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". . . be patient toward all that is unsolved in your heart and try to love the questions themselves like locked rooms and like books that are written in a very foreign tongue. Do not now seek the answers, which cannot be given you because you would not be able to live them. And the point is, to live everything. Live the questions now. Perhaps you will then gradually, without noticing it, live along some distant day into the answer."

Rainer Maria Rilke (1875-1926)[1]

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A number of important developments have occurred since this Commentary was first written, including (as of May 19, 1992) the following: (i) at its 1992 Annual Meeting, the American Law Institute approved a final draft of "Principles of Corporate Governance: Analysis and Recommendations" (*see infra* note 5 and accompanying text); (ii) in a series of letters dated February 13, 1992, the SEC reversed a long-established interpretive position and ruled that non-binding shareholder proposals relating to director and senior executive compensation were not excludable from a public company's proxy statement under the "ordinary business operations" exception of Rule 14a-8(c)(7) of the proxy rules; (iii) in a letter dated February 28, 1992 addressed to Exxon, the SEC ruled that a binding proposal to amend a company's bylaws so as to establish an elected shareholder advisory committee was not excludable under either the "ordinary business operations" exception or the "improper subject of shareholder action under state law" exception of Rule 14a-8(c)(1); (iv) the SEC announced that it intended to propose new requirements for more detailed proxy statement disclosure of executive compensation (as part of a revised package of proxy reform proposals expected this summer); and (v) SB935, the bill discussed in note 29 *infra*, died in committee but a new bill, SB1552, introduced by Senator Dan McCorquodale, is pending in the California Senate which would require both California corporations and "quasi-foreign" corporations that are subject to the provisions of Section 2115 of California's General Corporation Law and have a market capitalization of at least $100 million to create certain board committees composed of outside directors.

1. LETTERS TO A YOUNG POET 35 (M.D. Herter Norton trans., rev. ed. 1954). I am greatly indebted to my partner Ronald M. Loeb, who read a draft of this Commentary,

If the greatness of a debate is measured by volume, then clearly this country is engaged in a great debate on the issue of corporate governance. The literature concerning corporate governance represents a broad spectrum of views. It is vast and grows daily.[2]

However, I believe that the greatness of a debate should be measured by quality rather than quantity. By a qualitative measure, I find our national debate over corporate governance to be falling short. In my view, the discourse has become mired excessively in detail, in means rather than ends and in mechanics rather than fundamentals. That is not to say that questions such as how shareholder proposals should get on the ballot, who should control the shareholder list, how directors should be selected and how much executives should be paid are not appropriate, timely and relevant. Rather, it is to argue that these questions are tangential to the central issues: What do we expect of the modern corporation as the predominant legal vehicle for capital-raising and deployment? Does the body of corporate law present structural problems in attaining those expectations? If so, how may we go about solving these problems?

What is equally disheartening about the debate over corporate governance is that it is characterized by a degree of adversarial confrontation that is not conducive to the resolution of these central issues. Essentially, corporate managements and business groups stand in one corner of a boxing ring while shareholder activists stand in the other, the Securities and Exchange Commission (hereinafter SEC) reluctantly acts as referee, and Congress keeps score.[3] Although a caption such as "Business Roundtable Meets CalPERS" might sound like an intriguing match-up on the marquee, slugfests do not constitute great debates. Indeed, as the United States enters a presidential election year with its economy in continuing recession, there are already signs that the debate over corporate governance has become increasingly

for drawing my attention to this passage as an elegant apologia for posing questions without answering them, which is what this Commentary does. However, my questions are not intended as rhetorical and I hope they will be answered sooner than "some distant day" and that we can live with the answers.

2. As a "starter kit" for those readers who have so far managed to avoid being buried by the verbal avalanche, I have appended a highly selective bibliography.

3. SEC Chairman Richard Breeden is apparently aggrieved at the rancor with which some opponents of one of the SEC's June 1991 proxy reform proposals, namely the proposal to permit "disinterested persons" to solicit proxies without the need for SEC filing or pre-clearance, have attacked the notion. See *infra* note 25 and accompanying text. *See* 23 Sec. Reg. & L. Rep., (BNA) No. 46 at 1670 (Nov. 22, 1991) (reporting on Chairman Breeden's testimony before the Senate Committee on Banking on October 17, 1991). Chairman Breeden is reported to have charged the opponents of the June 1991 SEC proxy reform proposals with conducting a "disinformation campaign" against what he viewed as a "modest" proposal to eliminate unnecessary interference with shareholder communications. *Id.* Chairman Breeden has also been quoted as having likened himself to a "referee at a sumo wrestling match" who did not "want to be left at the bottom of the pile." IRRC CORP. GOVERNANCE BULL., Nov.-Dec. 1991, at 17.

politicized, with issues such as proxy reform, executive compensation, and board representation rapidly acquiring the characteristics of polemic banners.[4]

In such an environment, it is imperative that we lawyers set about the task of refining the corporate governance debate by asking, and attempting to achieve a consensus in answering, the important questions in the debate. After all, our professional forebears provided the pioneers of modern capitalism with the invention of the limited liability joint stock corporation itself. Lawyers work with that invention and its constituent parts—shareholders, directors, officers, charters, bylaws, stocks, bonds and the rest of the elements that collectively define the current paradigm—every day. Thus, who better to disassemble the invention and determine, in a dispassionate manner, whether it still functions properly?

