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Sovereignty Over Corporate Stock

Lyman P.Q. Johnson

Washington and Lee University School of Law, johnsonlp@wlu.edu

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SOVEREIGNTY OVER CORPORATE STOCK

LYMAN JOHNSON*

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* Associate Professor of Law, Washington and Lee University School of Law. B.A. 1973, Carleton College; J.D. 1978, University of Minnesota. The author wishes to thank David Caudill, Paul N. Cox, and David Millon for their comments on earlier drafts of this article, and also Denis Brion for several discussions about certain ideas contained in it. Financial support was generously provided by the Frances Lewis Law Center of Washington and Lee University.

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I. INTRODUCTION

There are few things which rouse people like a good turf war, especially when the feud erupts between two neighbors who have jointly worked a patch of ground for decades. As long as both landowners trust that they labor in harmony, neither may know or particularly care where the boundary lies. But once agreement on the use of the property dissolves, and ill will sets in, apathy about the border gives way to a consuming zeal for a fixed and favorable dividing line. Renewing faded claims to the contested plot of land, the estranged disputants covet the clearest badge of property ownership: power to exclude the other and sole dominion.¹

The Securities and Exchange Commission (SEC) has just lost a key battle for legal turf.² The United States court of appeals vacated the SEC's so-called "one-share, one-vote" rule,³ thereby dealing federal law its third major setback in a boundary war dating back to the 1960s.⁴ The SEC's adversary is state corporation law, and the disputed "property" is regulatory hegemony over corporate stock. Victory for state law has earned it the usual prize of a territorial conquest: power to oust federal securities law as an equal source of influence over the shifting contours of stock ownership. States, not the federal government, now have the decisive say on what it means to own a share of stock in American corporations.

1. Cohen, *Property and Sovereignty*, 13 CORNELL L.Q. 8, 12 (1927) ("[T]he essence of private property is always the right to exclude others.").

2. *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

3. Voting Rights Listing Standard; Disenfranchisement Rule, 53 Fed. Reg. 26,376, 26,394 (1988) (codified at 17 C.F.R. § 240.19c-4 (1990)).

4. See *infra* text and accompanying notes 112-21, 200-16 & 240-50 (discussing *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (rejecting the application of Rule 10b-5 to "short-form mergers" carried out under Delaware law); *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987) (holding that Indiana's control share acquisition statute was constitutional and not preempted by the Williams Act); *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (rejecting SEC authority to regulate voting rights under § 240.19c(4) of the Securities Exchange Act of 1934)).

For many decades the claims of federal securities law (as regulator of interstate commerce in stock) and state corporation law (as prescriber of stock's substantive property rights) overlapped but peacefully co-existed.⁵ Recent events,⁶ however, have severely strained—if not shattered—this tacit accord on joint control. The breakdown does more than highlight the vast degree to which these two regimes intersect, significant as this is in revealing the scope of the disputed legal terrain. It also exposes surprising disagreement on the core question of what attributes attach to (and can be detached from) corporate stock.

The latest skirmish—over the one-share, one-vote issue—can only be understood as one manifestation of this deeper controversy, a controversy with profound implications not only for the perennial state-federal tug-of-war but also for the striking way in which corporate stock, the quintessential species of property in a capitalist society, is now being redefined by state lawmakers. This reformation touches more than shareholders, and implicates ideas and concerns extending far beyond the blinkered field of corporate law.⁷ It signifies, first, that legal power *over* the structural make-up of corporate securities rests not with the federal government but with states. It also stunningly realigns power *within* corporations in a way that dramatically scales back the traditional voting and alienability prerogatives of the shareholding function.⁸

These twin outcomes constitute nothing less than a major upheaval in contemporary corporate law in the United States. The outcomes are all the more intriguing because they stand in marked contrast to events unfolding in Western Europe. It is there that twelve sovereign nations are relinquishing centuries of autonomy over commercial affairs in quest of greater economic and political

5. See *infra* Part II.

6. The most notable event has been the response of state law to hostile takeovers. See *infra* notes 177-215 & 265-71 and accompanying text.

7. For a critique of contemporary corporate law's narrow focus on the shareholder-manager relationship, see Coffee, *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990); Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865 (1990).

