶ 1741 (on periodic disclosure by issuers of listed securities); Sixth Council Directive 82/891/EEC, based on article 54(3)(g) of the Treaty, concerning the division of public limited liability companies, 25 O.J. EUR. COMM. (No. L 378) 47 (Dec. 31, 1982), *reprinted in* 1 COMMON MKT. REP. (CCH) ¶ 1411 (on division of public limited liability companies); Seventh Council Directive 83/349/EEC, based on the article 54(3)(g) of the Treaty on consolidated accounts, 26 O.J. EUR. COMM. (No. L 193) 1 (July 18, 1983), *reprinted in* 1 COMMON MKT. REP. (CCH) ¶ 1421 (on consolidated accounts).

6. For a compendium of diverse opinions, see COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE (D. Schwartz ed. 1979) [hereinafter cited as COMMENTARIES].

7. R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION 118-31 and *passim* (1976) [hereinafter cited as R. NADER]; C. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR 122-83 and *passim* (1975).

8. S. 2567, 96th Cong., 2d Sess., 126 CONG. REC. 7, 992-95 (1980); H.R. 7010, 96th Cong., 2d Sess. (1980).

9. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982) [hereinafter cited as Tent. Draft No. 1]; PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 2, 1984) [hereinafter cited as Tent. Draft No. 2]; PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 3, 1984) [hereinafter cited as Tent. Draft No. 3]. The pronouncements in this document consist chiefly of statements about how corporations "should" be structured (Tent. Draft No. 2, §§ 2.01-3.03), what is good "corporate practice" (*id.* at §§ 3.04-3.07), and what procedures will shield corporate decisions from judicial merit review (Tent. Draft No. 3, §§ 5.08-5.16).

10. Commission Directive, Proposition d'une cinquième directive tendant à coordonner les garanties qui sont exigées dans les États membres, des sociétés, au sens de l'article 58 paragraphe 2 du traité, pour protéger les intérêts, tant des associés que des tiers en ce qui concerne la structure des sociétés anonymes ainsi que les pouvoirs et obligations de leurs organes, art. 58, 15 J.O. COMM. EUR. (No. C 131) 49 (Oct. 13, 1972) [hereinafter cited as Fifth Directive 1972].

11. *Id.* art. 2.

12. *Id.* art. 3.

excluded.¹³ The lower tier was a managing board composed of executives, which would conduct the ordinary business of the company without interference from the supervisory board.¹⁴

The other major subject of controversy was the representation of employees in the supervisory councils of companies with 500 or more employees.¹⁵ Alternative modes of representation were specified. Under one, which resembled some provisions of German law,¹⁶ at least one third of the supervisory council members had to be chosen by employees or employee representatives.¹⁷ Under the other, which was analogous to some provisions of Netherlands law,¹⁸ the supervisory council would appoint its own members, but shareholders and employees could veto the appointments by majorities of votes cast in their respective meetings.¹⁹

These proposals aroused in Europe opposition fully as vigorous as they would have aroused in the United States. For eleven years they were debated, revised, redebated, and re-revised.²⁰ In 1983, the Commission put forward a revised Fifth Directive designed to appease its critics while achieving the principal objectives of the original proposal.²¹

With respect to the supervision of managers, the Fifth Directive of 1983 offered a choice between the original two-tier structure and a one-tier structure in which a majority of the members would be nonexecutives.²² With respect to the participation of employees in the supervision of large companies, the Fifth Directive of 1983 raised the threshold to 1000 employees²³ and offered an expanded variety of choices. It preserved the options based on the German model of election of one third to one half of the supervisory council members by employees,²⁴ and the Netherlands model of co-optation subject to objection by employees.²⁵ The elective method was extended to one-tier boards by requiring that employees should elect one third to one half of the nonexecutive members of these boards.²⁶ Another alternative, adaptable equally to one-tier and two-tier boards, relinquished the requirement of employee representation on supervisory councils, but set up a parallel council of employee representatives who would receive the

13. *Id.* art. 6.

14. *Id.* art. 2.

15. *Id.* art. 4. The requirement was applied to companies with 500 or more employees.

16. Aktiengesetz [AktG] §§ 95-116, 1965 BGBl I 1109 (W. Ger.); THE GERMAN STOCK CORPORATION LAW §§ 95-116 (R. Mueller & E. Galbraith trans. 2d ed. 1976).

17. Fifth Directive 1972, *supra* note 10, at art. 4(2).

18. Burgerlijk Wetboek [B.W.] bk. 2, art. 158(6) (13th ed. 1983) (Neth.).

19. Fifth Directive 1972, *supra* note 10, at art. 4(3).

20. See Welch, *The Fifth Directive — A False Dawn?*, 8 EUR. L. R. 83 (1983).

21. Commission Directive, Amended proposal for a Fifth Directive founded on article 54(3)(g) of the EEC Treaty concerning the structure of public limited companies and the powers and obligations of their organs, 26 O.J. EUR. COMM. (No. C 240) 2 (Aug. 19, 1983) [hereinafter cited as Fifth Directive 1983].

22. *Id.* arts. 2(1), 3(1), 21a(1).

23. *Id.* arts. 4(1), 21b.

24. *Id.* art. 4b.

25. *Id.* art. 4c.

26. *Id.* art. 21d.

same information and consider the same questions as the shareholder boards, but who would have only consultative functions.²⁷ Finally, member states could allow their companies to invent their own forms of employee representation by collective bargaining with labor unions.²⁸

In the United States, developments have taken a very different turn. The question of employee representation has not yet excited much debate,²⁹ but the establishment of independent supervision is the focus of considerable development and controversy.³⁰ On the side of supervision, the New York Stock Exchange requires that its listed companies maintain an auditing committee of nonexecutive directors.³¹ The Corporate Laws Committee's Director's Guide of 1979 recommended exclusion of executives from committees on compensation and nomination, and maintenance of nonexecutive directors on the whole board.³² By 1980, a majority of larger corporations had majorities of nonexecutive directors.³³ In 1982, a tentative draft of the American Law Institute declared that the law "should" require that a majority of the board members in the larger corporations³⁴ be nonexecutives.

One would hardly be surprised if corporate executives, like physicians, lawyers, professors and other clans, would see no advantage in providing outside supervision. The American Society of Corporate Secretaries found the recommendation of nonexecutive majorities inappropriate for some companies,³⁵ and the exclusion of executives from the nominating commit-

27. *Id.* arts. 4d, 21e.

28. *Id.* arts. 4e, 21f.

29. See Summers, *Worker Participation in the U.S. and West Germany: A Comparative Study from an American Perspective*, 28 AM. J. COMP. L. 367 (1980).

30. See Staff of Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess., STAFF REPORT ON CORPORATE ACCOUNTABILITY 427-582 (Comm. Print 1980) [hereinafter cited as STAFF REPORT ON CORPORATE ACCOUNTABILITY]; Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083 (1978) [hereinafter cited as Roundtable 1978]; Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799 (1976); Ruder, *Current Issues between Corporations and Shareholders: Private Sector Responses to Proposals for Federal Intervention Into Corporate Governance*, 36 BUS. LAW. 771 (1981); Williams, *Corporate Accountability*, in COMMENTARIES, *supra* note 6, at 513, 521.

31. NEW YORK STOCK EXCHANGE, THE NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 303.00 (1983).

32. *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1625-26 (1978) [hereinafter cited as *Guidebook*].

33. In 1980, the *Wall Street Journal* reported that "outside" directors constituted majorities of the boards of 87.6% of "major U.S. corporations." Ingrassia, *Outsider Dominated Boards Grow, Spurred by Calls for Independence*, Wall St. J., Nov. 3, 1980, at 33, col. 4. For reports of earlier surveys by the Conference Board, see *Guidebook*, *supra* note 32, at 1643-44. For data gathered by the SEC, see STAFF REPORT ON CORPORATE ACCOUNTABILITY, *supra* note 30, at 598, 600.

34. Tent. Draft No. 1, *supra* note 9, at § 3.03. The class of corporations affected comprised those with 200 or more shareholders of record and \$100,000,000 or more in assets. See *id.* at § 1.15. This principle was demoted in 1984 to a rule of good corporate practice. Tent. Draft No. 2, *supra* note 9, at § 3.04.

35. *Corporate Director's Guidebook: Comments Submitted by the American Society of Corporate Secretaries*, 33 BUS. LAW. 321, 322 (1977) [hereinafter cited as *Secretaries*].

tee inappropriate in all companies.³⁶ Choosing their own successors is among the prime responsibilities of executives, the Secretaries said.³⁷ The Business Roundtable, which is generally representative of chief executives, decries all legal requirements of disinterested membership on the board.³⁸

II. THE INDEPENDENCE OF SUPERVISION

A. *The Theory of Independent Supervision*

A credulous reader of state corporation codes, federal proxy rules, and corporation reports could easily conclude that independent supervision of management is firmly entrenched at two levels. Shareholders elect directors and can remove them;³⁹ they receive information on corporate affairs from annual reports and proxy statements from registered companies;⁴⁰ if they fail to receive reports, or find the reports insufficient, they may inform themselves by exercising their rights of inspection.⁴¹ Directors in turn appoint and remove officers,⁴² and manage or direct the management of the corporation's business.⁴³

The reality is well known to be quite different. Most shareholdings in companies of all sizes are too small to justify individual shareholders' making the effort required to ferret out the facts and to organize a nonexecutive group to supervise executives. In large companies, the problem is complicated by the impracticability of reaching and persuading the tens of thousands of shareholders who would have to combine their forces to exert influence. As a result, most shareholders mark their proxies in favor of directors whom the managers have nominated. In the end, the managers have chosen their own supervisors.

Berle and Means estimated in 1932 that nearly two thirds of the largest corporations were controlled by the managers with no substantial input from shareholders.⁴⁴ John Calhoun Baker showed in 1937 that in some of the very largest corporations almost all the directors were full-time employ-

36. *Id.* at 331-33.

37. *Id.* at 331.

38. Roundtable 1978, *supra* note 30, at 2105-13; BUSINESS ROUNDTABLE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" 17-35 (1983) [hereinafter cited as ROUNDTABLE 1983].

39. *E.g.*, General Corporation Law, DEL. CODE ANN. tit. 8, § 141(k) (Supp. 1982) (removal); DEL. CODE ANN. tit. 8, § 211 (Supp. 1982) (election); MODEL BUSINESS CORP. ACT § 36 (1979) (election); MODEL BUSINESS CORP. ACT § 39 (1974) (removal).