In fairness, it should be acknowledged that the American Law Institute (hereinafter ALI) is engaged in a major corporate governance project, and it now seems likely that the ALI's "Principles of Corporate Governance: Analysis and Recommendations"[5] will soon be completed after more than a decade of vigorous discussion. The reporters should be commended for wrestling with certain basic issues regarding the duties of directors and the rights of shareholders. In some ar-

4. *See*, for example, S. 1198, a bill introduced in the United States Senate by Senator Carl Levin (D-MI) on June 4, 1991. S. 1198 would enact a Corporate Pay Responsibility Act. S. 1198, 102 Cong., 1st Sess. (1991). Its companion bill in the House of Representatives, H.R. 2522, was introduced in the House by Representative John Bryant (D-TX). H.R. 2522, 102nd Cong., 1st Sess. (1991). Anyone who doubts the political overtones of the executive compensation issue need only read the statement issued by Senator Levin in connection with these bills. Senator Levin states: "American CEOs are paid 100 times more than the average American worker . . . . They are paid 2-3 times the amount of CEOs in Germany and Japan, and CEO pay increases far outpace company profits. Yet the Securities and Exchange Commission is actually hindering stockholder efforts to control runaway pay. This bill would get the federal government out of the way of shareholders who are angry about runaway executive pay." 137 CONG. REC. S6997 (daily ed. June 4, 1991) (statement of Sen. Levin). Apparently, the Bush administration is developing a growing awareness of the politics of corporate governance. *See Administration Views on Corporate Governance*, 4 INSIGHTS; THE CORPORATE & SECURITIES LAW ADVISOR, Sept. 1990, at 37 (summary of speech delivered by Michael T. Jacobs, Director of the Department of Treasury's Office of Corporate Finance). Jacobs is reported to have urged greater emphasis by directors on maximizing value because reduced institutional investor confidence in the effectiveness of board oversight results in demands for higher returns which, in turn, increases the cost of capital. *See also* S. 2030, introduced in the United States Senate on November 24, 1991 by Senator William Cohen (R-ME) (similar in substance to S. 1198 and H.R. 2522). S. 2030, 102nd Cong. 1st. Sess. (1991).

5. American Law Institute *Principles of Corporate Governance: Analysis & Recommendations* (Tentative Draft No. 11, 1991).

eas, such as the duties of a board in responding to hostile takeover bids, the reporters have consciously sought to reformulate, rather than merely restate, the applicable principles in response to evolving sentiment. Nevertheless, it strikes me that an implicit tenet of the ALI project is an acceptance of the basic current paradigm of corporate structure whereas the core issue of the current corporate governance debate is whether that paradigm still represents the optimum legal regime for regulating public investment in business enterprise.[6] The same is true of the ongoing project to update the Model Business Corporation Act[7] by the American Bar Association's Business Law Section Committee on Corporate Laws. Although the Committee undertook a major revision of the Model Act during the 1980s, in which considerable attention was paid to questions of directors' duties, the axiomatic principles of current corporate governance—the basic blueprint of the corporate scheme—were not, in my view, re-evaluated.

Although my goal is not to denigrate either of these worthy projects, which reflect the considerable constructive efforts of some of America's leading corporate lawyers, it strikes me that the questions at the core of the current debate are qualitatively different from those with which the ALI and the ABA have been dealing. It is my opinion that what is at issue in the present corporate governance debate is nothing less than the adequacy of the current paradigm to deal with the new realities of the corporation's role as an investment vehicle and a profit-making business enterprise in the economy and society at large.

Since the foregoing is very general, I will attempt to illustrate the point by looking at some of the specific issues currently under discussion, starting with the defining issue of institutional stock ownership. It is a well-documented fact that institutional investors such as public and private pension funds, mutual funds, insurance companies and broker/dealers dominate the shareholder ownership profile of our public companies. Institutional investors generally hold, in the aggregate, approximately half (and in many instances a much higher percentage) of a company's stock, even though no single institution typically holds more than one to two percent in the absence of a takeover bid or other arbitrage play.[8] It is also well-recognized that

6. For a much more detailed critique of the project, *see* Dooley, *Two Models of Corporate Governance*, ABA Section of Business, Section of Litigation and Division for Professional Education, Dec. 1991, at Tab U (hereinafter "ABA Materials," *see also* (i) of the Appendix to this Commentary).

7. *See* Model Business Corporation Act (1991).