8. The beneficiaries of state efforts to constrict shareholder claims on corporate activity are various enterprise-dependent noninvestor interests, including management. See Johnson & Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846, 848-51 (1989).

unity⁹ and, in doing so, are displaying special solicitude for the interests of capital providers.¹⁰ The American trend of empowering

9. Adoption of the Single European Act of 1986, Feb. 28, 1986, 30 O. J. Eur. Comm. (No. L 169) 1 (1987), represents an effort to revive and hasten the process of European integration begun many years before. Treaty instituting the European Coal and Steel Community, Apr. 18, 1951, 1988 Gr. Brit. T.S. No. 49 (Cmd. 455) 7, 261 U.N.T.S. 140; Treaty establishing the European Economic Community, Mar. 25, 1957, 1988 Gr. Brit. T.S. No. 49 (Cmd. 455) 82, 298 U.N.T.S. 11; Treaty establishing the European Atomic Energy Community, Mar. 25, 1957, 1988 Gr. Brit. T.S. No. 49 (Cmd. 455) 225, 298 U.N.T.S. 1672. See Riesenfeld, *The Single European Act*, 13 HASTINGS INT'L & COMP. L. REV. 371 (1990) (discussing the Single European Act). Although the scope of economic unification still remains controversial—e.g., whether and when a single currency will be used—even greater debate will ensue as the issue of political unification is pursued. Compare Kiefer, *Kohl Looks to German, European Unity*, The Christian Sci. Monitor, Dec. 4, 1990, at 1 (“More than ever, we’re ready to transfer sovereign rights to the European Community . . . We’re working further on the goal that unites us with our European friends—namely, the building of the United States of Europe.”) (quoting German Chancellor Helmut Kohl) with Wolf, *The Howe Resignation; Limits Defined Precisely in Treaties That Underpin EC—Sovereignty*, Fin. Times (London), Nov. 3, 1990, at 8 (“The EC cannot dissolve the national parliaments; but national parliaments can revoke the treaties and dissolve the EC. Thus, national parliaments remain sovereign.”).

10. In December, 1989 the European Communities Council adopted a merger control regulation aimed at facilitating governmental clearance of mergers having a “Community dimension.” Council Regulations (EEC) No. 4064-89, Dec. 21, 1989, 32 O. J. Eur. Comm. (No. L 395) 1 (1989) (on the control of Concentrations Between Undertakings). See De Smedt & Vandersanden, *The EC Merger Control Regulation*, 13 HASTINGS INT'L & COMP. L. REV. 437 (1990) (describing the merger regulation); Kennerley, *Europe's Myriad Merger Rules*, Fin. Times (London), Sept. 27, 1990, at 32 (critiquing merger regulation as not achieving the goal of “one-stop” review of proposed mergers).

With specific regard to takeovers, in February, 1989 the European Commission issued a Proposal for a 13th Council Directive on Company Law Concerning Takeover and Other General Bids. 32 O. J. Eur. Comm. (No. C 64) 8 (1989). As with the merger control regulation, the aim of the directive is more uniform regulation of cross-border hostile takeover bids. As of mid-1990, the proposed directive is still before the European Parliament for an initial reading but has not yet been placed on the agenda. See Greenbaum, *Tender Offers in the European Community: The Playing Field Shrinks*, 22 VAND. J. TRANSNAT'L L. 923 (1989) (describing and discussing the proposed directive). See Godden, *Threat of Takeover Directive*, Fin. Times (London), July 12, 1990, at 40 (critiquing the takeover directive by a former Secretary to the British Takeover Panel). In May 1990, the European Commission endorsed an initiative to limit use of “poison pill” takeover defenses. See Common Mkt. Rep. (CCH), May 24, 1990, at 8. A separate new directive on takeover defenses is not expected. Instead, existing legislation, probably the already-proposed directive on takeover bids, will be amended to limit deployment of various defense measures. *Id.*

All of this regulatory activity is the result of a favorable opinion of acquisition and takeover activity, a position summarized by Herr Martin Bangemann, the EC

states to advance various noninvestor goals by demoting shareholders is, therefore, not only apparently at odds with that in Europe, it seems to represent a step back to the very political fractionalization and imbedded social democratic practices Europe is moving to curtail.

This international dimension to corporate governance thus offers an instructive comparative vantage point on the American turf clash. But in a global economy it also raises another worrisome question: "Who has it right, we or they?" Answering this question demands, in turn, a fresh willingness to assess what financial, social, and political interests are truly at stake in this furor over the evolving property rights of corporate stock. It will not be resolved by curtly ruling certain inquiries as out of order. Thus, a dogmatic clinging to models of corporate affairs in which shareholders persist as the centerpiece of analysis needlessly hives off the concerns of capital providers from those of other corporate claimants.¹¹ Tired accounts of developments in state corporation law as representing the worst in benighted parochialism, regulatory capture,¹² management entrenchment, and as blocking attainment of the loftier goals of investor protection, market liquidity, efficiency in resource use, and international competitiveness, will also do little to advance debate on this matter.

