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DIRECTORS WHO DO NOT DIRECT

A POPULAR theme in recent years has been that "Directors should assume the responsibility of directing and if their manifold activities make real directing impossible, they should be held responsible to the unsuspecting public for their neglect."¹ To some this has meant a necessity for regression to simpler and smaller forms of organization, with a board of directors composed essentially of the managers and others in a position to know the details of the business intimately. To some it has meant a reduction in the size of the board to a more cohesive and active group with a greater feeling of responsibility to the company. To some it has meant an elimination from the board of those in high places whose names were bought and paid for with a directorship, no other consideration being expected or given in return. To some it has meant an elimination from the board of those who were there as specialists, such as bankers, lawyers, engineers, and the like, but whose interest or time did not permit them to assume a larger and more active rôle in the affairs of the company. To some it has meant an elimination of purely political appointees, men who have seats merely because

¹ See H. R. REP. No. 85, 73d Cong. 1st Sess., at 5, accompanying the Federal Securities Act. The Committee on Interstate and Foreign Commerce also said: "If it be said that the imposition of such responsibilities upon these persons will be to alter corporate organization and corporate practice in this country, such a result is only what your committee expects. The picture of persons, assumed to be responsible for the direction of industrial enterprises, occupying 50 or more directorships of corporations is the best proof that some change is demanded." *Ibid.*

they have valuable connections with other companies, banks, and the like. And to others it has meant that the use of seats on the board as advantageous trading posts should be placed outside the law.

In other words, the criticism has been symptomatic of indignation and disapproval of many different abuses and malpractices disclosed in recent years. Recent court records and Senate hearings are replete with specific and illustrative material — secret loans to officers and directors, undisclosed profit-sharing plans, timely contracts unduly favorable to affiliated interests, dividend policies based on false estimates, manipulations of credit resources and capital structures to the detriment of minority interests, pool operations, and trading in securities of the company by virtue of inside information, to mention only a few. These are not peculiar to recent times. They are forms of business activity long known to the law. But lately they have increased in intensity and frequency in spite of a more articulate statement of the law governing them and in the face of a growing recognition of the broad bases of an equitable jurisdiction for their regulation and control. All of which means that business, and its legal advisers, have shown great ineptitude in appreciating and appraising the social importance and significance of many of their activities. Also, it means that considerable refashioning of codes of conduct — in business as well as in law — must be effected if the next cyclical trend is not to produce as many malpractices and abuses as has the current one.

This program of reform for law and business calls not only for acute diagnosis, but also for skillful and highly specific corrective and therapeutic measures. These cover a wide range. Part, but only part, of the problem relates to differences in the size of business units. To date we have provided the same kind of regulation for the small, and even for the family, corporation as we have for their gigantic counterparts. Particularization of types of problems and of types of controls needed must soon lead to a segregation along these lines.² For the most part, the problems of control over management and finance which are be-

² Such separate treatment is urged in Weiner, *Legislative Recognition of the Close Corporation* (1929) 27 MICH. L. REV. 273. See (1931) 9 HARV. BUS. REV. 371.

ing currently discussed pertain to the type of corporation which Berle and Means² have described — the giants of industry and finance that epitomize the separation of ownership and control and that place in the hands of a few immense power which must be regulated not only for the public good, but also for the protection of those whose investments are involved.

Of the many and varied aspects of this problem there are three which are of primary importance and which are implicit in any basic reform and regulation of the large corporation. In the first place, the urge to bring the board closer to the details of the business involves the great danger of constituting it with "shirtsleeve" directors. This will prove to be an illusory form of protection. In the second place, extensive revision of both legal and ethical codes of conduct for directors and business executives becomes necessary for the protection of the stockholder against the management. Not the least difficult problem here is the development of a social mindedness hitherto sadly lacking both among business men and their legal advisers. In the third place, some method must be devised to mobilize scattered and disorganized stockholders and other investors into an active and powerful group so that there may be a competent and respectable patrol of the field of finance. These three problems become particularly germane as we move toward federal incorporation of the giants of industry or seek by other methods to afford additional protection against the evils of the last decade.

I

The problem of affording stockholders genuine and independent representation on the board of directors has several phases. Primarily it means avoiding or making impossible the vicious practice of having the board controlled or dominated by the managers. In the days of the small enterprise, with close identity of ownership and control, it might have seemed anomalous not to have the managers dominate the board, but as ownership and control became effectively separated, there came a need for a reappraisal and change of the functions of directors. Stockholders moved more and more from an entrepreneurial to an

² *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

investment position. Due to the wide diffusion of stock ownership and the growth in size of the business units the only effective check which the stockholders had on the managers was through the board. It is self-evident that if the board, under such circumstances, was composed wholly or dominantly of the managers, such control was wholly formal. The managers came to be their own supervisors, and the stockholders were moved into a position of effective subservience to those who by tradition and law were their servants. The need for having a board divorced from the managers is neatly shown by an interesting document from the contemporary annals of American corporation finance.

This document is the recent Report of the Stockholders Investigating Committee of the Texas Corporation.⁴ For months there had been a rather bitter fight between two factions on the board—the Holmes group on the one side and the Lapham group on the other. Charges and counter-charges were freely made, and solicitation of the support of stockholders and of their proxies for a special meeting had been under way for several months. At that point, on the initiative of the chairman of the board, the Investigating Committee was appointed.⁵ Formal hearings⁶ were held and a report of findings and recommendations was made to the stockholders.⁷

⁴ Dated Jan. 25, 1934.

⁵ The chairman of the board, Mr. C. B. Ames, asked Mr. A. L. Humes, who was satisfactory to both factions, to serve as chairman of the Investigating Committee and to appoint two or four other stockholders to serve with him. *Id.*, Exhibit A. Mr. Humes accepted (Exhibit B) and appointed to serve with him Messrs. P. H. O'Neil and Warren G. Horton.

⁶ The Report says at page 7: "Rules of procedure were adopted and were approved by him [Mr. Holmes] and the Management

"A statement of charges dated November 16, 1933 was filed by Mr. Holmes with the Committee. A copy thereof, marked 'Exhibit D,' is annexed. On the same day the Management submitted a statement, a copy of which is annexed marked 'Exhibit E.'

"Thereupon the Management and Mr. Holmes and their counsel appeared before the Committee first on November 22, 1933, and thereafter on November 23d, 24th, 25th, 27th, 28th, 29th and 30th, and December 1st, 5th, 6th, 7th and 8th, 1933. Testimony amounting to 2,382 typewritten pages was heard; documents and other papers numbering 139 were received in evidence and numerous additional documents were submitted."

⁷ The Report says, at pages 2-3: "Pursuant to a Rule adopted by the Committee at the request both of Mr. Humes and the Management, a copy of this report is sent to each stockholder", of which there are about 90,000. They live in "all parts of the United States and in several foreign countries". Exhibit A.