8. *See, e.g.*, Walters, *Study Documents Rising Institutional Ownership*, IRRC CORP. GOVERNANCE BULL., Sept.-Oct. 1991, at 15 (citing latest statistics gathered by Carolyn Kay Brancato, Executive Director, Institutional Investor Project at Columbia University Law School Center for Law and Economic Studies).

this phenomenon, which is of relatively recent origin, has profoundly altered the nature of shareholder scrutiny over board efficacy. Institutional shareholders both possess and use financial and technological resources to monitor corporate performance that are vastly greater than those available to the "mom-and-pop" public investor around whom the paradigm of modern corporate governance—with its substitution of the director-delegee for the owner-manager—was built. The expectations of these professional investors are more rigorous, their time horizons are often shorter and they are simply less tolerant of the high degree of delegation that the paradigm has produced and enshrined in the business judgment rule.[9]

The institutionalization of the securities markets is at the heart of the current corporate governance debate. While various grassroots organizations, most notably the United Shareholders Association, have sprung up to represent the interests of individual shareholders, it is the institutions themselves, particularly the public retirement funds such as CalPERS, that are at the forefront of the debate. The institutions are the ones most effectively pressing the SEC to reform the proxy process while simultaneously using both the shareholder proposal machinery of the existing proxy rules and the power of face-to-face meetings with management to pursue their agenda of greater board accountability and their specific policies of confidential balloting, the dismantlement of takeover defenses, controls on executive compensation, and revision of the board nominee selection process.[10] At the same time, it must be recognized that institutional shareholders do not constitute a single monolithic block with identical goals.

9. *See, e.g.*, Taylor, *Can Big Owners Make A Big Difference?* HARV. BUS. REV., Sept.-Oct. 1990, at 70; Shaffer, *The Dragon Today: A Provocative Look at the New Role of Pension Funds in America's Economy*, Prentice Hall Law & Business Eleventh Annual Institute on Acquisitions and Takeovers 415 (1989). *See also* Memorandum to clients, Wachtell, Lipton, Rosen & Katz, December 12, 1991. In this memorandum, Martin Lipton, Esq. recommended various steps for corporations to "improve their relations with institutional shareholders and adopt policies and procedures that will protect management and the board of directors against liability through judicial erosion of the business judgment rule." *Id.* (A copy of the memorandum is on file at the offices of the Pepperdine Law Review, Malibu, Ca.)

10. The California Public Employees Retirement System (hereinafter referred to as CalPERS) and certain other public pension funds prominent in shareholder activism abandoned the weapon of shareholder proposals for the 1992 proxy season and instead favored closed-door discussions with managements of targeted portfolio companies. The United Shareholders Association has eliminated several companies from its 1992 "Target 50" list as a result of negotiated individual settlements over governance issues. *See Shareholders Win Concessions as Companies Sidestep Hit Lists*, 8 CORP. CONTROL ALERT 1 (Dec. 1991); Walters, *Shareholder activists place new emphasis on negotiation*, IRRC CORP. GOVERNANCE BULL., Nov.-Dec. 1991 at 1.

For example, the public pension funds typically take a longer-term view of their desired returns than private professionally-managed portfolios.

What does this new reality of shareholder institutionalization tell us about the current paradigm of corporate governance? Does it signify that fundamental change is needed in the allocation of responsibility between shareholders and directors? That the traditional degree of delegation to directors should be reined in? That a new concept of the role of shareholder voting needs to replace the existing system, which amounts in effect to an annual referendum? Or does it mean that we need to rethink the doctrine that every director owes the same fiduciary duties to the entire shareholder body? For example, should we be formally classifying shareholders into different groups, each group separately represented on the board by directors owing exclusive or primary duties to the group that elected them? Or does it mean that we should continue to leave it up to the institutions and their targeted portfolio companies to try to work out a *modus vivendi* through private bargaining and assume that the results will coincidentally serve the best interests of the individual investors? And, in any event, how do we satisfy the institutions that the directors are sensitive to their short-term wishes and still ensure that *some* organ of governance is free to focus on the enterprise's long-term goals? Such are the types of systemic questions that jurists should be asking.[11]

The institutionalization of corporate ownership, with its heightened level of interaction between shareholders and managements, also requires us to revisit another axiom produced by the current paradigm, namely the concept of director activism. In one of the seminal corporate law decisions of the 1980s, *Unocal Corporation v. Mesa Petroleum Co.*,[12] the Delaware Supreme Court reaffirmed the basic principle that our corporate law permits and expects directors to play a pro-active role in the fulfillment of their stewardship. In the specific context of *Unocal* and its progeny—namely, the board's role in resisting an unsolicited takeover bid—this principle has come

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11. For one suggestion and an example of the probing reexamination of the current paradigm that is in far too short supply, *see* Lipton and Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 UNIV. CHI. L. REV. 187 (1991). Under the current system, one third of the directors are replaced if the company has a staggered board; otherwise, the entire board must be elected annually. The authors contend that if this system were replaced with a new regime under which directors would serve for 5-year terms, shareholders would have greater rights to nominate their own candidates at each quinquennial election and U.S. corporations would be free to concentrate on long-term performance instead of director elections. *See also* Lipton, ABA Materials, *supra* note 6, at Tab R. The proposal is discussed in Longstreth, *Reflections on the State of Corporate Governance*, 2 J. CORP. DISCLOSURE & GOVERNANCE 89 (July 1991).