It is necessary to puncture key axioms of corporate orthodoxy and probe beneath the surface allure of conventional claims about the degenerate condition of state law. Nothing less than a re-examination of the linkage between the norm of shareholder pre-eminence and the realization of important social and economic goals is in order.¹³ Doing so requires a frank appreciation that the many

Commissioner for Industry and the Internal Market: "Takeover bids should be viewed in a positive light, in that they encourage the selection by market forces of the most competitive companies, and the restructuring of European companies, which is indispensable to meet international competition." Guilford, *EC Ban on Poison Pill Tactics*, *The Times* (London), May 9, 1990, § 2, at 1.

11. See Johnson, *supra* note 7, at 878-98.

12. For commentary on the political nature of state antitakeover statutes, see Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635 (1988); Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365; Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467; Macey & Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987); Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

13. In a series of articles, this author and David Millon have sought to question the tightness of the connection between shareholder primacy and various social and economic goals. See Johnson, *Corporate Takeovers and Corporations: Who Are*

entitlements customarily associated with corporate stock, such as equal voting rights and unfettered alienability, are not inherent, essential, and unalterable, but are deliberately constitutive, historically situated, provisional, and contestable. Accordingly, the various incidents that together comprise corporate stock as we know it can be legally unbundled, some to be retained while others are pruned or discarded. At the close of the twentieth century, into which of these categories should equal voting rights and other well-known features of corporate stock be placed? And, as always in our system of federalism, the companion issue of whether state or federal government should tackle such a foundational matter as the reformulation of corporate stock, and toward what ends, must be confronted. These are the rudimentary questions that lie behind discourse about corporation and securities law, a discourse which, in the end, is all about public control of private capital. These questions are enormously vexing. It is best to make them explicit.

Part II of this article relates the way in which for years federal and state law mutually and harmoniously regulated corporate stock. Cooperation was possible not because the fabric of corporate stock is innate and immutable, but because the regulatory objectives of each regime were well-served by the particular aggregation of attributes then composing corporate stock. Part III describes the reasons why cooperation broke down. It examines three issues spanning a twenty-year period that denote both the crumbling of shared assumptions about the desirability of certain traits of corporate stock and the gradual (but ultimately decisive) recognition that dominion over the substantive features of corporate stock is securely lodged in

They For?, 43 WASH. & LEE L. REV. 781 (1986); Johnson, *supra* note 7; Johnson, *The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct*, 14 J. CORP. L. 35 (1988) [hereinafter Johnson, *Eventual Clash*]; Johnson, *State Takeover Statutes: Constitutionality, Community and Heresy*, 45 WASH. & LEE L. REV. 1051 (1988); Johnson & Millon, *The Case Beyond Time*, 45 BUS. LAW. 2105 (1990) [hereinafter Johnson & Millon, *Case Beyond Time*]; Johnson & Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862 (1989) [hereinafter Johnson & Millon, *Misreading The Williams Act*]; Johnson & Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846 (1989); Millon, *State Takeover Laws: A Rebirth of Corporation Law?*, 45 WASH. & LEE L. REV. 903 (1988); Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201 [hereinafter Millon, *Theories of the Corporation*]. For recent responses to these articles, see Booth, *State Takeover Statutes Revisited*, 88 MICH. L. REV. 120 (1989); Cox, *The Indiana Experiment in Corporate Law: A Critique*, 24 VAL. U.L. REV. 185 (1990); Garfield, *Evaluating State Anti-takeover Legislation: A Broad-Minded New Approach to Corporation Law or "A Race to the Bottom"?*, 1990 COLUM. BUS. L. REV. 119.

state rather than the federal government.¹⁴ The one-share, one-vote decision is the culmination of this development.