40. Securities Exchange Act of 1934, Regulations, 17 C.F.R. § 240.14a-3 (1983).

41. General Corporation Law, DEL. CODE ANN. tit. 8, § 220 (Supp. 1982); MODEL BUSINESS CORP. ACT § 52 (1979).

42. General Corporation Law, DEL. CODE ANN. tit. 8, § 142 (Supp. 1982); MODEL BUSINESS CORP. ACT §§ 50-51 (1979).

43. General Corporation Law, DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1982); MODEL BUSINESS CORP. ACT § 35, ¶ 1 (1979).

44. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 94 (1933). This source classified 44% of the 200 largest corporations as under "management control," meaning that managers controlled through proxy voting, without the aid of other devices. Another 21% were estimated to be controlled through a "legal device" such as a voting

ees of the corporation or its subsidiaries;⁴⁵ they were consequently subordinates of the chief executive whom they nominally supervised. Today, most of the largest corporations have majorities of nonexecutives on their boards,⁴⁶ but there is no legal compulsion to do so.

Leading industrial countries outside the United States have required publicly held companies to provide for supervision of managers by nonmanagers. In Germany, where supervision is most fully developed, a supervisory council (*Aufstichtsrat*) has been required since 1870.⁴⁷ In its modern form, this council hires and fires the managers, sets their compensation, and supervises their management.⁴⁸ But the council cannot undertake acts of management, and none of its members can be managers.⁴⁹

In France, supervision of managers was introduced in 1863, through officers called *commissaires*.⁵⁰ Although the term is usually translated as "auditors,"⁵¹ the tasks of these officers would be better conveyed by calling them "inspectors" or even "commissars."⁵² Under the current law, they are specifically charged not only with verifying the accuracy of the information supplied to shareholders in the directors' annual report, but also with making sure that all shareholders receive equal treatment, notifying the shareholders of any "irregularities" discovered by them, and even notifying the State Prosecutor of any offense of which they have knowledge.⁵³

Great Britain has never required companies to set up an organ of continuous oversight, but has provided since 1862 for independent inspection of company affairs by a governmental agency known formerly as the Board of Trade, and currently as the Secretary for Trade and Industry.⁵⁴ The causes of inspection are fraudulent or unlawful purposes, oppression of

trust, so that a total of 65% appeared to be controlled by persons without substantial investment in the enterprise.

45. J. BAKER, *DIRECTORS AND THEIR FUNCTIONS* 24 (1945).

46. Ingrassia, *supra* note 33.

47. See R. WIETHÖLTER, *INTERESSEN UND ORGANISATION DER AKTIENGESELLSCHAFT IM AMERIKANISCHEN UND DEUTSCHEN RECHT* 285-87 (Berkeley-Kölner Rechtsstudien, Kölner, Reihe No. 1, 1961); Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 50-51 (1966).

48. AktG §§ 84(1), 87(1), 111(1), 1965 BGBl I 1106-07, 1114 (W. Ger.).

49. AktG §§ 105(1), 111(4), 1965 BGBl I 1113-14 (W. Ger.).

50. 2 J. HÉMAR, F. TERRÉ & P. MABILAT, *SOCIÉTÉS COMMERCIALES* 587-90 (1974) [hereinafter cited as J. HÉMAR].

51. See, e.g., J. CRABB, *FRENCH BUSINESS ENTERPRISES* 68 (1979); *French Law on Commercial Companies*, COMMON MKT. REP. (CCH) art. 218, at 108 (Jan. 1, 1971) [hereinafter cited as *French Law on Commercial Companies* (CCH)].

52. J. HÉMAR, *supra* note 50. At one time there was thought of naming them *commissaires censeurs* (literally, "commissar-censors"). *Id.* at 588.

53. Loi no. 66-537 du 24 juillet 1966 sur les sociétés commerciales, arts. 228, 233, 1966 J.O. 6402, 6419, 6420, 1966 D.S. 265, 278 [hereinafter cited as *French Law on Commercial Companies*]. For English translations, see J. CRABB, *supra* note 51, at 15, 69, 71; *French Law on Commercial Companies* (CCH), *supra* note 51, at 33, 111, 113.

54. An Act for the Incorporation, Regulation, and Winding-up of Trading Companies and other Associations (The Companies Act), 1862, 25 & 26 Vict., ch. 89, §§ 56-59; Companies Act, 1948, 11 & 12 Geo. 6, ch. 38, §§ 164-69. The functions of the Board of Trade are now exercised by the Secretary of State for Trade and Industry pursuant to The Secretary of State for Trade and Industry Order 1970, No. 1537, § 2(1), 1970 STAT. INST. 5293, 5293 (1971).

shareholders, misfeasance, misconduct, or failure to give the shareholders "all the information with respect to its affairs which they might reasonably expect."⁵⁵ If the inspection reveals that the affairs of the company are being conducted "in a manner which is unfairly prejudicial to the interests of some part of the members," a court may make a variety of remedial orders.⁵⁶

The historic purpose of supervision in these systems has been the protection of property interests — primarily those of shareholders, but possibly also of bondholders and other creditors.⁵⁷ Since World War II, the suggested purposes of supervision have sometimes been expanded to include protection of general public interests.⁵⁸ In order to avoid confusing issues, this Article analyzes supervision first as it relates to property protection. A later part of the Article deals with modifying supervision to protect employee interests. The engaging question of supervision for other public interests is outside the scope of the present inquiry.⁵⁹

Provisions for supervision of management are based on two assumptions. The first one is that managers are normally competent, loyal and fair. They should be allowed to manage the business without pervasive intervention of supervisors. The German law specifically forbids the allocation of management powers to the supervisory board.⁶⁰ Although the Fifth Directive of 1983 lacks the express prohibition of German law, it distinctly assigns managerial powers to one board and supervisory powers to another in the two-tier system.⁶¹ In the one-tier system, it specifies that the executive members of the board shall manage and the nonexecutive members shall supervise.⁶² A similar division of functions is recognized in the Corporate Director's Guidebook of the American Bar Association's Corporate Laws Committee,⁶³ and implicitly by the authorization in the Delaware and Model acts for the board to "direct" rather than "manage" the business of

55. Companies Act, 1948, ch. 38, § 165.

56. Companies Act, 1980, ch. 22, § 75. This section added "unfairly prejudicial" to the grounds of court orders, and authorized individual shareholders, in addition to the Secretary of State for Trade and Industry, to seek judicial correction.

57. The duty to shareholders was generally implicit in the specifications of liability to the "company." But supervisory members could be liable under some circumstances to creditors or to liquidators for the benefit of creditors. An express recognition of other interests was the notorious injunction of the German Stock Corporation Act of 1937 to manage so as to advance the welfare of the enterprise and its personnel, and the general good of the people and the nation ("*wie das Wohl des Betriebs und seiner Gefolgschaft und der gemeine Nutzen von Volk und Reich es fordern*"). Gesetz über Aktiengesellschaften und Kommanditgesellschaften auf Aktien [Aktiengesetz] 70(1), 1937 RGBl I 107, 120 (W. Ger.).

58. See R. NADER, *supra* note 7, at 118-28; C. STONE, *supra* note 7, at 30-34. For Great Britain, see Companies Act, 1980, ch. 22, §§ 46, 74, requiring directors at all times to have regard to the interests of employees and authorizing them in cases of sale of a business to make arrangement for employees at the expense of shareholders.

59. Literature on representation of noninvestor constituencies is reviewed in Conard, *Reflections on Public Interest Directors*, 75 MICH. L. REV. 941 (1977).

60. AktG § 111(4), 1965 BGBl I 1114 (W. Ger.).

61. Fifth Directive 1983, *supra* note 21, art. 3(1)-(a).

62. *Id.* at art. 21a(1).

63. *Guidebook*, *supra* note 32, at 1619-20. The Corporate Laws Committee is an organ of the Section of Corporation, Banking and Business Law of the American Bar Association.

the corporation.⁶⁴

The second assumption of the supervision arrangement is that some managers sometimes will lack competence or lose competence that they once had; that some managers would, if unrestrained, undertake imprudent expansions or make overgenerous arrangements for their own benefit; and that some would, on occasion, favor some sectors of security holders over others. In order to inhibit these deviations, and to deter them, supervisors are established who are sufficiently removed from management to view it objectively, and sufficiently powerful to decide who shall be managers and for how long.

The theory does not ignore the agency of other forces for good management. Managerial ethics is the most potent force, but ethics occasionally succumbs to vanity and ambition. Product markets and securities provide discipline,⁶⁵ but they sometimes offer rewards for mismanagement, as in manipulation of information for trading gains. Derivative suits provide deterrents to mismanagement,⁶⁶ but very irregularly and expensively. Supervision can be quicker and cheaper than derivative suits or market forces, and can fill gaps in managerial ethics.

The theory of supervision, as outlined above, is not immune to attack. If one were to accept without reservation some of the rosy descriptions of the discipline of the market, and the "market for control,"⁶⁷ one might conclude that supervision is superfluous, although the authors of these descriptions do not seem to have gone quite so far. The main contention of these theorists is that the market will indicate to investors how much supervision is optimal.⁶⁸ Governments should not interfere with investors' freedom to choose the form and intensity of supervision.

The present Article does not pursue this intriguing question of legislative policy. Instead, it operates within the postulates of known corporate codes, all of which contain supervisory requirements; it examines the differences in the procedures and speculates on the consequences that are likely to flow from these differences.

B. *The Effects of Independent Supervision*

The practical effects of establishing a structure of independent supervi-

64. General Corporation Law, DEL CODE ANN. tit. 8, § 141(a) (Supp. 1982); MODEL BUSINESS CORP. ACT § 35 (1979).

65. See Lorie, *An Economist's Perception I: A View On the Need to Revise Corporation Statutes*, in COMMENTARIES, *supra* note 6, at 51, 58; Weston, *Economist's Perception II: Large Corporations and Corporate Governance*, in COMMENTARIES, *supra* note 6, at 61, 72; Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959 (1980).

66. Cohen v. Beneficial Indus. Loan Co., 337 U.S. 541, 548 (1949) (Frankfurter, J.); *Brendle v. Smith*, 46 F. Supp. 522, 525-26 (S.D.N.Y. 1942) (Rifkind, J.); Dykstra, *The Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 77-82 (1967).