12. 493 A.2d 946 (Del. 1985).

to signify, by and large, that the board, provided it meets the requirements of disinterested and fully-informed decision-making imposed by the business judgment rule, may interpose defenses on its own motion and does not have to defer, as a legal rather than a practical matter, to the views of the shareholders.[13] Some would argue that this principle reached an unacceptable apogee in *Paramount Communications, Inc. v. Time, Inc.*,[14] where the board of Time was permitted to proceed with the acquisition of Warner Bros. knowing that, as a practical matter, the acquisition would force Paramount to drop its bid for Time. Others would contend that the decision was merely a logical application of the activist principle, particularly since, as pointed out by the Delaware Chancery Court,[15] the Delaware general corporation statute gives a board the power to commit the company to an acquisition, including both the expenditure of cash and the incurrence of debt, without shareholder approval.[16]

During the 1980s, controversy over the board's appropriate role in takeover defense was a major catalyst in the whole corporate governance debate because takeovers were the dominant corporate reality of that frantic decade. In the 1990s, hostile takeover bids have virtually disappeared from the corporate landscape due to financing constraints, a reappraisal of business priorities, and a shift in attention toward the pressures of economic recession and the need to improve corporate performance. Thus, the specific issue of director activism in the takeover arena is no longer "hot." The deeper question nevertheless remains in its broad application. What should a board's proactive powers cover? Does the paradigm go too far in its delegation? Should more decisions be subject to a shareholder vote? And, if so, where should the dividing line be drawn between the kinds of "extraordinary" decisions that require a vote and "ordinary" matters? In short, can the corporate structure function if we substantially revise our approach to the issue of director activism?

These kinds of systemic or structural issues tie in with several other themes that run through the current debate. For example, some activists advocate that companies amend their bylaws to establish shareholder advisory committees and, in some instances, compa-

13. *See generally*, 1 FLEISCHER, SUSSMAN & LESSER, TAKEOVER DEFENSE Chs. III & V (1990) (hereinafter "TAKEOVER DEFENSE").

14. 571 A.2d 1140 (Del. 1990).

15. Paramount Communications, Inc. v. Time, Inc. Fed. Sec. L. Rep. (CCH) ¶ 94,514 at 93,264 (July 14, 1989).

16. *See* Del. Code Ann. tit. 8, § 141 (1991).

nies have fended off proxy fights by agreeing to create such committees. On the surface, these committees may appear simply as a formalized channel of communication between shareholders and directors. However, I submit that this surface appearance is misleading and that if the internal consistency and doctrinal integrity of our corporate law are to be preserved, the concept cannot simply be grafted onto our existing corporate structure without a profound re-thinking of the relationship between shareholders and directors. For example: Who should serve on such a committee? How should the electoral or appointive process work? What should be the committee's inspection rights? What does it mean to call its recommendations "advisory"?

Dissatisfaction has been expressed over the process by which board candidates are selected. It is argued that nominating committees fail in the job of selecting qualified candidates, that they are dominated by the personal preferences of incumbent senior management, and that the system results in a form of self-perpetuating patronage inimical to the interests of shareholders. Two leading legal scholars have argued for a roster of "professional directors" from among whom the institutions would select their own candidates.[17] Others have suggested that the law should be changed so that there are more vacancies to be filled at each board election than management nominees in order to facilitate the election of some write-in candidates. Bills pending in Congress would give large shareholders the right to nominate their own candidates.[18] However, it seems to me that if the present selection process really needs an overhaul, we should be looking for a systemic alternative designed to produce consensus candidates and avoid polarization. I question how we can achieve this, and still attract men and women of high caliber to the boards of our public companies, until we have resolved the basic questions implicit in the debate regarding the balance of power between shareholders and directors.

The issue of executive compensation is particularly "hot" at the moment. A groundswell of shareholder activist thinking asserts that executive pay is excessive and should be much more directly tied to corporate performance. The aforementioned Congressional bills would revise the SEC's proxy rules to permit shareholders to vote on how companies set executive compensation and require more disclosure. However, these bills would not give shareholders the power to participate in individual compensation decisions. Some activists

17. *See* Gilson & Kraakman, *Reinventing The Outside Director: An Agenda For Institutional Investors*, 43 STAN. L. REV. 863, 866 (1991); and Gilson & Kraakman *Corporate Governance and Portfolio Performance: An Agenda for Institutional Investors*, 15 DIRECTOR'S MONTHLY, May 1991 at 1 (official newsletter of National Association of Corporate Directors, Washington, D.C.).

18. *See supra* note 4.

would proceed further and require a vote on the compensation of, at minimum, the most highly-remunerated executives.

This line of thinking runs directly counter to the paradigm under which shareholders elect the board while the board, in turn, appoints the senior executives and sets their compensation. The issue is, therefore, clearly a subset of the broader question concerning the allocation of power between shareholders and directors and, as such, raises the central systemic issue concerning the present corporate form. Can the selection of suitable executives effectively be entrusted to the board if the board is not to have the ability to work out a binding compensation package? If the shareholders vote down the board's compensation decisions *post facto*, where does that leave the individual executive? Can a meaningful distinction be drawn between compensation policy in general and its application in individual cases? If not, should each individual executive's personal package be subjected to a vote? If compensation is so closely tied to corporate performance as to warrant our reallocation of authority over it, what about important economic decisions that have historically been viewed as falling within the board's delegated authority, such as entering into material leases and purchase contracts or, indeed, basic strategic decisions over the direction of the business? While greater shareholder control over executive compensation may provide an effective rallying cry, from the viewpoint of the corporation as a workable legal mechanism it strikes me as a potentially serious mistake to view the issue separately from the backdrop of our current governance paradigm.