Part IV of the article discusses how the settling of this long struggle for sovereignty over corporate stock has now laid the groundwork for truly revisiting the normative issues that lurk behind (and often are masked by) this jurisdictional conflict. It contends that the very fact of struggle over warring notions of corporate stock reveals the faint stirrings of a significant transformation in popular belief and institutional practice in a distinctly mature capitalist economy. The task of ascribing features to corporate stock is, in short, different in a highly-developed society than elsewhere. We are not especially well-equipped, either in institutional practices, nomenclature, or patterns of thought, for this task. But at least we can see that there is not just one template with which common stock can be designed. Therefore, neither historic conventions in our own society nor events in less capitalistic societies, whether European or otherwise, are, standing alone, a reliable measuring rod of, or blueprint for, these changes. Instead, the challenge is to devise a strategy for addressing the fabric of corporate stock under particular, and ever-changing, social circumstances, and over the long haul. This strategy must be sensitive both to the reality of renewed muscle-flexing by institutional investors¹⁵ and to the rising expectations of non-investor claimants,¹⁶ two deep trends destined for prolonged tension. The article concludes that, on this score, continued deference to state authority is a better strategy than federal preemption for prolonging debate over, and coming to grips with, the possibilities and pitfalls associated with the task of reconciling these competing demands on the corporate institution.

II. COMMON GROUND

For the most part, state corporation law and federal securities law operate in distinct realms and do not overlap. But in one critical

14. See cases cited *supra* note 4 (listing the seminal cases that have dealt federal securities law major setbacks in control over stock ownership in America).

15. With the apparent demise of hostile takeovers in the United States, institutional investors such as pension funds, banks and insurance companies are asserting their views on matters of corporate governance with great vigor. See Anderson & Bullitt, *Institutional Activism—The Shareholder Proposal and the Role of the Institutional Shareholder in a Proxy Context* in TAKEOVERS—OPERATING IN THE NEW ENVIRONMENT, ALI-ABA COURSE OF STUDY MATERIALS 171 (Nov. 29-30, 1990); Dickson, *Investors Wake Up to Their Power*, Fin. Times (London), Dec. 3, 1990, at 18.

16. Millon, *Redefining Corporate Law*, 24 IND. L. REV. ____ (1991).

area, i.e., oversight of the stockholding function, these two regulatory schemes address the same subject matter. In a sense, stock is an inhabitant of both regimes. Even here, however, state and federal law have historically policed different dimensions of corporate stock and each has done so in a way that respects and reinforces, rather than competes or conflicts with, the efforts of the other. Among other matters, for example, corporation law provides for the authorization,¹⁷ issuance¹⁸ and redemption¹⁹ of shares of capital stock. It spells out the issues on which,²⁰ and the procedures by which,²¹ shareholders, directors, and officers are empowered to act. It also delineates the steps to be followed for taking various unusual actions such as amending articles of incorporation²² or bylaws,²³ and conducting a merger,²⁴ asset sale²⁵ or dissolution²⁶ of the enterprise.²⁷ Much of this structural architecture is enabling rather than "regulatory" in its thrust.²⁸ None of it is dealt with in federal securities law.

On the other hand, the Securities Act of 1933 mandates that corporations disclose detailed information to prospective investors in connection with the initial distribution of securities.²⁹ Likewise, the Securities Exchange Act of 1934 requires that companies with securities registered under its provisions³⁰ periodically disclose material

17. *See, e.g.*, Revised Model Business Corp. Act (RMBCA) § 6.01 (1984).

18. *Id.* §§ 6.03, 6.20-.28.

19. *Id.* § 6.31.

20. *See, e.g., id.* §§ 7.28, 8.03 (election of directors by shareholders); § 8.40 (appointment of officers by directors); § 8.41 (duties of officers).

21. *Id.* §§ 7.20-.28 (shareholder voting procedures); §§ 8.20-.25 (actions by the board); § 8.42 (conduct by officers).

22. *Id.* §§ 10.01-.09.

23. *Id.* §§ 10.20-.22.

24. *Id.* §§ 11.01, 11.03-.07.

25. *Id.* § 12.02.

26. *Id.* §§ 14.01-.33.

27. For a comprehensive treatment of the various rights, powers and duties of shareholders, directors and officers in the modern corporation, see M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* (1976). *See also* R. CLARK, *CORPORATE LAW* (1986).

28. *See* Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989) (describing and normatively assessing what Professor Eisenberg calls "enabling," "suppletory," and "mandatory" corporate law rules).

29. Securities Act § 7, 15 U.S.C. § 77g (1988). *See, e.g.*, Form S-1, 17 C.F.R. § 239.11 (1990); Regulation S-K, 17 C.F.R. § 229.10 (1990).

