GEORGETOWN UNIVERSITY LAW CENTER
WASHINGTON, D. C. 20001

October 5, 1978

Mr. Gordon Macklin
President
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C.

Dear Gordon:

Please find enclosed a copy of the speech Judge Friendly gave, through Ray Garrett, at Buck Hill Falls last May.

Jack Coffee and I want to thank you and Frank for your help, and our lunch, today. It was a very fruitful meeting for us.

We would appreciate if you would send us a copy of the study and the correspondence you described to us.

Sincerely,

Donald E. Schwartz

Talk at Buck Hill Falls

This is going to be a tough talk on a tough subject. The subject is tough because, as will appear, it is rather intractable. The talk is "tough", not, I hope, in the sense that it will be hard to understand, but in the sense of being a bit hard boiled or at least seeming so. By the time I have finished Bill Cary may think he was seriously mistaken in suggesting in his Yale Law Journal article that I was a forward looking federal judge who had shed his Wall Street clothes when he donned the judicial robe. Perhaps I have been a sheep in wolf's clothing all these years despite some decisions, like Rosenfeld v. Black, that did not precisely endear me to my many friends on Wall Street.

This is not the speech I had in the back of my mind when Professor Wechsler asked me to talk tonight. The change has come from reading the materials assembled for the California meeting and, most inexcusably, doing some more thinking. Some of you will suspect that I contracted Manningitis on the way to the forum -- Manning, or Manne, or both. Anyway my conclusion is "Festina lente." For those of you whose Italian is no better than mine and whose W.S. Gilbert is not so good, this means "Make haste slowly." Remember that what is placed in the Congressional hopper may bear scant resemblance to what emerges. While we have no veto on the hopper, we are not obliged to set it in motion or to accelerate its pace if we are fearful what the result will be. Of course, when I read what will be said here, I may change my mind concerning much of what I shall say tonight. But knowledge I have gained of myself over a considerable time suggests that this is unlikely.

At some time I should define what I am talking about when I refer to a corporation, and this had better be sooner rather than later. For the sake of familiarity, let us take

the test for required registration proposed in the ALI Federal Securities Code, a company with at least $1,000,000 of total assets and 300 security holders. For my part I would move up the asset limit for the purposes of what we are talking about but the definition will serve for the purposes of discussion.

A more important preliminary for informed discussion of the governance of a business corporation -- I hope someone will tell me sometime what is the difference between governance and government -- is to decide what the purpose of such a corporation is. It is fashionable these days to seek out the original understanding. Professor Rawls in his much discussed, if probably little read, book, A Theory of Justice, for which someone has now kindly provided a "trot" as we used to say, is certain that the founders of society, mercifully cloaked by the "veil of ignorance" agreed that

> All society primary goods -- liberty and opportunity, income and wealth, and the bases of self-respect -- are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favored.

Some are not so certain about this; they think a few selfish fellows might have been willing to take a chance on coming out a lot more equal than others even at the risk of becoming less so. However all this may be, there is no mystery about the original understanding of the business corporation today. Many of us have participated in forming them. The purpose of the founders I have known was always the same -- to make money. Not to improve race relations in South Africa or even in South Carolina, not to provide fairer trails or end political imprisonment in the Soviet Union, but to make money through operations conducted in conformity with the law. In other words I am an unequivocal endorser of Milton Friedman's much criticized remark, "the business of business is business."

Let me throw up a few protective walls before the stones start coming. I have already mentioned a very important one. The objective is to make profits through operations conducted in conformity with "the law." By "the law" I mean all sorts of law -- those most interesting of all laws, namely the ones about issuing securities, the laws against unfair competition and restraint of trade, the law of labor relations, the laws protecting consumers, environmental laws, tax laws, etc., etc. Moreover, the corporation should not approach its task of conforming to the law in a niggling spirit. While a corporation need not decide every doubtful legal question against itself, I do not condone behavior, which our court recently condemned in no uncertain terms, whereby a great national corporation persists in asserting its right to be heard in case after case with respect to conduct which the courts have repeatedly condemned. Indeed a corporation may legitimately choose on strict business grounds to do more than the law requires of it. A manufacturer may give longer and better warranties, may do more than avoid discrimination against minorities (unless perhaps it thus discriminates against majorities), cease operating in South Africa, make large charitable contributions, etc., if it honestly thinks this is better for its business. It may think this just because it believes continued controversy is not worth the price. However, that is the test and the only test that conforms to the original understanding. If government wants the corporation to do more than obey existing law, the remedy is to change the law. As Al Sommer said in California:

> . . . using the corporation laws to correct either the deficiencies of present legislation or deficiencies in enforcement is to seek remedy in the wrong place. The right way to correct these deficiencies, quite simply, is by tightening up the laws, if they are too loose; by substituting new laws if the old ones are conceptually inadequate; and by stepping up enforcement with a larger commitment of money and people if the fault lies there.