The same danger applies, in my view, to the issue of non-shareholder, or "stakeholder," constituencies. Like the issue of director activism, to which it is directly related, the stakeholder issue was fueled by the takeover battles of the 1980s. Boards confronted with hostile takeover bids were rebuked by their more vocal shareholders for standing in the way of offers that would provide an immediate premium over market price. It was contended that the interests of other constituencies who might be adversely affected—particularly employees and, in the case of leveraged buyouts, creditors—were irrelevant since the shareholders owned the enterprise. The courts, while supportive of the board's activist role in protecting the *shareholders* against reasonably perceived threats of coercion and unfairness, were understandably constrained in admitting non-shareholder interests into the equation by the precedential axiom that directors owed their fiduciary duties exclusively to shareholders; other constituencies could be considered only to the extent that "they [bore] some reasonable relationship to general shareholder interests."[19] When a sale or break-up of the company became inevitable, however, the *Revlon* doctrine was triggered and the board's exclusive duty was to auction the company on the best terms available for shareholders alone.[20] Moreover, the courts consistently rejected attempts to impose fiduciary duties on debtholders, whose rights were held to be limited to those set forth in the relevant contractual documents.[21]

In response to what critics contended was the failure of the courts to adapt the traditional concepts of fiduciary duty to the excesses of the takeover frenzy such as the leveraging, breaking apart and selling off of corporate America, over half the states stepped in and enacted stakeholder statutes permitting, and in a few instances requiring, boards of companies incorporated in those states to consider non-shareholder interests.[22] Some companies incorporated in states which did not enact such statutes, most notably Delaware, were able to obtain shareholder approval for a charter provision to similar effect, generally in the course of a transactional context, such as an initial public offering, reincorporation or spinoff, where shareholders were offered a total package and were not called on to approve its individual terms.

Although hostile takeover activity has largely abated, the issue of the board's right or duty to consider non-shareholder constituencies remains very much alive as directors wrestle with the economic constraints of the 1990s. Because the corporation is the predominant legal structure for public investment in U.S. business, and because a large part of the business of this country remains business, all of our lives are affected by what public companies do. Every major decision confronted by a corporate board has a potentially significant impact on non-shareholder groups such as employees, creditors, customers and suppliers, as well as on the local community in which the company functions and broader societal interests such as product safety, hazard-free workplaces and a clean environment. One example of great current relevance occurs when a company, though still solvent,

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19. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1282, n.29 (Del. 1988).

20. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). The court in *Revlon* declared that when the sale of a corporation is inevitable, the directors' role is to obtain the highest price possible. *Id.* at 184. For a detailed discussion of the *Revlon* doctrine, see TAKEOVER DEFENSE *supra* note 13, at Ch. XV.

21. *See, e.g.*, Metropolitan Life Insurance v. RJR Nabisco Inc., 716 F.Supp. 1504 (S.D.N.Y. 1989).

22. For a general compilation of these statutes, see STATE TAKEOVER LAWS (Institutional Responsibility Research Center). For general discussion of these statutes, see cited materials Appendix *infra* at (viii). *See also*, TAKEOVER DEFENSE, *supra* note 13, at Ch.IV.F.

is forced to consider an out-of-court financial restructuring. Its restructuring plan will necessarily affect, in differing ways depending on the specific approach chosen, not only the holders of its equity but a broad array of non-shareholder groups with diverse, and often mutually inconsistent, interests.[23]

However, the resolution of a fundamental question such as the nature and extent of a board's duties to non-shareholder interests is not susceptible to a "quick fix." This is why, in my view, both the stakeholder statutes and the corresponding charter provisions pose very basic questions within the existing paradigm. It is one thing to postulate that directors owe fiduciary duties to shareholders. Such a principle is axiomatic given the paradigm that the equityholders own the enterprise and elect the directors as *their* stewards. It is quite another thing to assert that other constituencies are proper, and perhaps even required, subjects of board consideration where their interests compete with the interests of the only group that elects the board. Under the current paradigm, these non-enfranchised constituencies have historically been viewed as protected from without—by contracts, statutes and regulations that confer entitlements and impose constraints extraneous to the corporate entity—rather than from within. It therefore seems to me that, from a doctrinal viewpoint, the current paradigm has no room for the position that directors may, or should, as a matter of their own business judgment and the proper discharge of their fiduciary duties, give equal or greater weight to stakeholders.