67. See R. WINTER, *supra* note 4, at 16-28; Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

68. See R. WINTER, *supra* note 4, at 25-26; Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Manne, *supra* note 67, at 119-20; see generally Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (outlining an economic theory of the market's role in determining corporate management behavior).

sion are problematic. Victor Brudney captured the uncertainty in the title, *The Independent Directors: Heavenly City or Potemkin Village?*⁶⁹

The most optimistic hypothesis is that corporations with independent supervision would enjoy a better selection of managers, wiser choices in major corporate actions, and greater impartiality in the treatment of various groups of investors.

A second possibility is that corporations with independent supervision would operate indistinguishably from corporations without it, because independent directors would be unable or unwilling to overrule or remove the managers.

A third eventuality is that corporations with independent supervision would operate less efficiently and less fairly than corporations without them. This could happen because nonexecutive directors would know less than executive directors about the enterprise and because the facade of supervision would block judicial control of mismanagement.

Puckish colleagues have suggested that these three alternatives be nicknamed the House of Commons model, the House of Lords model, and the Supreme Soviet model. Although these images illuminate some aspects of the alternatives, this essay will employ the less colorful terms, authoritative supervision, advisory supervision and deferential supervision.

The dominant variable in supervision, as in corporate management and in parliamentary chambers, will always be the quality of the supervisors — their intelligence, their integrity and their courage.⁷⁰ Without these qualities in the supervisors, corporate structures are largely irrelevant. But corporate structures are relevant to the utility or futility of possessing these qualities. They are even more relevant to the impulse of executives to procure directors who have these qualities or directors who lack them. The following pages contain a discussion of circumstances that are favorable or unfavorable to the exercise of effective supervision.

1. *Authoritative Supervision*

Authoritative supervision is easily envisioned in a corporation in which, for example, all the shares are held in about twenty separate blocks of approximately equal size, and each block is worth \$100,000 or more. Under these circumstances, the owners of each block have financial interests that are big enough to induce them to spend some time and effort protecting their investment. Since there is no public market in such a closely held company, the shareholders do not generally have the alternative of selling

69. Brudney, *The Independent Directors: Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982). "Heavenly City" is an allusion to the dream of a rational society recounted in C. BECKER, *THE HEAVENLY CITY OF THE EIGHTEENTH-CENTURY PHILOSOPHERS* (1932), and in a chapter in P. GAY, *THE PARTY OF HUMANITY* (1964). "Potemkin Village" is an allusion to false facades constructed by General Potemkin to please Catherine the Great in her tours of the countryside, as recounted by JOAN HASLIP, *CATHERINE THE GREAT*, 319-20 (1977). See also Feis, *Is Shareholder Democracy Possible?*, 31 BUS. LAW. 621 (1976); Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1981); Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?*, 76 MICH. L. REV. 581 (1978).

70. 3 THE CONFERENCE BOARD, *CORPORATE DIRECTORSHIP PRACTICES* 19-20 (1975) [hereinafter cited as DIRECTORSHIP PRACTICES].

out at a fair price. Furthermore, they cannot all be chief executives. Lacking other means of protecting their individual interests, they are impelled to combine to obtain the best obtainable managers and to watch them closely.

a. Dispersed holdings. As the facts diverge from this example, the probability diminishes that authoritative supervision by shareholder representatives will be exercised. As the holdings become more numerous and comprise smaller fractions of the share capital, the difficulties of corralling a coalition for the election of directors are aggravated. At the same time, the market is broadened, and the possibility of selling out instead of struggling becomes more attractive. As the value of the blocks decreases, the incentive to spend time and money on the corporation's affairs is attenuated. When shareholders stop making their own choices of directors, directors are chosen by the managers. For these reasons, the probability of authoritative supervision of management in the most widely held corporations is remote. This is the situation that has been characterized as "management control,"⁷¹ or as "managerialism."⁷²

Managerialism may be contrasted with "capitalism" in the early twentieth century sense of control by the suppliers of capital.⁷³ Although Berle and Means planted the inference that managerialism involves a subversion of the private property system,⁷⁴ some more recent writers contend that it is the essence of the private property system.⁷⁵ Their perspective is supported by theories about the "market for control," which brings enterprises into the hands of the managers who produce the greatest returns for investors.⁷⁶

In Germany, where the two-tier supervisory system originated, a number of practices and legal prescriptions tend to protect the supervisory board from being captured by the managers. Since most shares are embodied in bearer certificates, the issuing corporations have no way of communicating directly with most of the shareholders. They depend on the banks to obtain the proxies that are needed for shareholders' meetings.⁷⁷ The banks

71. A. BERLE & G. MEANS, *supra* note 44, at 84-90.

72. M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 24 (1976); *cf.* Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1660 (1981) (criticizing the traditional managerial model for not conforming to traditional legal principles); *see generally* R. MARRIS, *THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM* (1964).

73. WEBSTER'S INTERNATIONAL DICTIONARY (1932) defined capitalism (among other ways) as "An economic system in which capital or capitalists play the principal part . . ." A capitalist was defined as "One who has capital; one who has capital for investment, or capital invested; esp., a person of large property which is or may be employed in business." The 1968 definition of capitalism omits any reference to capitalists playing a "principal part," and substitutes a reference to "private decision rather than . . . government control." Perhaps a new term such as "investorism" is needed to preserve the idea that was formerly embodied in "capitalism." Since the meaning of this term would not be readily recognized by readers, this Article adheres to "capitalism" in what may be an outmoded sense.

74. A. BERLE & G. MEANS, *supra* note 44, at 247-76.

75. *See, e.g.*, Werner, *supra* note 72, at 1629-44.

76. *See* R. WINTER, *supra* note 4, at 18-28; Manne, *supra* note 67, at 112.

77. The system is described and evaluated by Bernhard Grossfeld in Grossfeld, *Management and Control of Marketable Share Companies*, in 13 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 98-101 (A. Conard ed. 1971) [hereinafter cited as Grossfeld]; A. HUECK, *GESELLSCHAFTSRECHT* 164-67 (1970); H. WÜRDINGER, *AKTIEN- UND KONZERNRECHT* 69-71 (1973); Grossfeld & Ebke, *Probleme der Unternehmensverfassung in rechtshistorischer und*

do not solicit proxies to be exercised by the management's proxy committee (as in the United States), but proxies to be exercised by the banks themselves.⁷⁸ Although the banks cast most of the ballots, the supervisors whom they elect are predominantly shareholders, with a sprinkling of banks' representatives, "experts" (lawyers, accountants, engineers, etc.), and others.⁷⁹

The banks that exercise the shareholders' proxies must tell the shareholders how they intend to vote if uninstructed, and follow the shareholders' instructions if any are given.⁸⁰ Unlike brokers who hold customers' shares in the United States,⁸¹ they are free to oppose the managers' proposals if they have announced their intentions in advance and have not been instructed otherwise.

In practice, there is very little conflict between the banks and the managers; one can hardly tell whether the banks are accommodating the managers, or vice versa.⁸² If, however, the managers should disagree with the supervisory board, they would have no means of going over the heads of their board with an appeal to shareholders. Although the law does not expressly say so, German jurists believe that managers are implicitly forbidden to participate in a proxy solicitation.⁸³

Whether independent supervision will have the same effects in other Community countries that it has in Germany is questionable, because of differences in proxy solicitation. One can be fairly certain that it would not work in the United States as it works in Germany, primarily because U.S. financial institutions would be unlikely to use their voting power as actively as German banks do, even if they had as many votes at their disposal.⁸⁴

rechtsvergleichender Sicht (II und Schluss), 22 AG 92-98 (1977). In 16 of the largest companies in which no single shareholder had a large holding, 92% of the shares present at the shareholders' meetings were found to be voted by banks or investment companies. *BERICHT DER STUDIENKOMMISSION: GRUNDSATZFRAGEN DER KREDITWIRTSCHAFT 111* (Schriftenreihe des Bundesministerium der Finanzen No. 28, 1979) [hereinafter cited as *BERICHT DER STUDIENKOMMISSION*].

78. Although the corporation code speaks of proxies being given to a bank and exercised by the "bank," AktG § 135(1), 1965 BGBl I 1120 (W. Ger.), the bank must inevitably delegate the exercise of the proxies to an individual. The individual who votes on behalf of the bank must be an employee of the bank, unless the bank has no branch in the city where the meeting is held, and has notified the shareholder that it will be represented by a nonemployee. AktG, § 135(3).

79. C. VOGEL, *AKTIENRECHT UND AKTIENWIRKLICHKEIT — ORGANISATION UND AUFGABENTEILUNG VON VORSTAND UND AUFSICHTSRAT 120-28* (1980). A significant number of directorships are also held by representatives of governmental bodies that hold shares in "mixed economy enterprises." According to a government study of codetermination, a panel of representative nominations is usually prepared by the managing board (*Vorstand*). *MITBESTIMMUNGSKOMMISSION, MITBESTIMMUNG IM UNTERNEHMEN: BERICHT DER SACHVERSTÄNDIGENKOMMISSION ZUR AUSWERTUNG DER BISHERIGEN ERFAHRUNGEN BEI DER MITBESTIMMUNG 32* (1970).

80. AktG § 128, 1965 BGBl I 1118 (W. Ger.).

81. See New York Stock Exchange, Rules 451-52, [2 Constitution and Rules] N.Y.S.E. GUIDE (CCH) ¶ 2451-52.

82. U. IMMENGA, *AKTIENGESELLSCHAFT, AKTIONÄRSINTERESSEN UND INSTITUTIONELLE ANLEGER 9* (WALTER EUCKEN INSTITUT No. 28, 1971); Grossfeld & Ebke, *supra* note 77, at 96.