Aside from clearing up several disputed matters of policy, the Report goes to the heart of the problem of the functions and status of directors under our modern forms of organization. The Report states:

" For many years executive officers of the Company have been directors. From November 16, 1909, when the Board was increased from eleven to thirteen members, until January 13, 1926, the majority of the Board consisted of directors who were executive officers. Thus during this period this majority had power to control policies and the conduct of the business. Since January 13, 1926, this management control has been somewhat modified but, except during a short period, and until the present time control has resided jointly with the management and one or two additional directors."⁸

The Report then reviews instances of the exercise of power by the management group and concludes that although " in the vast majority of cases " the decisions of the board have been " wise and conducive to the best interests of the corporation ", certain instances exist which demonstrate the need for a change in the system.⁹

In the first place, the board had approved and put into effect two so-called profit-sharing plans entitling officer-directors, directors who were members of the executive committee, and certain employees to a participation in earnings. Pursuant to these plans " large sums were distributed to executive officers " in 1929 and 1930 as additional compensation in excess of their salaries.¹⁰ Yet at no time, so it is said, were these plans submitted to the stockholders.¹¹ On the recommendation of the Investigating Committee and on the statement of the chairman that these plans were " contrary to the temper of the times and, if known, would be objectionable to many stockholders ", the board voted to terminate them.¹²

In the second place, at a meeting of the executive committee of the board held September 30th, 1930, the matter of assisting officers and employees (including certain directors who were executive officers) who were in debt to brokers, banks, and others

⁸ *Id.* at 5.

⁹ *Ibid.*

¹⁰ *Id.* at 5-6.

¹¹ *Id.* at 6. This may be technically correct on the basis of inadequacy of notice, but the Annual Report in 1933 at page 5 makes reference to the plans.

¹² *Ibid.*

was discussed. Their "collateral was fast becoming insufficient. The collapse of values created distress, which, it was believed, was impairing the efficiency of these officers and employees and thereby of the organization." The executive committee, without referring the matter to the board of directors, voted to authorize certain individuals "to take such action as in their opinion was warranted and necessary to assist employees."¹² The Report states that the president "directed the secretary not to report it to the Board"; and that "It was not so reported and, until the present Committee recently called attention thereto, several directors at no time had learned of the resolution or knew that the loans had been made."¹³ Pursuant to the resolution numerous loans were made to officers and employees, including one (unsecured) to the chairman of the executive committee.¹⁴ "At one time, on July 31, 1932, the total loans aggregated \$2,545,718.60. The loans remaining outstanding on October 31, 1933, had been reduced to \$2,363,535.62. The collateral declined in value so that it was inadequate."¹⁵ At a hearing of the Investigating Committee the chairman stated on its behalf that it did not approve of the making of the loans and urged that measures be taken to eliminate those outstanding without delay. Acting on this request the board took steps towards prompt liquidation, and at the time of the Report most of the outstanding loans had been paid in full.¹⁷

In the third place, the management group "without action at any meeting of the Board but, at the expense of the corporation" circularized the stockholders, answering charges made against them by the Holmes group.¹⁶ Thereafter,

"likewise at large expense to the corporation and without action of the Board, employees and others were instructed to and did interview and communicate with many thousands of stockholders" with the object of "inducing them to refrain from supporting the special meeting advocated by Mr. Holmes. Members of the Management also issued instructions to heads of departments which, whether intended as coercive or not, resulted in the decision of many employee stockholders that they would not sign proxies for the special meeting. Many employee stockholders were asked whether they had signed these proxies and in many

¹² *Ibid.*¹⁴ *Id.* at 7.¹³ *Ibid.*¹⁵ *Ibid.*¹⁷ *Ibid.*¹⁶ *Id.* at 9.

cases in which a proxy had been signed, the employee was thereupon furnished with a form of revocation. The Management's statement of September 20th [answering previous charges by Mr. Holmes] was called to the attention of certain employees. They were asked to decide whether they would or would not sign proxies for the special meeting and to report their decision to the Management. The enthusiasm of those who conducted this campaign carried further than was intended by the Management and resulted in some cases in exaggeration and, in a few instances, even in misstatement. In the opinion of the Committee some of these measures in effect and substance were coercive, although the intention that they be coercive was expressly disclaimed.¹⁹

The Investigating Committee added that "Large expenditures were made for these purposes which have been treated as corporate expenses on the ground that the special meeting would be disadvantageous to the corporation."²⁰ The Committee did not decide who was legally liable for these expenses, but it recommended consideration of the matter by the new board.²¹

In the fourth place, there had been a bitter fight between the two factions in the management, ending in one faction acquiring a dominant position and charges and countercharges being made.²² In the opinion of the Investigating Committee, the friction and dissension thereby engendered resulted in a state of affairs disadvantageous to the interests of the corporation.²³

From the survey of these four instances of power and control by a board dominated by the management, the Investigating Committee concludes:

" . . . neither a numerical majority of the Management as directors, nor the existence of the power to control the action of the Board by decision of the Management when only slightly supplemented, is desirable or calculated to result in harmonious and successful conduct of the business. At times dissension and jealousy has [*sic*] thereby been engendered. Moreover, the membership of the Board has not been sufficiently representative of the ownership of the stockholders of the corporation.

" This situation is not peculiar to the Texas Corporation. It is typical of that existing in many present day corporations but recently there

¹⁹ *Id.* at 9-10.

²⁰ *Id.* at 10.

²¹ *Ibid.*

²² See *id.* at 8-9 for a more detailed account.

²³ *Id.* at 5, 8-9, 14.

has been a sharp awakening to the fact that the rights of stockholders entitle them to an adequate and controlling voice."²⁴

The Report continues:

"The existence of power such as is above referred to [in the four instances given] results in the Committee's conclusion that heretofore the stockholders have not had their just share in the control of the corporation. The ownership of stock is widely scattered and the great majority of stockholders can exercise no control except through the naming of proxies to vote at the next annual meeting for the election of directors who will carry out the policies advocated."²⁵

Accordingly, it is recommended, *inter alia*:

"II. That the fifteen directors to be elected at the next annual meeting of the stockholders to be held on April 24, 1934, shall be representative more adequately than heretofore of the ownership of the stockholders; that not more than four directors shall be executive officers and that the remaining directors shall be selected from stockholders owning or representing sufficient number of shares to insure their active interest and participation in the affairs of the corporation. . . .

"VI. That the Board to be elected take steps, by the adoption of appropriate by-laws or otherwise, to effectively separate the power to determine financial questions from the control of those entrusted with the conduct of the business of the corporation.