30. Companies must register securities with the SEC if the securities are to be traded on a national securities exchange, Securities Exchange Act § 12(b), 15

information to their shareholders.³¹ As one part of that overarching objective, the 1934 Act confers rule-making authority on the SEC to regulate the solicitation of proxies.³² Pursuant thereto, the SEC has adopted Regulation 14A,³³ the heart of which is a specification of the information to be furnished to security holders in connection with a proxy solicitation.³⁴ Inasmuch as state law requires corporate management to disseminate very little information to shareholders on a regular basis,³⁵ federal law strives to rectify this disparity in knowledge about company affairs. It does so not to imbue shareholders with decision-making authority not otherwise conferred on them under state law, but for the limited purpose of making the exercise of such decisions as are assigned to shareholders under state law better informed.³⁶

U.S.C. § 78l(b) (1988), or if the corporation has 500 or more holders of a class of equity securities and more than \$5 million in assets. Securities Exchange Act § 12(g)(1)(B), 15 U.S.C. § 78l(g)(1)(B) (1988) (codified at 17 C.F.R. § 240.12g-1 (1990)).

31. Corporations must file annual reports, Rule 13a-1, 17 C.F.R. § 240.13a-1 (1990), and Form 10-K, 17 C.F.R. § 249.310 (1990); quarterly reports, Rule 13a-13, 17 C.F.R. § 240.13a-13 (1990), and Form 10-Q, 17 C.F.R. § 249.308a (1990); and current reports, Rule 13a-11, 17 C.F.R. § 240.13a-11 (1990), and Form 8-K, 17 C.F.R. § 249.308 (1990).

32. Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (1988). Under Securities Exchange Act § 14(c), 15 U.S.C. § 78n(c) (1988), Regulation 14C, 17 C.F.R. § 240.14c 1-7 (1990), and Schedule 14C, 17 C.F.R. § 240.14c-101 (1990), a corporation with securities registered under Securities Exchange Act § 12(g) must distribute to its shareholders an information statement and an annual report in connection with an annual meeting at which directors are to be elected, even if the corporation's board of directors is not soliciting proxies.

33. 17 C.F.R. § 240.14a-1 to -14 (1990).

34. Rule 14a-3, 17 C.F.R. § 240.14a-3 (1990) and Schedule 14A, 17 C.F.R. § 240.14a-101 (1990). The federal proxy rules govern various other related matters as well. *See* Eisenberg, *supra* note 28, at 1484-85 nn.116-21 and accompanying text.

35. Delaware's corporate statute, for example, contains no provision requiring annual distribution of financial information to shareholders. *But see* RMBCA § 16.20. Delaware does, however, provide shareholders with a right to inspect corporate books and records. DEL. CODE ANN. tit. 8, § 220 (1983 & Supp. 1989).

36. As stated in the Report of Special Study of Securities Markets: "The keystone of the entire structure of Federal securities legislation is disclosure." Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963). Professor Louis Loss has described the theme of federal securities law thusly: "Then, too, there is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure." 1 L. LOSS, SECURITIES REGULATION 27 (3d ed. 1989). *See also* Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 614 (1964) ("This concern over a free market was based on the theory that, given adequate information, the laws of supply and demand, combined with action by each purchaser for his own best interest, would establish a true market value for the security.") (emphasis added).

Thus, from the earliest days of American corporation law, and long before (and continuing after) passage of the federal securities laws, state law was both the agency by which corporate stock was authorized and issued, and the lawmaking instrument by which its substantive property and governance attributes were prescribed. For example, as a form of personal property, stock is, for the most part, freely alienable.³⁷ Traditionally it can be purchased, sold, gifted, pledged, bequeathed, and otherwise transferred.³⁸ Moreover, the decision as to whether, when and to whom stock should be disposed of is, absent prior agreement otherwise,³⁹ solely that of the shareholder,⁴⁰ and does not require the consent of the corporate enterprise itself, the board of directors or other shareholders. All of this stems from state law.