83. Grossfeld & Ebke, *supra* note 77, at 95.

84. Factors inhibiting aggressive exercise of voting power by institutions are analyzed below in part II.B.2 of this Article.

b. *Concentrated holdings.* If some of the shareholdings are substantially larger than in the example sketched above, the probabilities are more complex. When the leader of the principal share block is not determined to be the chief executive, he is likely to induce active supervision by his own financial manager or by his nominees on the board. This situation probably existed in the Standard Oil Companies for several decades after the breakup of the original company. A historic example of its operation is illustrated by the forcing out of Colonel Stewart from the presidency of Standard Oil of Indiana, after he was indicted for perjury in connection with the Teapot Dome scandal.⁸⁵ The situation also existed in General Motors when the Du Pont Company held a dominant block of shares.⁸⁶ Although Du Pont may have influenced General Motors' choice of paints, lacquers, and upholstery,⁸⁷ General Motors was regarded as an exemplar of efficient management in many respects.⁸⁸ Contemporaneous examples of action led by holders of significant minority blocks of shares include Samuel Heyman's ouster of a chief executive of GAF Corporation on charges of mismanagement.⁸⁹

If the leader of the dominant block aspires to executive power in the company, independent supervision vanishes, because the holder of supervisory power has become a manager. The results may be excellent if the leader is talented, honest, and devoted to his job. The possible variations are suggested by the progress of the Ford Motor Company, which seemed to advance during the early years of leadership of Henry Ford II, but to slow down when the chief's caprices led to rapid hirings and firings of Miller, Knudsen, and Iacocca.⁹⁰

Although the holding of a controlling block of shares may lead to efficient operation of the business, it has no particular tendency to produce fairness among groups of shareholders. The controlling shareholder may favor itself. Du Pont may have imposed some costs (probably minuscule) on General Motors' minority shareholders by shifting GM's paint

85. See P. GIDDENS, *STANDARD OIL COMPANY (INDIANA): OIL PIONEER OF THE MIDDLE WEST* 403-35 (1955).

86. See *United States v. E.I. Du Pont de Nemours & Co.*, 353 U.S. 586, 588 (1957) (Du Pont's influence on GM's choice of paints); see also *Winkelman v. General Motors Corp.*, 44 F. Supp. 960, 967-68 (S.D.N.Y. 1942) (Du Pont's influence on executive compensation policies).

87. See 353 U.S. at 596.

88. See P. DRUCKER, *CONCEPT OF THE CORPORATION passim* (1946) [hereinafter cited as P. DRUCKER, *CORPORATIONS*]; R. GORDON, *BUSINESS LEADERSHIP IN THE LARGE CORPORATION* 101, 110 and *passim* (1961); see generally P. DRUCKER, *THE PRACTICE OF MANAGEMENT* 53 and *passim* (1954).

89. *GAF Holder Unveils Dissident Slate, Urges Werner to Debate Him*, Wall St. J., Mar. 2, 1983, at 23, col. 1; *GAF Proxy Defeat Reflects Revolt by Impatient Institutional Holders*, Wall St. J., May 12, 1983, at 35, col. 4; *GAF Dissident's Victory Upheld in Appeals Court*, Wall St. J., Dec. 9, 1983, at 4, col. 1. Another instance is the initiative of Howard Keck, owner of 12 percent of Superior Oil, to oust the company's management. Keck's initiative was settled by the company's abandoning a charter amendment to repel a takeover bid. *Superior Oil Proxy Battle Studied by Keck*, Wall St. J., Nov. 28, 1983, at 3, col. 1; *Superior Oil Co. Rescinds Issue of Preferred*, Wall St. J., Dec. 6, 1983, at 2, col. 2.

90. See *Henry Ford's Bumpy Journey off into the Sunset*, *ECONOMIST*, Apr. 21, 1979, at 101; *Ford After Henry II*, *BUS. WK.*, Apr. 30, 1979, at 62, 64-65. According to the *Economist* story, Ford's only explanation to Iacocca was "I just don't like you"; according to *Business Week*, his statement to the board was: "Him or me."

purchases toward Du Pont.⁹¹ More significantly, Christiana (the Du Pont family holding company) may have induced Du Pont to make a favorable deal in the Christiana-Du Pont merger, at some expense to Du Pont's other shareholders.⁹² Consequently, the concentration of shares in a controlling block may be less favorable to the entire body of shareholders than relatively equal distribution of large blocks. But the latter arrangement is practically unavailable in most billion-dollar companies, so that single block control may be shareholders' best hope for active supervision.

2. *Advisory Supervision*

In most U.S. corporations, a majority of independent nonexecutive directors seems likely to produce no different effects than a minority. In either case, the presence of nonexecutives on the board is likely to be helpful.⁹³ They will contribute viewpoints that are free of the biases of incumbent executives. Since most of them will have experience with other enterprises, they will bring additional observations to the attention of executives. Executives' desire to retain the outsiders' approval will exert some restraint on the self-serving exploits that might otherwise tempt them. But the independent directors will rarely if ever act to change the management.⁹⁴

a. *The passivity of independent directors.* The most likely behavior of nonexecutive directors who disapprove of the executives' course was dramatically illustrated in Bendix Company. When distinguished independent directors lost interest in Agee's program, they did not organize a movement to block or depose him; they resigned.⁹⁵

91. See *Du Pont*, 353 U.S. at 595. The government's accusation did not imply that GM's purchases of Du Pont's products were uneconomical, but that they foreclosed competition of other suppliers.

92. See *E.I. Du Pont de Nemours & Co. v. Collins*, 432 U.S. 46 (1977), where the Court sustained an exchange by which shareholders of Christiana Securities Co. received Du Pont shares worth more on the market than their Christiana shares.

93. See J. BAKER, *supra* note 45, at 131-38; M. MACE, *DIRECTORS: MYTH AND REALITY* 10-42 (1971); R. WINTER, *supra* note 4, at 40-42; cf. P. DRUCKER, *CORPORATIONS*, *supra* note 88, at 91-92 (although not the solution to corporate board reform, in some cases outside directors may provide important contributions).

94. See M. MACE, *supra* note 93, at 72-85. A Conference Board study declares that a director "must be willing to take on the unpleasant assignments that can go with the position, such as getting rid of incompetent management," but adds in the next sentence that "[t]he ultimate protest of a director, of course, is to resign from the board." *DIRECTORSHIP PRACTICES*, *supra* note 70, at 20.

95. For a news story on the resignation, see Rowan & Moore, *Behind the Lines in the Bendix War*, *FORTUNE*, Oct. 18, 1982, at 157, 163. There seemed to be no way of knowing whether the resigning directors' loss of interest was occasioned by disapproval of Agee's actions, or by loyalty to Blumenthal (Agee's predecessor), or by the decline in status of their directorships that was incident to the acquisition by Allied Corporation. Among the non-executive directors who appeared on Bendix' board in the report for 1982 but not for 1983 were Wilbur J. Cohen, Professor of Public Affairs at the University of Texas and former Secretary of Health, Education and Welfare; Donald H. Rumsfeld, President and CEO of G.D. Searle Co. and former Secretary of Defense; William P. Tavoulaareas, President of Mobil Corporation; and Hugo E.R. Uyterhoeven, Professor at the Harvard Business School. [1982] 1 *MOODY'S INDUSTRIAL MANUAL* 1001; [1983] 1 *MOODY'S INDUSTRIAL MANUAL* 949. A year earlier Robert W. Purcell of the Rockefeller Brothers Fund had retired with a public statement

There are good reasons for independent directors to act as the Bendix directors did. Fighting the management is enormously costly in time, energy, and personal relations even when it is successful. If unsuccessful, it brings about an enormous loss of prestige, which is a director's stock in trade.

The more conscientious an independent director is, the less likely he is to organize opposition to the management. Most independent directors (corporation executives, university executives or professors) have full-time obligations to other enterprises. To involve themselves in opposition to management would divert their energies from their primary loyalties. An independent director can be expected to take the risks and pay the costs of opposition only if he owes his primary loyalties to a large investor — if not a Rockefeller or a Du Pont, at least a Heyman.

b. The passivity of financial institutions. The passivity of directors in widely held corporations is probably not inevitable. Although there are few large family holdings in billion-dollar corporations, there are holdings in trust companies, investment companies, pension funds, and endowments that are large enough to form powerful coalitions.⁹⁶ The SEC found in 1970 that from 10 to 54 percent of the shares of the largest New York Stock Exchange companies were managed by institutions, with an average institutional holding of 36 percent.⁹⁷ A Senate staff study based on 1976 data placed the institutional fraction in a large group of companies at about 43 percent.⁹⁸ Although financial institutions generally support management in

of "[h]aving lost confidence in the top Bendix management and having tried without success to remedy the situation . . ." Koten, *Robert Purcell Quits as Bendix Director, Says He "Lost Confidence" in Management*, Wall St. J., Aug. 28, 1981, at 4, col. 2. At the time of the earlier resignation of Mr. Purcell, the nonexecutive directors outnumbered the executives. The other five nonexecutives (in addition to those who resigned between the 1982 and 1983 reports) were Coy G. Eklund, president and CEO of Equitable Assurance; Thomas P. Stafford, Vice Chairman of Gibraltar Exploration; John C. Fontaine, partner of Hughes, Hubbard & Reed; Jewel S. Lafontant, partner of Lafontant, Wilkins & Bintler; and Jonathan L. Scott, chairman and CEO of J.L. Scott Enterprises. There were only five executive directors — Agee, Hartz, McDonald, Purple, and Searby. [1982] 1 MOODY'S INDUSTRIAL MANUAL 1001.

Five other nonexecutive directors disappeared from the Bendix masthead between the 1980 and 1981 reports — Malcolm Baldrige, Chairman and CEO of Scovill, Inc.; Henry B. Cunningham, Honorary Chairman of K-Mart; Paul S. Mirabito, Chairman and CEO of Burroughs Corp.; Allan E. Schwartz, partner of Honigman, Miller, Schwartz & Cohn; George R. Vila, former chairman of Uniroyal Corporation. [1980] 1 MOODY'S INDUSTRIAL MANUAL 702; [1981] 1 MOODY'S INDUSTRIAL MANUAL 777. Three of these (not designated) were reported to have resigned because of prospective conflicts of interest arising from Bendix' plans to acquire an interest in a "technology company." Koten, *supra*.

96. See D. BAUM & N. STILES, *THE SILENT PARTNERS: INSTITUTIONAL INVESTORS AND CORPORATE CONTROL* 53-80 (1965); J.A. LIVINGSTON, *THE AMERICAN STOCKHOLDER* 247-48 (1958); see also P. BLUMBERG, *THE MEGACORPORATION IN AMERICAN SOCIETY* 109-26 (1975) (illustrating the extent of institutional concentration); cf. Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 560 (1981) (discussing effect of corporation law on investment companies).

97. 6 U.S. SECURITIES AND EXCHANGE COMMISSION, *INSTITUTIONAL INVESTOR STUDY REPORT*, H.R. DOC. NO. 92-64, 92d Cong., 1st Sess., Summary Volume (1971) [hereinafter cited as *INSTITUTIONAL INVESTOR STUDY*]; see also P. BLUMBERG, *supra* note 96, at 109-26.