"VII. To accomplish these results, that, in issuing proxies for the next annual meeting, the corporation designate, as the persons authorized thereby to vote and to select the new Board " five named individuals, three of whom are " independent directors of the corporation against whom no charges have been made and who are in no manner involved in any transaction disapproved by the Committee " and two of whom are " stockholders of ability but not directors and are designated as proxies as additional representatives of the stockholders." ²⁶

But this Investigating Committee's conception of the functions and status of directors runs counter to some current notions. It is frequently asserted that services which are furnished by directors who are not managers should be bought and paid for on a professional basis. It is urged that if directors who

²⁴ *Id.* at 5.

²⁵ *Id.* at 11.

²⁶ *Id.* at 14-15. As an alternative a majority of these five were to be named.

are not operating heads are valuable as members of the board because of their expert advice, they should be hired as experts.²⁷ The answer to this seems clear. If stockholders are to be protected against the managers, the group which protects them must, in the first place, have responsibility. In the second place, they must have power. And that power will never be present in experts who have no vote and who are called in by the managers, who work for the managers, and who are limited by the desires of the managers. Furthermore, boards wholly or dominantly filled with "shirtsleeve" directors drawn from the executive management, without outside representation, are apt to suffer

²⁷ In SAMUEL, SHAREHOLDERS' MONEY (1933), the view is taken that the "expert" should be called "consultant expert" rather than director. And as for those whose real function was merely to "lend the prestige of their names or to introduce business", it would be wholly adequate to give them "such honorific title as Patrons or Associates". He believes they should have "no status at Board Meetings". See *id.* at 124. And see note 44, *infra*. On this it is difficult to generalize. Some technical experts ought to have a place on the board; others might well be left off. The sole criteria are the stockholders' interests. Even the "business connection" director may have a place. Berle and Means have said: "Most Banks have two classes of directors. One class is made up of bankers. The other consists of business men who may be able because of their business affiliations to shift accounts and banking transactions towards the Bank. These connections are openly known and are perfectly well understood. The director himself gains power. But his corporation may obtain assistance through having 'friends at court' in the Bank; and the Bank is strengthened by the connection with a business enterprise. The situation has its dangers but it also has its advantages; in the business view the advantages outweigh the dangers." See BEALE AND MEANS, *op. cit. supra* note 3, at 231, n.16. Recent legislation, however, has affected this practice. See notes 57, 58, 59, *infra*. Berle and Means likewise take a realistic view of interlocking directorates. After affirming that all adverse interest should be disclosed they say: "The writers feel that the charge that directors are interested on both sides of the transaction is entirely too loosely made in the financial community. A director, especially if he is an important man financially, will have a dozen or more interests all going at once. In many cases the action taken by him in one corporation is necessarily more or less adverse to the interests of other corporations in which he may be interested. Yet, in a number of cases known to the writers, the directors have scrupulously ignored their own interests. The real problems arise where the director is an important factor in the 'control' of two corporations at once. There, it would be almost beyond possibility for him not to consider the possibilities of both situations before casting a vote or inducing an action. Many directors are elected frankly because they have interests in other corporations whose activities may complement those of the corporation electing him. In other words, the corporations expect to transact business with each other or in the same field, to their mutual advantage; and the very duality of interest of the director is thus turned to the advantage of both." *Id.* at 232, n.15.

from myopia and lack of perspective. It is one thing to operate a business efficiently, but it is quite another to be sufficiently detached from the business to be able to see it in relation to its competitors, trade trends, and the like. Such experts, as a general rule, are to be found outside the executive management. Their experience and judgment on matters of policy will prove to be invaluable not only as corrective factors, but also as directive influences in determining a course of conduct for the managers. Experts having such perspective are the better qualified to determine financial and commercial policy. Hence, they should have a position of dominance and power on the board rather than the subordinate position to which some reformers would relegate them. They should be in a position to make their directive influence effective. That entails giving them real power over the executive management.

The solution then, though by no means a simple one, is to be found in taking the control or dominance of the board away from the executive management, as indicated by the Investigating Committee in the Texas Corporation. The representatives of the stockholders would be there, not for the purpose of managing the enterprise, but with the object of supervising those who do and of formulating the general commercial and financial policies under which the business is to be conducted. Such a body of men would not always be in a position to know the details of the business in such a way as to satisfy the standards which the Securities Act, for example, imposes on them.²⁸ But they would be in a position of dominance and power to serve the stockholders effectively.

The minimal requirements in this regard are statutory provisions that a majority of the board shall be composed of stock-

²⁸ Section 11 of that Act imposes on directors (as well as others) the standards of trusteeship and makes them liable for misstatements or omissions in the registration statement (not made on authority of experts, or not purporting to be a statement made by an official person or to be a copy of or extract from a public document) unless they can prove that they had "after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." See 48 STAT. 82 (1933), 15 U. S. C. SUPP. VII § 77k (1933).

holders who are not employees or officers of the corporation, but it would be idle dreaming to suppose that the solution was as simple as that. In order to effectuate a real reform, control must be had over the proxy machinery. Once any group comes into a position of dominance on the board they become self-perpetuating, electing their own successors or designating their own nominees or dummies. The mechanism, though well known, has been vividly described by Berle and Means:

" In the election of the board the stockholder ordinarily has three alternatives. He can refrain from voting, he can attend the annual meeting and personally vote his stock, or he can sign a proxy transferring his voting power to certain individuals selected by the management of the corporation, the proxy committee. As his personal vote will count for little or nothing at the meeting unless he has a very large block of stock, the stockholder is practically reduced to the alternative of not voting at all or else of *handing over his vote to individuals over whom he has no control and in whose selection he did not participate*. In neither case will he be able to exercise any measure of control. Rather, control will tend to be in the hands of those who select the proxy committee by whom, in turn, the election of directors for the ensuing period may be made. Since the proxy committee is appointed by the existing management, the latter can virtually dictate their own successors. Where ownership is sufficiently sub-divided, the management can thus become a self-perpetuating body even though its share in the ownership is negligible."²⁹

So, though by statute the executive management may be in a numerical minority on the board, the power of control over the proxy machinery may well gravitate into their hands. Once it does it may be used to fill the board with nominees of the executive management. We would then have in substance, though not in form, the situation which the Investigating Committee of the Texas Corporation condemns.

Furthermore, control over the proxy machinery envisages much more than protection against the executive management. Abuses as great as those of the executive managements have arisen where a minority with "working control" have dominated the corporation and exploited it for their own ends. In other words, the

²⁹ *Op cit. supra* note 3, at 86-88.

power over the proxy machinery is susceptible to great abuse, and all the righteous intent and emphatic resolutions in the world will not shift the balance of power back to the stockholders. The group that names the proxyholders controls the board. It is no easy task to design a system whereby widely scattered, lethargic, disorganized, and disinterested stockholders can be moved into a position of control over that strategic position.