Other countries have attempted to address these issues through different conventions, such as the German supervisory board on which employee representatives sit.[24] However, our traditional view of the directors' duties of care and loyalty have not been constructed along these lines. Hence, if we are really to come to terms with this complex issue, we must ask some very basic structural questions,

23. Commentators appear to agree that when the corporation is *insolvent*, current case law imposes on the directors, as trustees, fiduciary duties to the entire body of creditors. *See, e.g.*, Miller & Goldstein, *The Chapter 11 Players in Contemporary Bankruptcy Practice: Roles, Obligations and Ethical Considerations*, in the ABA Materials *supra* note 6, at Tab O; and Lewis & Camahort, *Corporate Governance: Responsibilities of Directors of Companies in the Context of Takeovers, Proxy Contests and Insolvency*, 2 ACQUISITIONS AND MERGERS IN A TROUBLED ENVIRONMENT (Practising Law Institute) 415, 537 (1991). However, this principle itself raises significant questions regarding the nature and extent of the board's continuing duty to shareholders and the legally permissible relevance of other constituencies.

24. *See* Conard, *Corporate Constituencies in Western Europe*, 21 STET. L. REV. 73 (1991). See cited materials Appendix, *infra* at (viii).

rather than take what is essentially a "Band-Aid" approach. Who should elect directors? Do we need different levels of boards? Do we need directors with duties to differing groups? Under what circumstances may shareholder interests be subordinated to stakeholder interests? Is the business judgment rule an adequate analytical tool to deal with the board's role in weighing competing interests? If not, what is a workable alternative? Does the answer lie, after a decade of deregulation, in increased legislative and regulatory protection for these interests, which should be looking to the political process rather than corporate law to increase their influence on board decisions?

I now turn to the issue of proxy reform, which has become something of a bellweather for the entire corporate governance debate. Such questions as how issues get on the agenda for shareholders meeting, how the protagonists' views on those issues get disclosed and how they get voted on do not directly bear on the kinds of doctrinal questions I have discussed so far. However, within the framework of the current paradigm, the shareholders' annual vote on the election of directors and eligible shareholder proposals has become, as a practical matter, the only certain vehicle for a referendum or corporate performance—albeit, shareholder activists contend, a flawed vehicle. Therefore, the process of communication between directors and shareholders and among shareholders themselves regarding the issues to be voted on has become fundamental to the question of how corporations should govern themselves.

In connection with the proposals it issued in June 1991, the SEC set itself the laudable goal of focusing on three fundamental issues: whether the proxy rules unnecessarily restrict or interfere with the ability of securityholders to communicate among themselves or with management; whether they impose unnecessary costs on issuers and soliciting persons; and whether they fail adequately to address the concerns of securityholders. The June 1991 proposals were subsequently withdrawn in November 1991 due to the approximately 600 highly polarized comments letters the SEC received.[25] However, in its initial proposals, which were viewed by the SEC as only the first step in an ongoing review, the SEC confined itself to certain fairly narrow technical suggestions: to exempt solicitations by "disinter-

25. *See Regulation of Securityholder Communications*, Exchange Act Release No. 34-29,315, 56 Fed. Reg. 28,987 (June 25, 1991) (setting forth the proposals); McGurn, *The Future of Proxy Reform*, 5 INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Dec. 1991 at 3 (summarizing responses to the proposals). According to the Associate Director of the SEC's Division of Corporate Finance, the SEC expects to issue the revised proposals in early 1992 without making any major changes. The SEC remains committed to changes that ease communications between institutional investors and other shareholders during proxy contests. See 6 CORPORATE COUNSEL WEEKLY (BNA) 8 (Dec. 18, 1991).

ested persons" from all except the anti-fraud proscriptions of the proxy rules; to abandon the requirement that proxy materials be filed in preliminary form (except the proxy statement and form of proxy); to make all proxy material public upon filing, whether preliminary or final; and to give securityholders the right to obtain a shareholder list for solicitation in connection with an upcoming meeting.

If the firestorm of controversy generated by these proposals serves as a gauge, many people clearly feel that the proposals will work a significant shift in the balance of control over the solicitation process between incumbent management and shareholders. But in reality the proposals deal with mechanics, not substance. The essence, it seems to me, is whether or not we have achieved the correct balance between freedom of communication and protection from falsehood within the present regulation of the proxy solicitation process and the very important concomitant of Williams Act[26] requirements governing disclosure of group shareholder activity.[27] Equally central to the issue of corporate governance is whether, in our state corporate statutes as distinct from our federal securities legislation, we have attained the optimum balance between shareholders and directors with respect to the entire process of meeting and voting. Is a system of annual elections efficient or should shareholders vote for directors with greater or lesser frequency? Have we given shareholders too much power to call special meetings? Have we moved in the right direction by permitting the elimination of shareholder consent action in the charter? Should a broader range of board decisions be subject to shareholder approval (again, executive compensation is one example)? Such questions became so inherently provocative and polarizing in the 1980s—because of their association with hostile takeovers and proxy contests—that we tended to shy away from them as philosophical inquiries. As a result, we allowed such concerns to be resolved on an *ad hoc* basis by state legislatures responding to individual "raids" on local companies and by courts attempting to apply broad and subjective equitable principles or on a case-by-case and fact-intensive basis to the interstices left open by the legislatures. Surely, a dispassionate and careful reexamination of these issues is overdue.

26. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78M(d)-(e) to N(d)-(f) (1988 & Supp. 1991)).

27. *See generally*, Lesser, *Williams Act—An Overview*, 3 SEC. L. TECH. Ch. 70 (1989); and Lesser, *Williams Act—Beneficial Ownership Disclosure*, *id.* Ch.71.