98. STAFF OF THE SUBCOMMITTEE ON REPORTS, ACCOUNTING AND MANAGEMENT OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, *VOTING RIGHTS IN MAJOR CORPORATIONS*, S. Doc. No. 99, 95th Cong., 2d Sess. 14 (1978) [hereinafter cited as *VOTING RIGHTS*].

elections of directors and votes on shareholder proposals,⁹⁹ they more frequently take opposing positions on defenses against takeover bids.¹⁰⁰

The question arises why financial institutions do not organize to supervise management before the takeover crisis arrives.¹⁰¹ The statement that they find it easier to sell out than to fight is not satisfying. Many of their blocks are too large to sell without depressing the market. If the price of their holdings has been depressed by poor management, improving management might be more economical than selling large blocks of shares.

If a financial institution were to consider forming a group of institutional holders to supervise managers, its lawyers would have to advise it of a number of dangers. The mere formation of a group might require public disclosure under an interpretation of the Securities Exchange Act.¹⁰² The announcement would imply a negative view of incumbent management, which might depress share prices, and impair the performance record of the financial institution, as measured by market values of its holdings.

If a group of institutions should be successful in installing directors of their choice, they would face additional complications. Their directors might be regarded as their deputies, so that the institutions' gains in short-swing trading would have to be surrendered to the corporation.¹⁰³ This would disable the institution from serving efficiently the interests of its own investors.

If the institutions were so successful that they installed a majority of directors of their choice, they might become "controlling persons" under the rules of the SEC.¹⁰⁴ As such, they would have prima facie liability for any securities violations of the "controlled" companies,¹⁰⁵ and would be forbidden to sell large blocks of their own holdings without a new registration.¹⁰⁶ The holdings of the entire group would probably be aggregated in

99. INSTITUTIONAL INVESTOR STUDY, *supra* note 97, at 2749-826.

100. INSTITUTIONAL INVESTOR STUDY, *supra* note 97, at 2827-43.

101. P. BLUMBERG, *supra* note 96, at 131-44; U. IMMENGA, *supra* note 82, at 23-30.

102. "The history and language of section 13(d) make it clear that the statute was primarily concerned with disclosure of *potential changes* in control resulting from new aggregations of stockholdings and was not intended to be restricted to only individual stockholders who made future purchases and whose actions were, therefore, more apparent." *GAF Corp. v. Milstein*, 453 F.2d 709, 718 (2d Cir. 1971) (interpreting the Securities Exchange Act of 1934, § 13(d), 15 U.S.C. § 78m(d) (1982)), *cert. denied*, 406 U.S. 910 (1972).

103. *See Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969) (applying Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1982)), *cert. denied*, 396 U.S. 1036 (1970).

104. "Control" is defined by Securities Act Regulations, 17 C.F.R. § 230.405 (1983) [hereinafter cited as Sec. Act Regs.] and Securities Exchange Act of 1934, Regulations, 17 C.F.R. § 240.12b-2 (1983), as the power "to direct or cause the direction of the management . . ."

105. Securities Act of 1933, § 15, 15 U.S.C. § 770 (1982); Securities Exchange Act of 1934, § 20(b), 15 U.S.C. § 78t(b) (1982).

106. Under the Securities Act of 1933, §§ 2(4), 2(11), 15 U.S.C. §§ 77b(4), 77b(11) (1982), anyone who sells on behalf of an issuer is classified as an "underwriter," and anyone who controls the issuer is classified as an issuer. Therefore, a broker who sells for a controlling person is an "underwriter," and sales by or through the broker are excluded from the broad exemption of 15 U.S.C. § 77d and are subject to the registration and prospectus requirements of 15 U.S.C. § 77e. *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 947 (1969). An exemption exists for sales in small amounts (known to the trade as "leakage") when a number of other conditions are fulfilled, but the limits are low enough to encum-

determining the necessity of registration.¹⁰⁷

The deterrents to institutional activism posed by the Exchange Act (and the SEC's interpretations of it) present an ironic contrast with the purposes of another part of the Act — the proxy section.¹⁰⁸ This section imposes a heavy burden of disclosure to shareholders in solicitation of shareholders' preferences, presumably in order to establish shareholder control over managers.¹⁰⁹ But most of the shareholders who are big enough to exercise any influence are deterred from doing so by the SEC's control rules. Whether institutions would exert greater efforts to control management if they were relieved of these deterrents cannot be known so long as they are impeded.¹¹⁰ But it seems clear that their avenue to authoritative supervision has been strewn with mines.

c. Potential impacts of activating control by financial institutions. Although institutional activism in the choice of directors is unlikely to arise, an estimate of its consequences is relevant to the advisability of reforming the law to make it feasible.

On the positive side, institutionally-oriented directors would presumably favor managers who maximize returns to the institutions.¹¹¹ Since these returns would be in the form of distributions or price appreciation, or both, the same benefits would flow to all shareholders.

The negative aspects are more obscure. Although congressional investigators seem to view with alarm the concentration of financial power in institutional investors,¹¹² the nature of the dangers is not clearly articulated. One worry has been that officers of a powerful institution sitting as directors on boards of different companies may cause them to patronize each other rather than competitors,¹¹³ or restrain competitors from competing.¹¹⁴ These perils, if they exist, seem likely to be diminished rather than aggravated if numerous financial institutions combine to install their own nominees on boards, since a broader spectrum of interests would be represented.

Another concern about institutional investors has been related chiefly to institutions that combine trust and commercial banking functions.¹¹⁵ One fear is that trust departments might use their voting power to direct the

ber severely the liquidation of large blocks of shares. See Sec. Act Regs., 17 C.F.R. § 230.144 (1983).

107. Rule 144(e)(3)(vi), 17 C.F.R. § 230.144(e)(3)(vi) (1983).

108. Securities Exchange Act of 1934, § 14, 15 U.S.C. § 78n (1982).

109. Exchange Act Regulations, 17 C.F.R. §§ 240.14a-1—14a-12 (1983).

110. Some other deterrents to active participation in corporate affairs are reported in 5 INSTITUTIONAL INVESTOR STUDY, *supra* note 97, at 2756-59.

111. See J.A. LIVINGSTON, *supra* note 96, at 247-48.

112. See VOTING RIGHTS, *supra* note 98, at 1-4.

113. *Id.* at 20.

114. E. HERMAN, CONFLICTS OF INTEREST: COMMERCIAL BANK TRUST DEPARTMENTS 34 (1975).

115. See STAFF OF SUBCOMM. ON DOMESTIC FINANCE OF THE HOUSE COMM. ON BANKING AND CURRENCY, 90th Cong., 2d Sess., Report on Commercial Banks and Their Trust Activities: Emerging Influence on the American Economy (Subcomm. Print 1968). See generally E. HERMAN, *supra* note 114.

business of portfolio companies toward the banking department.¹¹⁶ The best antidote for this problem would be to facilitate voting by *all* institutional investors, so that none would have an advantage. A further fear is that commercial departments will pass confidential information to trust departments, which the latter can use for a trading advantage.¹¹⁷ Since this danger is unrelated to institutional voting power, it has no bearing on the instant inquiry.

From another angle, institutional shareholders are criticized for being unresponsive to "social responsibility" questions such as pollution, labor relations, and apartheid in South Africa.¹¹⁸ To a large segment of economic and juristic opinion this bias, if it exists, would be a virtue rather than a vice.¹¹⁹ For those who favor "social responsibility," the question should be whether the total effect of increasing institutional influence would be positive or negative. One can reasonably suppose that the consensus of institutional managers would be less responsive than the impulses of some corporate managers, and more responsive than the impulses of some other corporate managers. One may also assume that institutional managers will give corporate managers some leeway to indulge their social concerns when the costs to investors are not noticeable. But one is left with the suspicion that influential institutional investors would be likely to block bold ventures in risking investor interests for the sake of employees, consumers, or neighbors. Social reformers may be right in guessing that they can obtain their objectives more easily under a regime of managerialism (the rule of managers) than under a regime of capitalism (the rule of investors).

A concern that the author has encountered more in private conversations than in published comments is that financial institutions are inclined to favor short-term gains at the expense of long-term advantages. They are said to favor tender offers or partial liquidations that offer a quick return in preference to long-term prosperity of the enterprise. Similarly, they are said to oppose constructive policies that will depress real or apparent earnings in the short term because of the negative effect of such policies on share prices.

Biases of this sort are likely to be shared in different degrees by different institutions, which have varying investment objectives. The more numerous the institutions participating in control, the greater will be the conformity of institutional interests to the interests of other shareholders. Even if a majority of institutions have a bias that diverges from the interests of other investors, their bias seems likely to be a wholesome counterpoise to the bias of managers toward saving their jobs and enlarging their domains.

3. *Deferential Supervision*

Independent directors may be not only passive, but deferential. They may vote to approve or ratify whatever the directors propose, and never

116. E. HERMAN, *supra* note 114, at 38.

117. See E. HERMAN, *supra* note 114, at 73-87.

118. VOTING RIGHTS, *supra* note 98, at 571-72; cf. Brudney, *supra* note 69, at 639-58.

119. See Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times, Sept. 13, 1970, § 6 (Magazine), at 32.

resign in protest because they value their relations with managers more highly than their own opinions or the interests of investors. Executives of large corporations can easily find lawyers, physicians, and officers of small corporations who will enjoy the honors and emoluments of directorships and who will respect the wisdom of their patrons.

Executives of the most visible corporations today do not seem to be filling their boards with deferential directors. On the contrary, they seem to value the prestige that they and their companies derive from having a board that contains some illustrious members. Executives probably value, too, advice that is contributed by directors who think for themselves.

Against these advantages of a free-thinking board, the executives will weigh the extraordinary blessings that deferential "independent" directors can confer on executives by absolving them from past and present transgressions.

a. Independent directors and derivative suits. Under a recent extension of the "business judgment rule," a derivative suit may be dismissed without determining its merits if a committee of disinterested directors has found that maintenance of the suit would not be in the best interests of the corporation.¹²⁰ According to a Delaware refinement, the court will sometimes examine the circumstances of the committee's decision to determine whether the members inquired, were informed, and reached a decision that was reasonable on the facts available to them. But it will accept the committee's decision without examining its reasonableness if the board of directors that appointed the disinterested committee contained a majority of disinterested directors.¹²¹

These cases provide the managers with a ritual that will insulate them from derivative suits.¹²² The first step in the ritual is to elect to the board a majority of nonexecutives who have no significant financial interest in the corporation, and a deferential attitude toward the incumbent managers. The next step is to withhold important decisions from the whole board, so that a majority of the board will seldom have been implicated in a decision. The third step — to be taken when a derivative suit is filed — is to appoint deferential directors to a special litigation committee to consider whether maintenance of the suit is in the best interests of the corporation. The board may simultaneously authorize the special committee to recommend that the corporation demand any damages or restitution that the committee

120. *Burks v. Lasker*, 441 U.S. 471 (1979); *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

121. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). The court indicated that it would examine the merits of the litigation committee's decision in cases where making a demand on directors before suing was excused by complicity of a majority of directors who participated in the alleged wrong, but that the court would not examine the merits in cases where a preliminary demand had to be made because a majority of directors were disinterested in the subject of the suit. 430 A.2d at 784.