The practical and political aspects of that problem are considerable. Direct prohibition of proxies, under the system which we have, would be futile, as the average stockholder in the corporation which Berle and Means describe is in no position to think for himself on this issue. Some one must think and act for him, and it is merely a question of who does it. An attempt to give stockholders some protection against abuses of the proxy machine has been made in various drafts of the National Securities Exchange Act by prohibiting the use of the mails or agencies of interstate commerce or any facility of any national securities exchange to solicit proxies in respect to any registered security unless, pursuant to rules and regulations of the commission, certain disclosures relative to the solicitor and the proxyholders be made.³⁰ Such a provision may result in some control, but it does not proceed very far. There are great practical limitations on setting forth the "truth" about people up for election or about the proxyholders. Only bare minima can be stated, and those could hardly be used profitably by stockholders in deciding how to cast their votes. Furthermore, stockholders in the type of corporations involved here seldom have the desire or the initiative to act, or the ability to act intelligently. They are far removed from the enterprise. Their relationship with it is an impersonal one. They have bought with a view towards increments of value other than control. So long as things run smoothly they are content to remain inactive. And when things go wrong and there are crises in the corporation, either they lack the information or strategic position to mobilize for action, or they accept the events in the spirit of futility and resignation to the inevitable. Those who have expended time, energy, and money in the extremely difficult task of organizing security holders for their own

³⁰ See, e.g., § 13 of the original administration bill (so-called) introduced into Congress Feb. 9, 1934; N. Y. Herald Tribune, Feb. 10, 1934, at 24.

protection, or in an effort to get even a majority or a two-thirds expression of opinion on certain policies, can bear witness to the fact that this incidence of absentee ownership is very great. Hence, efforts to get into the hands of investors a larger fund of information respecting the candidates for election or the members of the electoral college will probably be of little value *per se*. The basic effects of absentee ownership will remain the same.

One method of control over the proxy machinery sometimes visualized is by means of a governmental commission which would not only umpire the election, but for all practical purposes would control the proxy machine. The trouble is that no such agency in our present stage of development would have the omniscience and wisdom which the delicate judgments on intangible qualities of management require, if business is to be operated successfully. The immediate steps necessary for the protection of investors in this connection lie in other directions. But before considering other alternatives there is a further problem which should be examined, since it has an important bearing upon the protective devices needed for the task at hand.

II

That problem is to set up codes of conduct for those who have been elected to serve the stockholders, with adequate machinery for their enforcement. Stockholder control over election machinery — direct or vicarious — would be only a partial achievement of the desired result. Human nature being what it is, directorships will always be susceptible of abuse. Some directors will always be faithless to their trust. No matter if they are, in fact as well as in name, representatives of the stockholders, they may still capitalize on their strategic position in the company by making it serve effectively their own but not the stockholders' interests. The impotence of widely scattered and disorganized stockholders will be conducive to that end.

In this connection a recent study³¹ of conditions and practices under the English Companies Act is particularly timely and relevant. We have the habit of turning to England for a precedent

³¹ SAMUEL, *SHAREHOLDERS' MONEY*. For a review of another part of this book, see (April, 1934) 34 *COL. L. REV.*

when our own system boggles. We incline to the view that England is years ahead of us in control over corporations and that the directors of British companies are conservative, respectable, and above reproach. We also accept the tradition that England's legal system for control over corporations should serve as a model for our own system. Such implicit confidence in the efficacy of the English system is considerably shaken by this report. It reveals a condition of depravity in the management of British companies which is at times beyond the imagination of the American reformer. Furthermore, it shows the counterparts of many practices on the part of directors which have been prevalent in this country. The diagnosis of them and the therapeutic measures designed for their cure or control, therefore, are of great current interest here.

English companies apparently have a great demand for "financial gigolos". The London Daily Telegraph of October 4th, 1932, carried the following advertisement:

"A Titled Gentleman is invited to communicate with a progressive company with a view to installing him as a director. Write A., Box 10, 161." ³²

Mr. Samuel, a critic of companies law and practice, takes this as one bit of evidence that the use by British companies of "financial gigolos" as directors has reached alarming proportions. Their function is two-fold: "Their names act first as the bait by which the public is induced to acquire the shares of the Company, and, secondly, after the Company has been formed, as a means of preserving confidence."³³ Though the "prestige of the aristocracy" even in conservative England is not what it used to be, nevertheless, at company meetings "the medieval glamour still shines bright, and the average shareholder dearly loves a lord."³⁴ In fact the "financial decay" of the old nobility inevitably tends "to increase the supply of titled gentry prepared to lend the use of their names for adequate annual emoluments."³⁵ Indeed, a "definite market" exists for them, as is apparent from the fact that "they can be supplied almost immediately on demand by certain firms of solicitors."³⁶ A chairman of the board with

³² SAMUEL, SHAREHOLDERS' MONEY 112.

³³ *Id.* at 111.

³⁴ *Id.* at 112.

³⁵ *Ibid.*

³⁶ *Ibid.*

a distinguished war record may be able to pour oil on the troubled waters of a company meeting and thus give full value for his money. By the same token these "guinea pig" directors consolidate the control which the active directors exercise over the company machine, since they take only information which is given them and make no embarrassing demands for inquiry into the true state of affairs. This practice becomes increasingly vicious when, as is common, the qualification shares come from the promoters, so that the director "tends to become, in practice, neither more nor less than the paid hack of the promoters or dominant spirits who were responsible for his original appointment, who by their control of the voting machine can procure his dismissal or non-election, and are thus ultimately responsible for his receipt of his directorial fees".⁸⁷ The racket of qualification shares apparently has reached large proportions. Mr. Samuel points out that under the Companies Act the board can be, and frequently is, filled wholly by these "financial gigolos", so that the prospectus in no way reveals the persons behind the scenes who tell these controlled persons what to say and how to act. Nevertheless, the director is advertised as a shareholder, even though the beneficial ownership is in some promoter or financially sterile corporation. As an instance of the latter he cites the way in which the calls in the Royal Mail were avoided.⁸⁸

But these "guinea pig" directors, according to Mr. Samuel, are only a part of the unhealthy condition in English management practices. There are other surplus directors. Many of them are men of ability and experience. Their activities, however, are so manifold and their directorships so multiplied that it is

⁸⁷ *Id.* at 115.