Acceptance of even this brief analysis seems to me sufficient to eliminate some proposals that have been advanced. One is for board representation for a variety of interests which the corporation affects -- labor (which thus far wisely does not seem to want this particular goody), consumers, suppliers, minorities, communities where the corporation has plants, breathers of air and drinkers of water, etc. Apart from other formidable difficulties -- how many, how to choose, conflicts of interest among themselves, etc., the basic objection is that of conflict, or at least difference, of interest between the putative board member and the stockholders whose investment he is bound to protect and further. The consumer wants the lowest price that will permit continued production; the business of the corporation is to charge the price that will maximize profits over the long term within the limits of the law. A supplier has a legitimate interest in having a corporation continue an operation that produces profits for him and jobs for his employees even if the operation is certain to run at a loss; the corporation's interest is to close it down, with whatever severance pay obligations this may entail. If one wants to aggravate the already desperately serious problem of inadequate capital formation by American business, nothing could be better than this proposal for board representation for all sorts of interested groups.

My fears on this score are so great as to lead me not only to oppose this particular proposal but also to take a negative view with respect to federal incorporation and even, although with somewhat less conviction, about minimum federal standards, which I once favored. While I have faith in Congress sufficient to believe that such proposals would ultimately be rejected, they would attract support large in sound if not in volume and would be heavily lobbied for. At least at this moment our economy should not be subjected to years of uncertainty on this subject -- not

to speak of the disastrous possibility of a wrong result -- unless the opportunities to deal in other ways with such evils as we have are less than I think them to be.

Professor Eisenberg has brilliantly exposed how far the realities of corporate governance depart from the myth. The myth is that the stockholders function as a democracy and elect the directors; that the directors function as a legislature, set corporate policy, and carefully monitor the results achieved by the managers; and that management functions, much as does the chief executive of a state or the United States, by seeing that the laws made by the directors are faithfully executed, proposing new ones, and regularly reporting on the state of the corporation. In fact, except for the rare proxy contest, the election of directors is a formality, and the directors are chosen not by the stockholders but by the management and themselves. Moreover, directorial oversight has likewise been a myth and approval of management proposals a foregone conclusion, at least until very recently and subject to some exceptions where a director represents a large financial interest or the corporation is on or has passed over the brink. Professor Eisenberg rightly points out that such a "skew between the legal and working models of management structure" is bound to lead to trouble.

If you are not already familiar with Professor Eisenberg's proposals to deal with this dysfunction, you will be -- or ought to be, before you leave. Broadly speaking, and limiting myself to day-to-day management rather than structural changes such as mergers and takeovers which are too complicated for an after-dinner speech, he thinks there are ways in which we can make the board live up better to its important functions of monitoring management performance, passing on management proposals, firing the chief executive officer, CEO in the convenient acronym, and selecting his successor when he passes from the scene in this or a more

conventional fashion -- in either case loaded down with fringe benefits to delight the heart -- at least his heart.

The key element in the Eisenberg proposal is that a "clear majority" of the board be independent of the management. I agree with this both in its affirmative position and in its not insisting that all or all but one of the directors be so independent. I believe the presence of two or three other management directors, especially if they are old enough not to be candidates for further advancement, is a good thing, not so much because they will often speak out against the management at a board meeting, but because their sitting at the table restrains the CEO from bending the long bow too far. The expression of the eyes and the possibility of a pre or post meeting cocktail should not be disregarded. To be sure, some of this advantage could be obtained by having them present without their being directors, but if they are directors, others will be more inclined to inquire why they are not present at a particular meeting. The requirement of a "clear majority" of independents is rather inconsistent with the provision of § 10(a) of the Investment Company Act requiring only 40% in a situation far more ridden with conflict of interest potential than the ordinary business corporation, which to my regret, would be continued by the proposed Federal Securities Code. But that shows only that the Investment Company Act is wrong and Professor Eisenberg is right. I also agree with his proposal that any person "who has a professional relationship or material business dealings with the corporation, or any close relatives of such persons, must be treated as non-independent" -- although I am not altogether sure that a partner in a law firm that would like to get the company's business is all that more independent than a partner in one that had it; he may sometimes be less.

I would go further than Professor Eisenberg in one respect. I would place a strict limit on the number of directorships that may be held. There might be one number, say two

outside directorships, for persons currently employed on a full time basis, and a higher one, say five, for persons who are not, primarily retired persons. Writing this during the proxy season, I have been struck by the confirmation of what I already knew -- the number of directorships which persons who supposedly are fully employed seem to think themselves qualified to fill. The proxy statement of a three billion dollar company, the largest in its industry, discloses that one candidate, a partner in a law firm which is not the company's counsel, is a director of five other companies. These include one of the country's largest life insurance companies, the largest manufacturer of electrical equipment and a leading bank, in addition to the three billion dollar industrial which I shall not name. Another candidate to guide the destinies of this large company is the CEO and a director of a great pharmaceutical manufacturer, and also a director of the country's third largest bank and of its largest automotive manufacturer. It seems to me simply impossible that these people -- and I am not suggesting that the two I have mentioned depart markedly from the norm -- can discharge their primary responsibilities and their civic duties and still have time or desire to fulfill the arduous tasks that Professor Eisenberg would impose upon them for so many companies as they do. I am not disturbed over the prospect that such a restriction would make the available pool too small. Professor Eisenberg has estimated that the number of seats required to be filled is in the neighborhood of 15,000 to 16,000. The CEO is not the only person in a company who would make a good independent director in another, although seemingly he thinks so. Moreover, I would not reject so cavalierly as Professor Eisenberg does, the extensive use of retired persons which he fears would create "a corporate gerantocracy" in defiance of the present trends to compel early retirement. Apart from the fact that the trend seems to be changing, the fact that it may be sound policy to be able to get rid of persons over a certain age as a class does not establish that a carefully selected few may not have enough life in