122. See Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 262 (1981); Cox, *Searching for the Corporation's Voice in Derivative Suits: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 969-72.

finds appropriate, or take other remedial action.¹²³ Under these circumstances, the committee could hardly doubt that it is able to solve the problems of mismanagement more advantageously than would a derivative suit prosecuted by the pesky lawyer who has filed it.

The principle of dismissal on the recommendation of "independent" directors has been embraced, with modifications, by the recommendations of the American Law Institute.¹²⁴ Under the Institute's formulation, the court will determine whether the litigation committee has offered a sufficient justification for its conclusion.¹²⁵ But it is the sufficiency of the report, rather than the merits of the suit itself, that the court evaluates.¹²⁶ The rule places a high premium on the casuistry of the committee's report-writers.

b. Independent directors and the validity of transactions involving conflicts of interest. Notwithstanding developments in the dismissal of derivative suits, there are still some possibilities of bringing before a court the validity of transactions in which executives have a conflict of interest. One possibility arises when control passes to a new group via a takeover or sale of control; a second arises when the enterprise fails and a trustee in bankruptcy is appointed; a third arises when a plaintiff somehow surmounts the obstacles in the way of a derivative suit.

When a transaction involving a conflict of interest is challenged, deferential decisions of independent directors assume special importance. Most states have corporation code provisions on conflicts of interest, which declare that transactions are not invalid by reason of the conflict if (among other conditions) they are approved by disinterested directors.¹²⁷ Courts have generally held that these provisions do not validate transactions that are unfair to a corporation; they merely make validity turn on fairness rather than on absence of conflict.¹²⁸ "Fairness" in this context may be a very loose requirement; in one case, the Delaware court indicated that it

123. See *Joy v. North*, 519 F. Supp. 1312, 1315 (D. Conn. 1981), where a committee was appointed to "review, investigate and analyze," and recommended that the derivative suit be continued as to seven defendants, although dismissed as to 23, *affd.*, 692 F.2d 880, 884 (2d Cir. 1982); *Abramowitz v. Posner*, 513 F. Supp. 120 (S.D.N.Y. 1981), where audit committee was appointed in settlement of SEC proceedings, and to recommend whether action should be taken against any person, and committee recommended demanding restitution of over \$1,000,000 from defendants, *affd.*, 672 F.2d 1025 (2d Cir. 1982).

124. Tent. Draft No. 1, *supra* note 9, at § 7.03(b).

125. Tent. Draft No. 1, *supra* note 9, at § 7.03(c)(ii).

126. The requirement of § 7.03(c)(ii) is stated as follows in Tent. Draft No. 1, *supra* note 9:

(ii) The business justification *advanced by the committee* in its report warrants dismissal of the action, and in the court's independent judgment such justification (A) is not outweighed by the probable recovery or other relief that the court determines is likely to result from the litigation, (B) does not frustrate any authoritatively established public policy, and (C) is advanced in good faith

(Emphasis added.)

127. General Corporation Law, DEL. CODE ANN. tit. 8, § 144 (1974); MODEL BUSINESS CORP. ACT § 41 (1979).

128. *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 241 P.2d 66 (1952); *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976); *David J. Greene & Co. v. Dunhill International, Inc.*, 249 A.2d 427 (Del. Ch. 1968).

meant the absence of a gratuitous gift or waste.¹²⁹ But the transaction must be, in the Delaware court's phrase, "objectively fair,"¹³⁰ meaning presumably that the court compares values exchanged, rather than appraising the intentions or the reasoning of the independent directors.

The extension of the business judgment rule that has been made in dismissing derivative suits¹³¹ suggests that the judgment of independent directors might be given a similar effect in determining the validity of transactions affected with a conflict of interest. If this should occur, a self-serving transaction of the executives might survive a judicial attack because the independent directors could reasonably have believed that it was fair, regardless of what the court thinks. In *Cohen v. Ayres*,¹³² the court seems to have glided unconsciously into this position by equating a ratification by independent directors with a ratification by shareholders.¹³³ The ALI reporters have embraced the test of what disinterested directors could reasonably believe to be fair to the corporation.¹³⁴

c. Effects on selection of directors. Executives select directors, or influence the selection of directors, for two main goals. One is for these directors' advice on how to run the company; the other is to protect themselves from liability and from losing the benefits of personal advantages.

One might suppose that both objectives would be served by selecting individuals with wide experience, high intelligence, and the courage to reach conclusions that differ from those of the executives. The directors who resigned from Bendix — including a chief executive of Mobil and two former United States cabinet members — seemed to fit this mold.¹³⁵ Similar directors might be expected to help the executives run the company wisely, and to dissuade them from pursuing courses that will result in their incurring liability or suffering annulment of their transactions.

If, however, courts refuse to examine the merits of transactions that have been approved by "independent" directors, executives will have a strong incentive to select independent directors who are unlikely to make use of their independence. Executives will have much to gain by filling the seats with agreeable and deferential individuals who will never doubt that the executives are right. Choices of this kind can make "independent" supervision more dangerous to investor welfare than inside directors, to

129. *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 58 (1952). This decision was not based on the statute, but on prestatutory case law.

130. *Fliegler v. Lawrence*, 361 A.2d at 221.

131. See notes 121-22 *supra*.

132. 596 F.2d 733 (7th Cir. 1979).

133. See 596 F.2d at 739-40. Since the case before the court involved ratification by shareholders, the reference to ratification by independent directors was unnecessary to the decision. See also Sparks, *Recent Developments in Substantive Business Judgment Rule*, 61 N.C. L. REV. 534, 537 (1983).

134. Tent. Draft No. 3, *supra* note 9, at §§ 5.08(a) & 5.08(c). The former paragraph implies that the director or officer does not violate a duty if disinterested directors could reasonably believe the transaction to be fair to the corporation; the latter implies that the transaction cannot be set aside if there was no violation of duty. Since the test is fairness to the corporation, there is no basis of attack on the basis of unfairness to minority stockholders.

135. See note 95 *supra*.

whose business judgment courts will not defer on conflicts of interest.¹³⁶

d. Promoting effective supervision in the United States. Whether effective supervision of management is possible in the United States for very large, very widely held corporations is debatable. It will not be brought about merely by electing a majority of directors who are "independent." That condition may even impair supervision, if courts continue to extend the "business judgment rule" to transactions in which executives have conflicts of interest. Effective supervision will not take place unless it is accompanied by additional measures to activate it.

The first prerequisite of effective supervision is to remove juridical risks that would deter any possible impulse toward activism on the part of financial institutions. Instead of busying itself with the demands of individual shareholders to circulate whimsical proposals at company expense, the SEC might turn its mind to liberating the large shareholders, who are presumably interested in maximizing returns, to exercise the powers that are entrusted to them by the corporation codes. This involves relieving them, at the least, from the duty to announce a coalition prematurely,¹³⁷ the liability to surrender "profits" on short-swing trades,¹³⁸ and the consequences attached to "control."¹³⁹

Since none of the provisions that create these risks is deliberately aimed at financial institutions' participation in supervision, the measures are susceptible to revisions which would permit financial institutions to play the role that corporation law assigns to shareholders. Concert to supervise management, as distinguished from concert to acquire shares, should be exempted from section 13(d) reporting. Financial institutions should not be considered to be directors by deputization under Exchange Act section 16(b) when their influence over directors is exercised by a combination of rival institutions. Under the same conditions they should not be deemed to be in "control," with the secondary liability and the inhibition on selling that accompanies that status.

Liberation of financial institutions from securities law risks would be only the first step forward. Institutions would still confront the formidable task of assembling a majority of votes. In the absence of cumulative voting, institutions could not put directors on the board unless holders of a majority of shares could reach agreement on a single slate of nominees. This would be a much more formidable undertaking in the United States, with its dispersion of financial institutions, than in Germany, where a half-dozen banks often vote a majority of the shares.¹⁴⁰

The ability of different groups of institutions to elect independent direc-

136. Cf. Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894 (1983) (discussing the residual influence of board approval on judicial decisions involving conflicts of interest).

137. See *GAF Corp. v. Milstein*, 453 F.2d 709, 712-19 (2d Cir. 1971), cert. denied, 406 U.S. 910 (1972).

138. See *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970).

139. See notes 105-06 *supra*.

140. BERICHT DER STUDIENKOMMISSION, *supra* note 77, at 113.

tors without assembling a unified majority would be facilitated if every block of five or ten percent of the shares had the power to choose a director. This power could be given by the simple expedient of restoring the cumulative voting right, which was guaranteed by the constitutions of several states only a few decades ago.¹⁴¹

The once-prevalent institution of cumulative voting has succumbed chiefly to the competition of Delaware. What other states might do if they were not afraid of driving away business is suggested by California's enforcement of cumulative voting in corporations of other states that have a majority of their economic contacts with California.¹⁴²

A secondary nemesis of cumulative voting has been the argument that rival forces on the board will destroy its effectiveness in managing corporate affairs.¹⁴³ This argument would have a good deal of validity in a corporation in which the board engages in management. But in most corporations, and especially the larger ones, management in the usual sense is carried on by executives acting singly or in small committees. This distinction was recognized by amendments of corporation codes in the 1960's to provide that the business of the corporation was to be managed by or under the direction of "the board."¹⁴⁴ If management decisions are made by a coherent group of executives, they will not be impeded by some difference and debate among the nonmanaging directors. Although debate will take more time than deference or passivity, it may be an indispensable cost of effective supervision.

Whatever may be the merits of these suggested methods of effectuating supervision, a harder problem is discovering forces that might lead to their adoption. There is no organized lobby for the reform of corporation law. Individual investors are widely dispersed, and most of them mistakenly assume that their interests are identical with those of corporate executives. Financial institutions perceive political hostility to increasing their power over enterprises,¹⁴⁵ and no gain in their institutional rewards for handling investors' money. Reformers who denounce the autarchy of executives expend their energies on impractical plans for the simultaneous representation of investors, employees, consumers, communities, and others.