⁸⁸ Various calls on shares registered in the names of the directors were made, until each director owed the company about £300. None of these was paid, though the directors were "notoriously good for the money". All directors then transferred these shares back to the Royal Mail Steam Packet Co. ("notoriously insolvent"), for whom the directors had held the shares all along and to whom all dividends were to be sent. The action was frankly defended on behalf of the directors on the grounds that the "amounts were trivial and that it would have been inequitable to have made the registered owners pay, inasmuch as they were mere nominees for the beneficial owners". *Id.* at 158-59. For other aspects of the collapse of the Royal Mail group, see *id.* at 179 *et seq.*; MacIntyre, *Criminal Provisions of the Securities Act and Analogies to Similar Criminal Statutes* (1933) 43 *YALE L. J.* 254.

physically impossible for them to make an "adequately intensive study of the affairs of the Company, the responsibility for which will normally be left to those Directors who, being in the office, are in daily touch with the business."³⁹ Indeed, for such directors to visit the office voluntarily and to investigate any situation would "in any ordinary Company unquestionably be regarded as savouring of officiousness and eccentricity."⁴⁰ The time spent by directors, other than those from the management, in the exercise of "directorial functions" is practically limited to the time expended in board meetings. Mr. Samuel observes that many of the directorates are "grossly swollen", numbering from twenty to thirty-five. He concludes that barely "50 per cent really pull their weight" at meetings and that of the balance about "40 per cent are prestige Directors and 'connection' Directors."⁴¹ Such vested interests, he deplores, are "almost as difficult to dislodge as the pocket-boroughs of the eighteenth century."⁴² He concludes that the "whole system of non-directing Directors is based on a convention of elaborate falsehood"⁴³ which, if treated openly and frankly, would result in such ridiculously ironic representations "as to end the evil.

In this connection he reviews reports of some of the committees on the Companies Act showing that any tightening in the law of negligence was deemed to be too drastic. After it had become fashionable for companies of first importance to insert in their articles stipulations granting immunity to directors from liability to the company for any acts of commission or of omission unless involving fraud or wilful default, the City Equitable Fire Insurance Co. collapsed. The situation there exposed caused such foment as to lead to legislation abolishing "contracting-out."⁴⁴ But his survey of the English cases shows the extent to which the *laissez-faire* attitude of the courts has built up an al-

³⁹ SAMUEL, *SHAREHOLDERS' MONEY* 118.

⁴⁰ *Id.* at 119.

⁴¹ *Id.* at 120.

⁴² *Ibid.*

⁴³ *Id.* at 124.

⁴⁴ The *reductio ad absurdum* appears in Mr. Samuel's book in the vivid description of the composition and capabilities of the board of directors of "Spanish Air and Castles, Ltd." See *id.* at 122-24.

⁴⁵ Companies Act, 1929, 19 & 20 GEO. V, c. 23, § 151.

most impregnable defense for directors. Their immunity extends to everything except gross negligence or wilful acts. Their duties begin and end with the entering and leaving of the board meeting. So far as reported English cases go they show probably a lower minimal standard than do the American cases, though students of finance on this side of the water think our standards are far too lax.

His description and analysis of the problem of interlocking directorates, too, are most illuminating. Against the background of Mr. Justice Brandeis' *Other People's Money*,⁴⁶ he places the sordid picture of English high finance. He draws from some of England's recent, bitter experiences, including the Royal Mail.⁴⁷ He shows specifically what Berle has described analytically⁴⁸—how the manipulation of credit resources of one company for the benefit of another company, which is in a position of dominance, works to the prejudice and ruin of independent interests in the former company. He leads one to believe that such activities are substantially beyond the pale of the English legal system. The picture of English procedural and substantive law which he presents is a dismal one. In effect, the thesis that in this situation the directors are trustees has been repudiated.

As Mr. Samuel views it, the vice of English reform to date has been that it has accommodated "the law to a state of affairs in which the majority of Directors are out of touch with the inner workings of the Company", rather than changed the "existing state of affairs with the object of promoting safety and efficiency in the actual working of the Company machine".⁴⁹ In other words, somewhat the same attitude has been revealed there as in certain types of problems under the New Deal. Real reform and improvement frequently have called for cutting the Gordian knot of traditional practices. To do so, however, frequently meant swelling the ranks of the unemployed or stopping the flow of capital goods at a time when both increased employment and stimulation of production were needed. Those close to the task know too well how permanent measures were, and still are, sacrificed for

⁴⁶ (1913).

⁴⁷ See note 38, *supra*.

⁴⁸ BERLE, *STUDIES IN THE LAW OF CORPORATION FINANCE* (1928) c. VIII.

⁴⁹ *SHAREHOLDERS' MONEY* 138.

temporary expedients. Mr. Samuel detects in the English timidity at tampering with the Companies Act and in the reluctance at prohibiting a combination of profit and immunity from liability, an indication of unwillingness to put a large number of people out of business. The fear of increased unemployment (even among the nobility) has had its retarding influence.

The American counterparts of the foregoing malpractices need not be reviewed here, for they are fresh in memory. But it is timely to consider the corrective measures necessary if the board is to be employed as a medium for the protection and enhancement of the interests of the corporation and the stockholders, rather than as a convenient device for the exercise of economic and political power for the selfish interests of those who happen to be in a position of dominance. As contrasted with the English system, we begin and end with the assumption that the directors are trustees by virtue of business ethics as well as law; and that the powers which they exercise are powers in trust.⁵⁰ We also proceed on the hypothesis that the directors are custodians of the interests of the stockholders, and that they supervise the management and formulate generally the financial and commercial policies, rather than act as operating or managing heads. The problem then becomes one of making as explicit as possible the various types of situations to be controlled. The record of the last decade has revealed most of them. Specific statement in a statute, within minimal and practicable limits, has several advantages. It makes more definite and certain the business and legal risks involved. Furthermore, the isolation and specific treatment of the various malpractices and abuses which have arisen will make for more effective administration and control. That, in the last analysis, will be measured in terms of the protection and enhancement of the interests of the investors in the business to the extent that such interests are compatible with the public good. This leaves the difficult, and in spots the insoluble, problem of designing methods of control which will be both just and fair from the viewpoint of directors and efficient from the viewpoint of investors. In that connection our remedies should not be as hysterical as the practices which made the demand and need for regulation insistent. Prevention will prove more wholesome than punishment. It

⁵⁰ BERLE AND MEANS, *op. cit. supra* note 3, cc. V-VII.

is a rebuke to our skill and judgment if we cannot effect competent police measures without driving from the field of enterprise the men of greatest competence and substance.

Publicity alone can accomplish much — not publicity in the sense of a registration in some dusty file in Washington or in some state capitol, but publicity in the sense of direct and unequivocal statement in the periodical reports to stockholders. Mr. Samuel employs this device in a number of instances. He would require full disclosure of all loans to directors. He would require disclosure in the annual reports of all amounts paid to directors by way of remuneration resulting directly or indirectly from their directorships.⁸¹ He would require directors to file each year a statement of all shares of the company traded in during the year in order to correct the practice of buying and selling shares in the company as a result of inside information available to directors — a practice indulged in by fifty per cent of all directors, so he estimates, though it violates the “best City etiquette”.⁸² He would require disclosure, in prospectuses, annual reports and the like, of the affiliations of the various directors and the general rôle each was expected to fill on the board. On the problem of the interlocking directorate he would apply a “persistent course of treatment rather than the root and branch method of wholesale surgery”⁸³ — the latter being a method apparently more in vogue here than in England. Specifically, he would not abolish them but would require full disclosure of all conflicting interests — at elections, in prospectuses, in annual reports, and the like. And for the benefit of directors he would require the auditors to send to each director, prior to the meeting at which the directors were to consider and pass on the annual reports and accounts, a statement of affairs. This statement would be in sufficient detail to

⁸¹ His insistence for such disclosure apparently has met with considerable opposition in England. The criticism was of the same cast as that directed against the comparable provision of our Securities Act, that it would disclose valuable information to competitors. Mr. Samuel's reply is that the competitors already know everything there is to know about each other's employees “even down to the Christian name of the Jewish office boy” and that the real basis for the opposition is to “prevent high fees being made a target of criticism by unappreciative shareholders”. *SHAREHOLDERS' MONEY* 160-64.