This issue leads me to my final question: what body should regulate the issues I have raised, such as the balance of power between directors and shareholders, and access to the electoral machinery? Specifically, how satisfied should we be with the present system, in which the issues are resolved on a state-by-state basis by legislatures and courts which, according to some critics, have been engaged in a race to the bottom? In short, is it time to consider a federal corporations statute as a mechanism for expressing a national consensus on these issues?

Historically, the "internal affairs" doctrine has been seen as a sacrosanct byproduct of federalism. As a result, America has fifty different sets of corporate laws, each of which creates its own set of corporate governance rules. There is sufficient commonality among these laws and a long enough shadow cast by Delaware to make it possible to discuss a paradigm in general terms. Nevertheless, the fact remains that on any given issue in the corporate governance debate, the outcome is capable of varying, and often does, depending on where a particular company is incorporated.

The response of the various states to the takeover boom of the 1980s is instructive in this regard. Most states enacted some form of anti-takeover statute but the form of each statute varied significantly.[28] A few states failed to enact any legislation whatsoever and indeed, in the case of California, the Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions recommended against such legislation on the basis that the entire subject should be dealt with by preemptive federal legislation.[29] More than half of the states enacted stakeholder interest statutes, but, once again, significant difference existed among the statutory formulations and a substantial minority of states enacted no such legislation. Some states enacted statutes designed to codify the Delaware "heightened scrutiny" version of the business judgment rule as

28. *See generally*, TAKEOVER DEFENSE, *supra* note 13, at Ch. IV.

29. *See* California Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions, CORPORATE TAKEOVERS: A RECOMMENDATION FOR A CALIFORNIA POLICY (March 1988) and the accompanying document issued under the same title by the Commission's then-Chairman Senator Dan McCorquodale (D-12th Dist.). Note, however, that on March 8, 1991, Senator David Roberti (D-23rd Dist.) introduced SB. 935 in the California legislature, initially drafted under the Senate Commission's aegis. SB. 935, Cal. Reg. Sess. 1991. Senator Roberti's bill would amend the quasi-foreign corporation provisions of Section 2115 of California's General Corporation Law and effectively subject all publicly traded companies which have a market value of at least $100 million and constitute "Foreign-California Corporations" by virtue of satisfying any three of six tests of California nexus to special and extensive corporate governance rules. CAL. CORP. CODE § 2115 (West 1990). As a practical matter, given the way the nexus tests are drafted and the sheer size of the California economy, if SB. 935 were enacted and withstood constitutional scrutiny, the bill would "California-ize," rather than federalize, corporate governance in the United States for many public companies.

applicable to takeover defenses such as "poison pills" while other states, such as Indiana, passed laws repudiating that standard in favor of a less rigorous test.[30] Hence, if recent history is an accurate guide, we can be sure that whatever changes in corporate law the current governance debate engenders, those changes will vary in scope and effect from state to state. Additionally, it must be remembered that we already have significant state differences on such basic governance issues as whether written shareholder consent action can be eliminated by charter provisions, the extent of shareholders' rights of inspection, and the entitlement of shareholders to call special meetings.

Last summer I came across a document entitled a "discussion draft," dated June 11, 1991, of a proposed bill for introduction in the United States Senate. This bill, which has not yet been introduced but which very well could be, given the current political environment, would enact a "Federal Corporate Governance Act" establishing a single set of fiduciary standards governing directors of companies with securities registered under Section 12 of the Securities Exchange Act of 1934.[31] The specifics of the draft bill included: broader rights to shareholder lists; a mandatory "one share/one vote" rule; prohibition of supermajority voting requirements; mandatory confidential balloting; the abolition of staggered boards; compulsory cumulative voting; mandatory shareholder votes on golden parachutes, greenmail, poison pills and large executive bonuses; and the imposition of the burden of proof on the board to prove the inherent fairness of challenged directorial conduct. These specifics make it clear that the draft legislation is an aggressive populist charter for expanded shareholder rights. However, whatever one might think of its merits or of its prospects for passage, its very existence, coupled with the bills pending at present concerning executive compensation, highlight the fact that the corporate governance debate is a *national* debate and that there is a school of thought which believes it needs to be resolved on a *national* basis.

To be sure, serious constitutional issues have to be addressed in considering a national corporate law, not to mention daunting political obstacles to achieving the necessary consensus. But is it unthinkable heresy to suggest that a national approach be discussed? Does the corporate governance debate not relate, in the most profound

30. *See* TAKEOVER DEFENSE, *supra* note 13, at Ch. V.F.2.b (discussing state legislation of poison pills) and Ch. V.F.4.d. (discussing Indiana's poison pill statute).
31. 15 U.S.C.A. § 78 (West 1981 & Supp. 1992).

way, to the future direction of our much-prized national and indeed, global, market in the securities of public U.S. corporations? And if that market so significantly affects interstate commerce as to warrant the pervasive federal regulation of securities transactions we have accepted for almost sixty years, is there not at least a colorable case to be made for the federalization of some, if not all, substantive aspects of the relations among the issuers and holders of those securities? Maybe we will conclude that the inconsistencies of intrastate regulation of corporate governance are a worthwhile price to pay for the diversity of choice our present system offers. However, perhaps we should not assert that conclusion as unquestionable dogma until we have tested it.