them to be excellent directors, particularly since the exposure is limited to one year at a time. Immodestly I think I would be quite a good director even at my advanced age. This is not an ad since the canon of judicial ethics forbid.

Professor Eisenberg is also right in noting that no matter how high the quality of such a reconstituted board may be, its effectiveness is limited by the information flow. Most corporations that I have known content themselves with comparison of the current year with the preceding one or several preceding ones; if things have not gotten worse, and there are always explanations when they have, apparently there is no cause for concern. Apart from questions of consistency in accounting, this may not be true at all. Such figures should be complemented with comparative figures concerning other companies in the same line of business, but for a multitude of reasons, such figures are hard to get, except in regulated industries, even if management wants them, which it often does not. I think Professor Eisenberg overrates how much can be done to cure these problems by vesting the decision among competing accepted accounting principles in the independent accountants even if I were surer than I am that the position is sound. I do agree with his proposal for an audit committee composed wholly of independent directors, in which the board's power to recommend the nomination and dismissal of the accountants shall be vested, although, here again, I am not so sanguine as he that this will produce much except in truly flagrant cases and perhaps in the shape of fuller disclosure, with attendant opportunities for financial analysts. Also I think the directors would be greatly helped in passing on policy proposals if management were required to present a detailed set of pros and cons, much as is done in presenting matters to members of the cabinet or to the President. Sometimes the job of preparing such a memorandum will cause the pros to become cons and vice versa, as judges know all too well from the opinion that will not write.

With respect to the nomination of directors, I agree with the proposal to vest this in the independents, again without believing that much will happen as a result. At the moment I am unconvinced that opening up the management's ballot to candidates nominated by stockholders is a game that is worth the candle.

In sum, therefore, Professor Eisenberg and others have produced a set of proposals, with most of which I agree, that can be expected to provide considerable, although modest, improvement in heightening the efficiency of corporate management and protecting investors in connection with structural change. Yet I would not now favor attempting to accomplish this by legislation both for reasons earlier elaborated and because I think almost everything which is described can be accomplished under powers which the Securities and Exchange Commission already has over stock exchange rules under §§ 6(b) and 19(c) of the Securities Exchange Act as amended in 1975. These now allow exchanges to promulgate and empower the SEC to force them to promulgate whatever rules are necessary to protect investors and the public interest. The exchanges are free to promulgate and the SEC to force them to promulgate rules that will deny listing or refuse continued listing to companies that do not comply with proposals along the lines I have been discussing. The New York Stock Exchange and the SEC have already taken some halting steps in the directions advocated by Professor Eisenberg. They should take more.

The great advantage of moving in this manner, apart from avoiding the risk of harmful legislation, is that it can be done gradually and experimentally. It is not necessary, perhaps not advisable, to make all of Professor Eisenberg's reforms at once. Of course, a statute also can be amended but Congress cannot realistically be expected to give serious attention to an area such as this more than once in a decade. The only objection I see to proceeding in this way

is that it would not reach unlisted companies. However, if the changes worked well, such companies, or at least the larger ones that would come within the proposed registration requirement, would generally be forced to adopt them as a competitive measure. Moreover, I have not considered what additional sources of powers the SEC might find in § 14 of the 1934 Act. I think Professor Cary has objected somewhere that attempts to get at the problem of corporate mismanagement by using SEC rules detract from the legislative process. While I understand the point, I see no real detraction in using tools that Congress itself has provided -- even perhaps in a way that it did not anticipate. I once wrote in an opinion that

> If Representative Rayburn would be surprised to learn what he had wrought with respect to misuse of corporate assets in the sale or purchase of securities, as we think he would be, this would not be the first occasion where statutory language has had a generative power going beyond what was in the forefront of the minds of its sponsors.

That is pretty good, and I will stick with it.

I therefore would advocate not donothingism but caution. We need not do everything at once. Beyond this we must always remember that the sharpest blade for the improvement of corporate management that has been forged in the last score of years is the takeover bid. While understanding the reasons, I therefore regret that Professor Loss somewhat moderated the strong preemption of state laws on this subject contained in earlier drafts of the Federal Securities Code. There have, indeed, been cases where management's resistance to an initial tender offer has provided higher rewards for stockholders, and some leeway to accomplish this should be afforded. But I suspect that, on balance, strengthening the position of management has worked the other way. Certainly no clearer instance of potential conflict of

interest can be seen, and providing a clear majority of independent directors should help in this area most of all.

Having said all this, I dispatch you to more pleasant pursuits.