⁸² *Id.* at 168.

⁸³ *Id.* at 191-92.

permit an intelligent appraisal and analysis of the affairs of the company. He feels that if such practices had been in vogue in recent years the collapse of several of the large English companies might have been avoided.

Certainly the domain of regulation by means of publicity is considerable. Many of the matters for disclosure urged by Mr. Samuel are relevant to directorships in this country. And there are many more. The simple device of publicity has been practically unexploited by us as a method of control,⁵⁴ though it has been urged for years by leaders of the legal and business professions.⁵⁵ And as we refashion in this transitional stage the devices for control of the corporation, we should vitalize the annual report to stockholders. We should employ it as the medium for disclosing not only the true condition of affairs of the company but also the activities of the managers and the board in relation to the shareholders' money. In the past it has been too much of a palliative for the anxious. It has been distinguished for its vagueness and generality and for its capacity to conceal and suppress vital facts. In the future it should be distinguished for the unhesitant manner in which it makes disclosures and sets forth information. That simple expedient will go far as a corrective of conditions which have been constantly recurring in our corporate history. Its prophylactic effects will equal in importance any other single measure which can be adopted.

There is also a small domain for regulation by prohibition.⁵⁶

⁵⁴ Professor Frankfurter, in speaking of the use of publicity in connection with the Securities Act, has aptly said: "The Securities Act is strong insofar as publicity is potent; it is weak insofar as publicity is not enough. Publicity is especially effective when a broad sales effort is under way. The existence of bonuses, of excessive commissions and salaries, of preferential lists and the like, may all be open secrets among the knowing, but the knowing are few. There is a shrinking quality to such transactions: to force knowledge of them into the open is largely to restrain their happening. Many practices safely pursued in private lose their justification in public. Thus social standards newly defined gradually establish themselves as new business habits." *The Federal Securities Act: II* (1933) 8 *FORTUNE* No. 2, 53, 55.

⁵⁵ *BERKE*, *op. cit.* *supra* note 43, c. IX; *RIPLEY, MAIN STREET AND WALL STREET* (1927) c. VII; *BRANDIS, OTHER PEOPLE'S MONEY* (1913) c. V.

⁵⁶ Mr. Samuel covers the following matters by methods of outlawry: (1) He would disqualify as directors or other managers not only those who had been adjudged bankrupt, but also those who had been directors of companies wound up compulsorily by the court, unless consent of such court were obtained. (2) He

Under the Banking Act of 1933 several such measures were adopted. Thus, interlocking directors and officers between member banks and investment houses are prohibited.⁵⁷ Such interlocking interests are also prohibited with companies which make certain types of loans to persons other than their own subsidiaries.⁵⁸ Also, loans by any member bank to its executive officers are banned.⁵⁹ In the field of industrial corporations prohibition of loans to officers and directors may also be desirable. Other matters, such as prohibition of certain types of profit-sharing plans and limitation in the size of boards, may be similarly handled. But by and large the rôle of regulation by prohibition will remain relatively slight.

Publicity and prohibition alone are too feeble for the task at hand even when they carry adequate enforcement machinery. The development of legal and equitable devices of a preventive and compensatory nature for the better protection of the rights of minorities will still be necessary. In this connection some of Mr. Samuel's suggestions will be of interest to students of American corporation finance. First, he would legislate into the law of England the doctrine that directors are trustees and that the corporate powers are powers in trust—a rule of law pretty well rejected under the common law of England and the present Companies Act. Of greater prophylactic importance, however, are his preventive measures of control. To assure greater power to

reviews the sad state of affairs existing as a result of the liberal dividend policy of many corporations—a policy dictated by the desire to keep stockholders placated and to make new financing easier by keeping the "flag of prosperity flying bravely at the mast". Among other things, he would prohibit the payment of dividends, when the paid-up capital was not intact, without an extraordinary resolution of each class of shareholders and the consent of the trustees for debenture holders, or, alternatively, with leave of court. (3) He would outlaw remuneration contracts determined by the rate of dividends paid each year or by the gross turnover of the business. The former he deems particularly vicious and observes that in many cases of business failures such contracts were involved—e.g., Lord Kylsant was the privileged possessor of one. (4) He would raise the qualification shares of directors in public companies to one-tenth of one per cent of the authorized capital or to the sum of £2,000, whichever sum shall be less. And he would prohibit directors in public companies from holding their qualification shares as trustees or nominees for any other person or persons. See *SHAREHOLDERS' MONEY* 143-68.

⁵⁷ See 48 STAT. 194 (1933), 12 U. S. C. SUPP. VII § 78 (1933).

⁵⁸ See 48 STAT. 194 (1933), 15 U. S. C. SUPP. VII § 198 (1933).

⁵⁹ See 48 STAT. 182 (1933), 12 U. S. C. SUPP. VII § 375A (1933).

deal with emergency and extraordinary situations which require prompt action in order adequately to protect the shareholders' interests, he would give each director power to convene a board meeting. To give shareholders and creditors greater protection against nonfeasance and misfeasance he makes two proposals. First, he calls for a statutory power for any shareholder or creditor to bring any such action on behalf of the company, giving the court power to stay the proceeding or to order security for costs if of the opinion that the action is frivolous. He states that due to lack of statutory power, inertia of individual shareholders and creditors, and the expensive procedure of the English court system, suits are now rare. Thus, directors enjoy a large measure of immunity, not only because of the state of the substantive law but as a practical matter. He would also give the Board of Trade power to bring such suits and, in addition, power to investigate the affairs of the company.⁶⁰ In all such cases he would give the court wide discretion as respects costs so that in a proper case an unsuccessful party could be absolved from costs or even recover them from the company. For further protection against the abuses of interlocking directorates he would give the Board of Trade a power, exercisable either at its own instance or at the instance of any interested party, to investigate the prejudicial effect of an interlocking directorate on the interests of the company. On application by the board or by any shareholder or creditor he would empower the court to remove any director who was exercising or was likely to exercise his functions in a manner adverse to the company. He would also give the court power to order, as a condition of the director being continued in office, that the minority whose interests were likely to be prejudiced be given adequate representation on the board. He would in all cases of misfeasance, negligence, or breach of trust brought against any person holding interlocking directorates, place the burden on the defendant to prove that the acts complained of were not prejudicial to the company as alleged. And, finally, he would require bonding of directors, in view of the fact that with the increasing scale of modern financial operations, the sums that may be recov-

⁶⁰ At this point he analogizes to the N. Y. GEN. CORP. LAW (1929) § 61, which gives the attorney general power to bring certain actions in behalf of the state or by the corporation, a creditor, a director, or an officer.

ered against directors will tend to exceed their private fortunes. Hence, he would regard any public company with a capitalization of over £1,000,000 as an "undertaking of a public character" and require bonds in such instances.