If reform is to come about, it must come because a wide public, including far-sighted executives, become concerned with the efficiency of the United States industrial establishment. Inefficiency in the management of one enterprise raises the costs that other enterprises pay, in the same way that inefficient labor or burdensome regulation does. Executives as a group might see the advantage of effective supervision as a means of cutting down on the national waste that has become so conspicuous in takeover battles.

141. For a general history and review of cumulative voting rights, see C. WILLIAMS, *CUMULATIVE VOTING FOR DIRECTORS* (1951).

142. See CAL. CORP. CODE § 2115 (Deering Supp. 1984); Halloran & Hammer, *Section 2115 of the New California General Corporation Law — The Application of California Corporation Law to Foreign Corporations*, 23 U.C.L.A. L. REV. 1282, 1295-99 (1976).

143. See C. WILLIAMS, *supra* note 141, at 182-83; Haft, *supra* note 69, at 24.

144. General Corporation Law, DEL. CODE ANN. tit. 8, § 141 (1974); MODEL BUSINESS CORP. ACT § 35 (1979).

145. See P. BLUMBERG, *supra* note 96, at 141-44.

The champions of employees' and consumers' causes might see increased efficiency as beneficial to them because it would swell the benefits available to all of the corporate constituencies. But no movement in this direction is visible on the horizon.

In the absence of effective supervision by financial institutions, the best chance for supervision lies in executives' voluntarily choosing directors who will exercise independent judgment about the executives' recommendations and decisions. Choices of this kind would be more likely to occur if "independent directors" were deprived of the power of absolution that is conferred on them by recent extensions of the "business judgment rule."

But the extensions of the business judgment rule will not be cut back unless other means are found for dealing with the problems that give birth to the extensions. The foremost of these is abuse of derivative suits by plaintiffs' attorneys who file suits on trivial grounds in the expectation of obtaining settlements and fee awards. This problem should be attacked at the source by reforming the practice of courts in awarding fees¹⁴⁶ or, more radically, by restricting the capacity to file derivative suits, as in Western Europe.¹⁴⁷

Another problem that may have inspired the extensions of the business judgment rule is the astronomic liability that executives and directors could incur if the black-letter rules of law were allowed to operate. Since a palpable mistake in the management of a multibillion-dollar corporation would involve multimillions of dollars, the general theory of damages would make participating executives individually liable for the whole amount.

The extended business judgment rule offers an escape from this intolerable result, but at the cost of excluding most corporate decisions from any kind of judicial evaluation. A better approach would be to limit severely the damage liability of directors¹⁴⁸ while leaving the courts free to decide for themselves whether corporate transactions are valid.

The preceding discussion of measures that might enhance supervision

146. See Conard, *Winnowing Derivative Suits through Fee Awards*, 47 LAW & CONTEMP. PROBS. (1984) (forthcoming).

147. French law authorizes a derivative suit to be brought by shareholders aggregating 5% of the equity, and forbids impairment of this power by charter clause or shareholder vote. *French Law on Commercial Companies*, supra note 51; *French Law on Commercial Companies*, COMMON MKT. REP. (CCH) art. 245, at 116 (Jan. 1, 1971) (Decree No. 66-537); *French Law on Commercial Companies*, COMMON MKT. REP. (CCH) art. 200, at 271 (Jan. 1, 1971) (Decree No. 66-236); J. CRABB, *FRENCH BUSINESS ENTERPRISES* 73, 175 (1979).

German law requires 10% of the shareholders to bring a derivative suit. AktG § 147(1), 1965 BGBl I 1124 (W. Ger.). For evidence that some derivative suits are maintained notwithstanding the height of this threshold, see Buxbaum, *Extension of Parent Company Shareholders' Rights to Participate in the Governance of Subsidiaries*, 31 AM. J. COMP. L. 511 (1983). The proposed law for incorporation of "European companies" does not provide for derivative suits, but for court appointment of a commission of inquiry on request of shares aggregating 10% of those outstanding, or a value of about \$200,000. Statute for European Companies, art. 97, BULL. EUR. COMM. 4/75, at 55.

In Great Britain, a single shareholder may petition for redress of prejudicial actions of the corporation, but will not be permitted to maintain a derivative suit on this ground unless the court finds that the petition is "well founded." Companies Act, 1980, ch. 22, § 75.

148. See Tent. Draft No. 1, supra note 9, at § 7.06(d)-7.06(e); FEDERAL SECURITIES CODE § 1708(c) (Proposed Official Draft 1978); see also Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L. J. 895, 912-15.

has omitted any mention of proposals to increase the input of small individual investors. One suggestion along this line would give equal voting power to each shareholder, equating voting power of the individual owner of 100 shares with that of the institutional owner of 10,000.¹⁴⁹ Another program would require institutional investors to consult their constituents and vote the institutions' shares in other companies as the institutions' shareholders or pensioners direct.¹⁵⁰ Upon analysis, these proposals seem to bear little relation to the efficiency or fairness of management. A small investor who would undertake to find qualified independent directors and organize a voting block to elect them would have to devote time and effort that would be worth more than his total investment. Small investor proposals are directed less to protecting investors' financial interests than to shifting the balance of power on "social responsibility" issues such as recognizing unions, manufacturing munitions, and operating in South Africa. Since the present essay is limited to supervision for investors' financial interests, the small investor proposals fall outside its scope.

III. EMPLOYEE PARTICIPATION IN SUPERVISION

In several European countries, the venerable institution of supervision in the interests of investors is in the process of modification to reflect also the interests of employees.¹⁵¹ Germany was the first to make a major modification, introducing employee representatives to supervisory boards as early as 1950.¹⁵² In 1971, the Netherlands followed less radically by enabling employees to interpose a conditional veto on nominations to the supervisory board.¹⁵³ In 1972, the European Economic Community Commission recommended that employee representation be made mandatory in all member countries;¹⁵⁴ the 1983 proposal softened the requirement, but retained the conception of an employee voice in the supervision of management.¹⁵⁵ In the following pages, we will refer to all of these

149. See Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote,"* 56 CORNELL L. REV. 1, 45 (1970).

150. See STAFF REPORT ON CORPORATE ACCOUNTABILITY, *supra* note 30, at 412-17, 424.

151. See E. BATSTONE & P.L. DAVIES, *INDUSTRIAL DEMOCRACY: EUROPEAN EXPERIENCE* (1976) (reporting on worker representation on boards in Austria, Denmark, France, West Germany, The Netherlands, Norway, and Sweden, with allusions to Israel, Spain and Yugoslavia); Commission of the European Communities, *Employee Participation and Company Structure*, Bull. Eur. Com. Supp. 8/75 [hereinafter cited as *Employee Participation*]; INQUIRY ON INDUSTRIAL DEMOCRACY COMMITTEE, FIRST REPORT, CMD. 6706 (1977) [hereinafter cited as *Bullock Report*].

152. The history is briefly reviewed in Streeter, *Co-determination in West Germany — Through the Best (and Worst) of Times*, 58 CHI.-KENT L. REV. 981 (1982); Gruson & Meilicke, *The New Co-determination Law in Germany*, 32 BUS. LAW. 571 (1977).

153. See Ottervanger & Pais, *Employee Participation in Corporate Decisionmaking: The Dutch Model*, 15 INTL. LAW. 393, 404 (1981). Under the Netherlands system, successors to supervisory board members are nominated by the incumbent members, and submitted to the shareholders' meeting and the employees' council for approval. If either body vetoes, the nominee cannot be appointed unless an administrative agency finds that the veto lacks sufficient cause.

154. Fifth Directive 1972, *supra* note 10, art. 4(2).

155. Fifth Directive 1983, *supra* note 21.

forms of worker participation as "codetermination," although purists would use this term more restrictively.

A. *The Theory of Codetermination*

The theory underlying codetermination is often misunderstood by Americans. They are likely to visualize it (if at all) as a means of encumbering board meetings with union leaders who persist in pressing at board meetings the same insatiable demands that they advance in collective bargaining sessions.

The European conception is very different. Codetermination is viewed as a means of breaking out of the cage of two-sided confrontation into a fellowship of cooperation for common ends. It is based, as Clyde Summers has written, on the assumption "that workers and management in an enterprise have common as well as competing interests; and the employment relation is envisioned not so much as one of confrontation between workers and management as one of integration of workers in the enterprise."¹⁵⁶ Although workers have some interests that conflict with those of investors, the same is true of managers. Workers are at least as dependent on the prosperity of the firm as managers are; they may be more so, because they are less mobile.¹⁵⁷

The difference between the German model of codetermination and the Chrysler experiment of putting a union officer on the board¹⁵⁸ is emphasized by the ways in which the employee representatives are chosen under the German system. They are not selected by the management (as in the Chrysler case), nor appointed by the the union leaders, but chosen by an election in which all employees may vote.¹⁵⁹ Moreover, different sets of employees are represented by different delegates. White-collar employees (*Angestellte*) and blue-collar workers (*Arbeiter*) have separate representatives, and employees with managerial functions (*leitende Angestellte*) have one of their own.¹⁶⁰ The resulting representation of nonunion employees was categorically rejected by the British labor movement¹⁶¹ and perhaps others; the 1983 proposal of the EEC Commission omits any express requirement of separating employees by function. It retains a requirement of

156. Summers, *supra* note 29, at 371.

157. "In particular, employees are increasingly seen to have interests in the functioning of enterprises which can be as substantial as those of shareholders, and sometimes more so." Employee Participation, *supra* note 151, at 9; *cf.* Bullock Report, *supra* note 151, at 27 (since capital and labor are in some sense equal partners, employees are entitled to representation on company boards).

158. *Codetermination hits U.S.: Fraser on the Chrysler Board*, IRON AGE, Nov. 5, 1979, at 17.

159. Mitbestimmungsgesetz [Mitbest G] §§ 8-15, 1976 BGBI I, pt. 1, at 1155-56 (W. Ger.); H. MEILECKE & W. MEILICKE, KOMMENTAR ZUM MITBESTIMMUNGSGESETZ 100-02 (1976); Gruson & Meilicke, *The New Co-Determination Law in Germany*, 32 BUS. LAW. 571, 574 (1977).