* * * *

I do not profess to have convincing answers to the kinds of fundamental questions posed in this Commentary. Perhaps, when we get through their examination, we will find that they are simply too intractable to permit a consensus resolution. Maybe we will conclude that the fundamentals of our forbears' great invention of the limited liability joint stock corporation are in good working order after all and that the invention's detailed workings should be allowed to continue to evolve on a piecemeal basis. But it is just conceivable that we could construct a new paradigm—a "second generation" corporation—that would offer comprehensive solutions to at least some of the pressing corporate governance issues of the 1990s and beyond, while nevertheless retaining the best of the earlier model. One thing seems clear to me, however: we will not know the outcome of the inquiry until we start asking the right questions. To initiate that process and help chart its course in a comprehensive and objective manner is, surely, a great challenge worthy of our collective talents.

APPENDIX: SELECTIVE BIBLIOGRAPHY

The following is a highly selective "starter kit." An additional bibliography, helpfully broken down by author background such as academics, lawyers and the ABA, private sector practice, investors, government officials and journalists, appears at the end of Longstreth, *Reflections on the State of Corporate Governance*, 2 J. CORP. DISCLOSURE & CONFIDENTIALITY 89 (July 1991).

(i) For an excellent compendium of papers on the broad spectrum of issues currently under debate, see *Dynamics of Corporate Control V*, jointly published by the ABA Section of Business Law, Section of Litigation and Division for Professional Education in December 1991 (hereinafter ABA Materials). Readers who wish to access the ABA Materials should note that two valuable additional papers, bound separately, were distributed at the ABA Institute held in New York City on December 5-6, 1991 in connection with which the ABA Materials were compiled: Friedman, *Corporate Governance in the 90s: Institutional Investors and the Evolution of the Law*; and Goldstein, *Will Directors Have a Duty to Consider Bondholders?* Most of the topics for which I have singled out additional publications in the following paragraphs of this Appendix are also covered in the ABA materials, *supra*.

(ii) For a thoughtful overview of the debate, see the Longstreth article cited *supra* and its companion piece, Johnson, *Further Reflections on the State of Corporate Governance: A Response to Bevis Longstreth*, 2 J. CORP. DISCLOSURE & CONFIDENTIALITY 99 (July 1991).

(iii) For a useful collection of articles on the subject of proxy reform, see 5 INSIGHTS: CORP. & SEC. L. ADVISOR, No. 12 (Dec. 1991); Martin, *Proposals For Proxy Reform — A Change For Proxies or Proxies For Change*, 2 J. CORPORATE DISCLOSURE & CONFIDENTIALITY 105 (July 1991); and the materials issued by the Business and Corporation Law Section of the Los Angeles County Bar Association in connection with its December 18, 1991 program, entitled *Recent Developments in the Proxy Process: New Rules, New Standards and New Tactics*.

(iv) For a selection of articles encapsulating the views of prominent shareholder activists, see Monks and Minow, *Playing Baseball In A Football Field: The Shareholder Perspective*, 2 J. CORP. DISCLOSURE & CONFIDENTIALITY 119 (July 1991), (reproduced in ABA materials *supra* paragraph (i) and adapted from Monks and Minow *Power and Accountability* (1991)); and Hanson, *What Does CalPERS Want?*, XII J. CORP. GOVERNANCE 1 (Sep.-Oct. 1991).

(v) Increasing reference is being made to a document entitled *A New*

Compact for Owners and Directors, Harv. Bus. Rev., Jul.-Aug. 1991, at 141. The document was issued by an informal body called The Working Group on Corporate Governance.

(vi) For a stimulating new look at the question why the public corporation is the dominant form of business enterprise in the United States, see Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10 (1991).

(vii) For a study of the correlation between takeover defenses and corporate performance, see de Silva & Hoag, *Corporate Governance and Corporate Performance* (Aug. 1991) an unpublished paper available through The Analysis Group, Inc., Los Angeles, California.

(viii) For an excellent compendium of papers on the subject of non-shareholder constituencies, see *Symposium: Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 1 (1991). James J. Hanks, Jr., who has written extensively on the subject of non-shareholder constituencies, has published papers on this topic both in the Symposium Volume of the Stetson Law Review, *supra*, and in the ABA materials, *supra* paragraph (i). *See also*; The Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990); Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355 (1991); and Lewis and Camahort, *Corporate Governance: Responsibilities of Directors of Companies in the Context of Takeovers, Proxy Contests and Insolvency*, 2 ACQUISITIONS AND MERGERS IN A TROUBLED ENVIRONMENT (Practising Law Institute) 415 (1991).

(ix) Readers wishing to stay current, at least anecdotally, on the corporate governance debate are well-advised to consult *The Corporate Governance Bulletin*, a bi-monthly publication of the Institutional Responsibility Research Center in Washington, D.C. (IRRC) and IRRC's weekly *Corporate Governance Highlights*, as well as the monthly *Corporate Control Alert* published by American Lawyer Media L.P.