These suggestions⁸¹ for preventive control and for reparation and compensation for damages suffered at the hands of directors are exceedingly germane in this country as we currently endeavor to refashion our regulatory devices. As stated above, we start here with the assumption that directors are trustees and that the powers which they exercise are powers in trust. On the whole, those standards are not so high or so strict as to be impracticable in application or unjust in effect. The ordinary sense of fitness, of decency, and of fair dealing is by and large wholly adequate to warn of transgressions. Their harshness in particular cases can be further tempered, not by lowering them but by stating them, within minimal and practicable limits, in a statute. The enforcement of these obligations of trusteeship has two aspects. In the first place, there is the small and isolated investor who needs adequate opportunity for protection against the managers or the board. In the second place, there are the managers and the board who need effective protection against the blackmailer or striker, lest the risks attendant to those business positions prove to be too onerous. Making it easier for the legitimate plaintiff and harder for the illegitimate is a problem which will never be wholly solved, but some progress can be made. In one form or other it means granting to trial courts greater discretion. It involves extensive re-examination and refashioning of procedural devices to admit of more specialized treatment of these types of cases. In some instances it may mean the shifting of the onus of proof, as Mr. Samuel suggests in connection with interlocking directorates, and as has already been done in the Securities Act⁸² in this country. Or it may mean revisions of rules on interlocutory motions and appeals in interlocutory proceedings. Or it may mean greater control over examinations before trial, over motions for stay, dis-

⁸¹ Mr. Samuel carries in an Appendix a Draft Bill which incorporates all of his suggestions in specific form.

⁸² Sections 11 and 12, granting actions of rescission or damages to buyers of securities, contain similar provisions. The changes in burden of proof are discussed in Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 *YALE L. J.* 171, 173 *et seq.*; Shulman, *Civil Liability and the Securities Act*, *id.* at 227.

missal, or consolidation of stockholders' suits. And it certainly would embrace a reconsideration of the control over costs or security for costs.⁶³ These are but a few examples, but they show the range and nature of the inquiry necessary for adaptation of procedural devices to the various types of situations giving rise, on the one hand, to the issue of responsibility of officers and directors and, on the other, to the need of protecting them against impossible risks and burdens which perverted use of the enforcement machinery would entail. Also, progress in the solution of this problem eventually means the evolution of more flexible and adequate administrative controls⁶⁴ so that the domain of regulation will be neither wholly in the courts nor largely *ex post facto*. And for that pervasive administrative control it means the training and development of a professionalized class skilled in the technique of business, the art of law, and the skill of government. To these will fall the task not only of policing business so that the profit motive will be articulated with the public good, but also of assuring to the investor more protection against the malpractices of management than management has supplied to date on its own initiative.

All of these measures, of course, merely check or control rather than cure a fundamental condition which underlies the whole

⁶³ Section 372 of the English Companies Act, 19 & 20 GEO. V. c. 23 (1929), would prove to be extremely useful in many connections. It provides that "(1) If in any proceeding for negligence, default, breach of duty, or breach of trust against a person to whom this section applies it appears to the court hearing the case that the person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as the court may think fit." The section provides further for a declaratory judgment and gives the court discretion as to allocation of costs. It applies to directors, managers, and officers of a company, and to persons employed by a company as auditors, whether they are or are not officers of the company.

⁶⁴ There are in the Federal Securities Act and in the National Securities Exchange Act analogies to Mr. Samuel's suggestion to employ the Board of Trade to protect investors. These relate primarily to the power to make investigations and to prevent or enjoin certain types of practices. The development and increase of these administrative powers should result in the granting of power to bring representative actions on behalf of investors, as Mr. Samuel suggests in case of the Board of Trade.

problem. That condition has been reflected by the amazing absence of social consciousness on the part of directors and business executives and by their lack of any awareness of the implications and results of many practices which flourished in recent years. It has not been so much a matter of depravity and of evil intent as the consequence of cutting as close to the mythical legal line as possible. This lack of social mindedness has not been wholly or largely that of business. It has been equally shared by lawyers.⁶⁵ It has been evidenced by the almost perverted singleness of purpose with which they have championed the cause of their clients, whether it be in the drafting of a deposit agreement, the handling of a merger, the conduct of a reorganization, or the marketing of securities. It resulted in getting accomplished what clients wanted but without regard for the long-term consequences of those accomplishments. That singleness of purpose has been wholly incompatible with the use of these aggregations of capital for either the welfare of the investors or the good of the public. But the social awareness which has been lacking cannot be created by a wish, or by a commission, or by a statute. It is a gradual and slow educational process — as gradual and slow as any break from tradition and as any change in the ethical standards of a group. Accordingly the intermediate legal controls should condition that change and accelerate it, with resort to extreme measures of outlawry and *in terrorem* when mandatory.

III

So, as we move forward towards federal incorporation or as we seek more effective regulation of corporations by the several states, the foregoing matters constitute at least a partial agenda

⁶⁵ A columnist has stated it more popularly as follows: "But just as a fine, natural football player needs coaching in the fundamentals and schooling in the wiles of the sport, so, too, it takes a corporation lawyer with a heart for the game to organize a great stock swindle or income tax dodge and drill the financiers in all the precise details of their play."

"Otherwise, in their natural enthusiasm to rush in and grab everything that happens not to be nailed down and guarded with shotguns, they would soon be caught offside and penalized, and some of the noted financiers who are now immortalized as all-time all-America larcenists never would have risen beyond the level of the petty thief or short-change man." Westbrook Pegler, N. Y. World Telegram, Jan. 24, 1923, at 19.

for the fashioning of adequate legal controls. But they leave the task half done. That is so because they assume a system which is self-enforcing. No such system can be. Investors need a device which will not only assure them of continuous and effective supervision of the board but will also afford them ample protection in times of trouble.

Several measures are immediately necessary for the protection of investors in this connection. All non-voting, qualified voting, or contingent voting shares should be eliminated. A vote should be restored to each share. With this restoration other devices might be adopted, such as cumulative voting, pluralistic voting, or division of stock into blocks, each block electing a specified number of directors and no more. All these schemes would be designed to make it easier and more convenient for scattered minorities to express themselves, and to break up the present concentration of control in the hands of a few.