160. Mitbest G § 15(2), 1976 BGBI I, pt. 1, at 1157 (W. Ger.).

161. TRADES UNION CONGRESS, INDUSTRIAL DEMOCRACY 46 (2d ed. 1977); Bullock Report, *supra* note 151, at 109-13. The Bullock Report was issued by a committee appointed and reporting to a Labour government. The minority's statement took particular exception to the nonrepresentation of nonunion employees. *Id.* at 175-76.

proportional representation for the protection of "minorities,"¹⁶² which presumably connote ethnic or gender classes, rather than job groups.

B. *Codetermination in the United States*

There is hardly any European idea that has received a colder reception in the United States than codetermination. Before Fraser's appointment to the Chrysler board, its use in the United States was rarely considered worth suggesting.¹⁶³ American executives do not live under the shadow of a militant socialism that drives European leaders to accept alternative alleviations of the class conflict. Labor leaders have traditionally opposed codetermination suggestions, either on the ground that labor directors would be seduced by management, or that their constituents would suspect them of being seduced.¹⁶⁴ If they contemplated employee representation on the German model, which bypasses union machinery, they would probably be even more hostile.¹⁶⁵

A variety of legal provisions in the United States would impede U.S. corporations from adopting codetermination on any of the European models, even if they wanted to.¹⁶⁶ Corporation codes provide for election of directors only by shareholders¹⁶⁷ or, rarely, bondholders.¹⁶⁸ In accordance with these laws, the rare labor representative on boards must have been "elected" by the votes of the shareholders' proxies, not by the votes of workers. In fact, Fraser's directorship was offered to him by Iacocca, the company president, who refused to consider giving it to any alternative labor representative.¹⁶⁹

Another possible obstacle to employee representation on the board is

162. Fifth Directive 1983, *supra* note 21, art. 4i(a).

163. The present author's suggestion that U.S. industry might "move experimentally in a similar direction" was unnoticed except for one reviewer's firm rejection. See A. CONARD, *CORPORATIONS IN PERSPECTIVE* 366 (1976); Vagts, Book Review, 33 *BUS. LAW.* 2063, 2064 (1978) (reviewing A. CONARD, *CORPORATIONS IN PERSPECTIVE* (1976)). For recent comments, see Forst, *Labor Union Representation on Boards of Competitors: An Antitrust Analysis*, 7 *J. CORP. L.* 421 (1982); Comment, *Broadening the Board: Labor Participation in Corporate Governance*, 34 *SW. L.J.* 963 (1980); Note, *Labor Unions in the Boardroom: An Antitrust Dilemma*, 92 *YALE L.J.* 106 (1982).

164. See Fraser, *Worker Participation in Corporate Government: The U.A.W.-Chrysler Experience*, 58 *CHI.-KENT L. REV.* 949, 955 (1982); see also Summers, *supra* note 29, at 370-71 (noting that the American labor system emphasizes confrontation rather than cooperation); Summers, *Worker Participation in Corporate Management — The United States Version*, 1 *J. COMP. CORP. L. & SEC. REG.* 157, 176 (1978).

165. The British trade unions and Labour government's Bullock Committee report have insisted that employee representation be articulated through union machinery. *TRADES UNION CONGRESS*, *supra* note 161, at 35; Bullock Report, *supra* note 151, at 109-13.

166. See Comment, *supra* note 163, at 964-72 (1980) (citing problems of fiduciary duty, labor law and antitrust law); Note, *supra* note 163, at 111-24.

167. See, e.g., *MODEL BUSINESS CORP. ACT* § 36 (1979). Conceivably the exclusive power of shareholders could be side-stepped by a charter provision under the "otherwise provided" clause of *MODEL BUSINESS CORP. ACT* § 35 (1979), giving the power to manage or to supervise management to some organ other than the board of directors. The validity of such an arrangement is arguable.

168. *General Corporation Law, DEL. CODE ANN. tit. 8, § 221* (1974).

169. Fraser, *supra* note 164, at 954.

the Clayton Act prohibition of interlocking directorships.¹⁷⁰ When the appointment of Fraser to the Chrysler board was followed by a proposal to put another UAW representative on the American Motors Corporation board, the latter action was blocked by the refusal of the Department of Justice to give it clearance.¹⁷¹ The refusal was based on the hypothesis that both representatives would be deputies of the union, which would then hold directorships on competing corporations. Obviously, this obstacle would be surmounted if employee representatives were elected directly by employees, without union interposition.¹⁷² But that form of employee representation has gone unnoticed by most U.S. commentators.

With a fertile imagination, one can envision a state passing a law that authorizes corporate charters to provide for election of one third of the directors by employees, and some corporation putting this kind of a clause in its charter. What would be the result? In a company with a history of destructive strikes, such as a major automobile or steel company, one might expect antagonism to carry over to the board of directors. The union that represents employees in bargaining would probably elect a solid panel of union nominees, who would view their function as bargaining in directors' meetings for employees' rewards. Like some congressmen, they might demand a boon for their constituents as the price of a vote on any subject.

In a company without any employee organization, codetermination might be equally unproductive. The elected representatives would be likely to use their board positions to promote advancement for themselves rather than to exercise control over their bosses.

Effective codetermination probably requires a reasonably strong employee organization to whom employee board members are answerable. But the organization must be one that sees its function as including promotion of the enterprise as well as of workers' emoluments. In Germany, cooperative interaction of managers and employees at the summit is reinforced by cooperation at the shop level.¹⁷³ In shop committees, operatives confer directly with bosses, without intermediaries.¹⁷⁴ In the United States, this kind of relationship would require changes in attitudes¹⁷⁵ and also, probably, in labor laws. By making most terms of employment a mandatory subject of collective bargaining with a union,¹⁷⁶ U.S. labor laws impede direct employer-employee accommodation.¹⁷⁷

170. 15 U.S.C. § 19 (1982).

171. Forst, *supra* note 163, at 427-28; Fraser, *supra* note 164, at 958.

172. Cf. Note, *supra* note 163, at 124-27 (representatives should not be chosen by national officials nor by representatives of the national union).

173. Summers, *supra* note 29, at 373-81.

174. The Bullock Report rejected the European institution of shop committees on the ground that they would undermine the British institution of the shop steward, who is a union agent. Bullock Report, *supra* note 151, at 110.

175. See, e.g., SPECIAL TASK FORCE TO THE SECRETARY OF HEALTH, EDUCATION AND WELFARE, WORK IN AMERICA 17-20 (1973). For faint signs of changing attitudes, see *Companies Widen Worker Role in Decisions*, N.Y. Times, Jan. 15, 1984, at 1, col. 3.

176. Labor Management Relations (Taft-Hartley) Act § 8(d), 29 U.S.C. § 158(d) (1982).

177. See Summers, *supra* note 29, at 381.

C. *Employee Share Ownership*

Efforts to ally employees with management in the United States have usually taken the form of promoting employee share ownership. U.S. tax laws have been repeatedly revised in order to facilitate various forms of employee stock ownership plans (ESOPs).¹⁷⁸ The shares are usually held in trust, at least initially. In "registered" companies, the employees are entitled to instruct the trustee how to vote their respective fractions of the shares; but since the employees have no ready-made way of joining forces, trustees will probably give their proxies to the directors' committee just as the other dispersed shareholders do.¹⁷⁹ ESOPs seem to be designed more to elevate employees' concern with profits than to give them a voice in control.¹⁸⁰

Another avenue through which employees are gaining beneficial ownership of industry consists of pension funds.¹⁸¹ If these funds were invested chiefly in shares of the same company that employs the prospective pensioners, they might have fulfilled the prediction of Peter Drucker's subtitle—"how pension fund socialism came to America."¹⁸² But since ERISA,¹⁸³ most of the funds are diversified and are administered by financial institutions, whose passivity in relation to the management of the enterprises in which they invest has already been noted.¹⁸⁴

Since employees' financial contributions to corporate capital do not give them any effective voice in control, and U.S. law gives them no participation in internal governance, defense of their interests depends on the effectiveness with which their leaders confront corporate managers. This arrangement is presumably more gratifying to leaders on both sides than a more cooperative structure would be.

IV. CONCLUSION

The ten nations of the European Community appear to be moving toward structures of enterprise organization in which representatives of investors and of employees have effective powers over executives. The reinforcement of investors' supervision is designed to maximize executive competence, loyalty, and impartiality. The strengthening of employees' su-

178. I.R.C. § 409A (1982); see Humphreys, *From TRASOP to CESOP*, 57 TAXES 319 (1979).

179. For an analysis of voting rights before recent amendments, see Note, *Employee Stock Ownership Plans, Voting Rights, and Plant Closings*, 11 U. MICH. J.L.REF. 162 (1977).

180. Cf. Note, *supra* note 179, at 168 (although ESOP may pose a higher risk than a diversified plan, the value of full voting rights offered by ESOPs which give employees a greater voice in management may outweigh the increased investment risk).

181. For a history of the growth of pension plans, see generally P. DRUCKER, *THE UNSEEN REVOLUTION: HOW PENSION FUND SOCIALISM CAME TO AMERICA* (1976).

182. *Id.*

183. Employee Retirement Income Security Act, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-461, and in scattered sections of titles 5, 18, 26, 31, and 42 U.S.C.). 29 U.S.C. § 1107 imposes restrictions on investment in securities of the employer; 29 U.S.C. § 1103 requires the establishment of a trust to be administered by a named trustee.

184. See text at notes 95-110 *supra*.

pervision is designed to move industrial relations away from bipolar confrontation toward mutual cooperation.

In the United States, the principal movements are in the opposite direction. Although "independent directors" are being named to corporate boards, the hobbling of institutional investors insures that the independent directors will make little use of their independence. Extensions of the business judgment rule increase the probability that independent directors will reinforce the autarchy of corporate executives.

With respect to employee participation in supervision, there is not even a semblance of interest in the United States. Corporation and labor laws alike are designed to exclude employee interests from being represented within the corporate decision-making structure.

The result of the developments in United States law is to widen the gap between the governance of business enterprise in Europe and the United States. While Europe is enhancing the participation of both capital and labor in corporate decision making, the United States is moving toward the exclusion of both forces from expression within the enterprise. Capitalists are increasingly left to the protective force of the euphemistically designated "efficient market." Labor is awarded the opportunity of protecting itself by the force of organization, and the threat of strikes. Both tendencies magnify the role of "leaders" who may be expected to identify the interests of their constituents with strengthening their own powers.

Whether these tendencies enhance or diminish the productivity of U.S. enterprise may never be known, but will surely be debated in 1984 and beyond.