It must be clear, however, that if we stopped there we would not have moved far from where we are. We would have put a few more effective weapons in the hands of stockholders, but we would not have solved, to any appreciable extent, the problem raised by their lethargy and impotence. The basic fact of absentee ownership remains untouched. The device needed is one which will give these scattered and disorganized investors group strength and power so that they can gain admittance to the councils of business and make their influence felt around the negotiation table or in the courts. Letting each investor look out for himself merely accentuates the conditions giving rise to the need for regulation and makes more likely the recurrence of abuses which have cost the investor so dearly in recent years.

We have several precedents for such an organization, both structural and functional. The first of these is the British Corporation of Foreign Bondholders.⁶⁶ Since its establishment over sixty years ago it has served British bondholders effectively. The history, structure, and *modus operandi* of this organization are too well known here to warrant detailed description. It early avoided the hazards of being on a profit-making basis and by Act of Parliament was established as a quasi-public body. The com-

⁶⁶ Described and discussed in Wynne and Borchard, *Foreign Bondholders Protective Organizations* (1933) 43 *YALE L. J.* 281.

petent and efficient services it has rendered to bondholders where bonds of foreign countries are in default has given it great prestige and influence. It is recognized as being perhaps the leading organization of its kind in the world, with a proud tradition of honesty and competency in serving scattered and helpless bondholders.

But its field of activity is rather limited. Hence, within the last two years another organization has been formed in England to render a service to all investors in British companies. This is the Shareholders Protection Association, organized for competent and respectable patrol duty in the field of finance. It is a company limited by guarantee and without share capital. Membership is open to all shareholders and debenture holders in public and private companies.⁶⁷ Primarily the Association attempts to keep a watchful eye on the affairs of British companies and to investigate alleged abuses. It does not, however, recommend particular investments. In speaking of the need for some such organization the *Economist* recently said:

"We have shown, in earlier articles, that the average shareholding in a British company is small. An analysis of the ordinary share registers of ten large concerns, given in the *Economist* some months ago, revealed that two-thirds of the total shareholders held less than 200 shares each. The proprietors of the average concern are thus a scattered army whose collective strength is difficult to mobilise. Most observers would readily admit that the procedure laid down in the Companies Act tends to become less successful in achieving this objective as the size of a company increases. There is, therefore, a sound economic *raison d'être* for a permanent body to safeguard the interests, not of any special group of shareholders, but of shareholders in general."⁶⁸

Already the Association has a record of considerable accomplishment. During the first six months of its existence it successfully intervened on four occasions to protect the interests of investors under moratorium and reconstruction schemes. Even in the cases in which its immediate objectives were not achieved, the activities of the Association have emphasized its possibilities for service in directing public attention to instances of abuse which

⁶⁷ It was organized in Oct., 1932. The membership fee is 10s. per year.

⁶⁸ *The Stock Exchange, Protection for Shareholders* (1933) 117 *ECON.* 499.

it discovers, or to situations in which legislative modification of the present laws would be desirable. Its possibilities in organizing legal action may prove of inestimable value where other measures prove ineffective.⁶⁹

This is the type of organization which we need in this country for the protection of investors. To date collective action has been taken only in times of crises, and at that stage it was largely for the purpose of salvaging something from the wreck. Organization for purposes of negotiation and prevention have been rare and all too cumbersome and expensive. It will take a permanent and competent organization to give the service needed. It must be organized and must function on a national basis. It must be above suspicion and reproach else it be transformed into a vicious organization of oppression and blackmail. Accordingly, it must have two salient characteristics. First, it must be organized as a quasi-public corporation on a service rather than on a profit-making basis. Second, it must have some form of governmental approval or backing. On the other hand, too close identification with the government would be unwise. The American Corporation of Foreign Bondholders⁷⁰ has never come into being because it was feared that the appointment of the board of directors by the Federal Trade Commission would cause that board to have in the eyes of bondholders and foreign debtors an official aspect.⁷¹ For the same reason, it would be unwise to have the government dominate or control the policies of this organization, but it ought at least to be created as a federal corporation by the Congress and given the respectability and prestige which that would ensure. Eventually the Chairman of the Federal Trade Commission and the Chairman of the proposed National Securities Exchange Commission might have an *ex officio* representation on the board. For the time being it would seem wiser to omit governmental representation.

Such a federal corporation, formed with the view towards broad public service, would be a welcome relief both to business and to

⁶⁹ *Ibid.* And see (1934) 118 ECON. 125. For an earlier expression of the need for some such organization in this country, see BERLE, *op. cit. supra* note 48, at 38-39.

⁷⁰ See 48 STAT. 92 (1933), 15 U. S. C. SUPP. VII § 77bb (1933).

⁷¹ Wynne and Horchard, *supra* note 66, at 283. On the Bondholders' Council, see N. Y. Times, Dec. 19, 1933, at 35; Dec. 22, 1933, at 35.

investors. In some instances it might merely appoint a committee to act, thus enabling investors to get competent and disinterested leadership. In other instances it might move directly. In any case it would assume the primary responsibility for devising the type of procedure necessary for each task at hand. This would be a great advance over our present system. So much of the time castigation of the culprits rather than prevention or reparation is the only relief available. This protective association would serve a high purpose in preventing certain types of actions, in safeguarding certain measures of the management, and in affording real compensation when the proper cases arose. Mobilization of votes and assets would make this possible. The association rather than the management might at times gain real control over the proxy machine. In any event, it would be in a position to make itself heard at annual meetings. And the costs of moving for the protection of investors would be borne by a large rather than a small group. Though the investor would pay for this protection, he would be paying for real service. He will, of course, always pay, and it is merely a question, how much, to whom, and for what? Finally, the mere presence of such an organization in the field would have a profound prophylactic effect on business conduct. If it developed, as it easily can, into a respectable and vigilant organization, management would always gauge its policy by its vulnerability at the hands of such agency. Honest and respectable business would have nothing to fear. In fact, such an organization should prove to be a boon and a comfort to business. Through it management could get a real expression of stockholders' views. The difficulty of mobilizing scattered and lethargic stockholders into action would be greatly minimized.

The range of activity of this organization would not be restricted to protection of stockholders against the board or the officers by gaining control over the proxy machinery, by investigating the affairs of a company, or by other methods discussed above. It would serve as effectively in any case where bondholder, debenture holder, note holder, creditor, or stockholder needed protection. But a consideration of its utility and value is peculiarly germane to the problem of acquiring for the benefit of stockholders further control over the board and the executive

management. With such an agency in the field of finance, the protective devices discussed above would have genuine vitality and usefulness for stockholders. Without some such agency all measures for further regulation will prove to be quite deficient if not wholly illusory. No program can be effective unless the scattered, disorganized, lethargic, and impotent stockholders have some one to think and act for them. Revision of the legal system is only secondary in such a program. No modification or adaptation of the common law can alter the basic factor of absentee ownership. The salient characteristics of any reform program must of necessity be organization and administration.

William O. Douglas.

YALE SCHOOL OF LAW.