When federal securities laws were first adopted in the early 1930s, they neither endowed corporate stock with the attribute of alienability nor embellished that feature. Federal law simply took alienability as a given and built its own disclosure scheme upon it. Accordingly, under the Securities Act of 1933, a prospective purchaser of corporate stock must be given specified information by the issuing corporation before stock is offered or sold to him in a distribution.⁴¹ That act, however, says nothing about the characteristics of the stock itself. Similarly, under the Securities Exchange Act of 1934, no person buying or selling stock may commit fraud in connection with a purchase or sale,⁴² nor may various corporate "insiders" buy or sell stock without the prior disclosure of material information.⁴³ The statute is silent, however, about what attributes must occupy the

37. H. BALLANTINE, *BALLANTINE ON CORPORATIONS* 776 (1946).

38. Article 8 of the Uniform Commercial Code-Investment Securities provides a set of rules governing rights and obligations of parties to stock transfers. U.C.C. § 8 (1977). Section 8-105 makes investment securities negotiable, but that attribute is narrower than transferability, a state law property incident apparently assumed, rather than conferred by, the Uniform Commercial Code.

39. BALLANTINE, *supra* note 37, at 775-80.

40. An exception not grounded on consent is the relatively unimportant case of judicial limitations on transferring control blocks of stock to looters and others. *See* *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (N.Y. 1941).

41. *See supra* note 29 (describing the applicable disclosure requirements under the Securities Act of 1933).

42. Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1988); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1990).

43. *See In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911-12 (1961).

stock. For all their notorious complexity, therefore, federal securities laws regulate the *disposition* of corporate stock with a remarkable singularity of focus:⁴⁴ parties to purchase and sale transactions should not be given materially false information or, in certain instances, have material information withheld from them, lest the exercise of their state-conferred power to purchase or dispose of corporate stock be inadequately informed and poorly employed.

The cooperative and mutually reinforcing relationship of state and federal law can easily be seen in the congruent treatment of stock dispositions sketched above. State law originates and defines the substantive features of the property to be transferred (including the very feature of alienability) and federal law supplements (and so honors) that regime by overlaying the further requirement that exercise of such capabilities be preceded by access to meaningful information.⁴⁵ This is not to say federal law does not significantly alter the legal status and entitlements of the stockholder. But federal law does so by complementing the constitutive provisions of state law, not by displacing or dismantling those vital qualities. For federal securities law, the deep historical premise of free alienability formed an indispensable part of the state-drawn legal landscape against which that momentous legislation was enacted in the early 1930s. This does not, however, mean that the trait of alienability was inherently

44. This is not to deny that federal securities laws are complex, or that they regulate many facets of the securities industry, including securities professionals and self-regulatory organizations. My point is simply that with respect to the *disposition* of securities, the regulatory philosophy of federal law is rather straightforward. See Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984).

45. This relationship of federal and state law is not atypical, but in fact is common. It is well-known that federal law

is generally interstitial in its nature. . . . Federal legislation . . . builds upon legal relationships established by the states, altering or supplanting them only so far as necessary for the special purpose. Congress acts, in short, against the background of the total *corpus juris* of the states in much the way that a state legislature acts against the background of the common law, assumed to govern unless changed by legislation.

H. HART & H. WECHSLER, *THE FEDERAL COURTS AND THE FEDERAL SYSTEM* 435 (1953).

See Hart, *The Relations Between State and Federal Law*, 54 COLUM. L. REV. 489, 526-27 nn.138-41 (1954) (giving examples of how federal law draws on, and sometimes assimilates, state law concepts and precepts). An instructive illustration is the area of patent regulation. While the United States Constitution empowers Congress to provide for the issuance of patents, state law "governs transfers of this federal interest and contracts concerning it." *Id.* at 527. See *Luckett v. Delpark, Inc.*, 270 U.S. 496, 510-11 (1926); *American Well Works Co. v. Layne & Bowler Co.*, 241 U.S. 257, 260 (1916).

immutable or politically inviolable; states themselves at any time could truncate free disposition. Rather, it means that federal securities law, unknown before 1933, had furnished none of the guiding principles by which the property attributes of corporate stock—indeed, of the entire corporate milieu—had theretofore been fused. Consequently, the pre-understandings then supplied by state law were so pervasive and ingrained into the regulatory subconsciousness as to be virtually unnoticed. Thus, they went unspoken, unchallenged and undisturbed.⁴⁶ The world designed by state corporation and property law was simply taken for granted.

Another pre-supposed feature of most common stock today is voting rights on various issues. Unlike free alienability, however, which was so historically imbedded as to seem indigenous to corporate

46. As with any assertion about the *unimportance* of various factors in forming law, proof depends on the *absence* of those factors from the visible policy agenda. A review of federal securities law legislative history reveals no congressional concern about the alienability of corporate stock. Concern centered, instead, on various species of fraud and the dearth of accessible financial information. See Knauss, *supra* note 36, at 613-16.

A recent Supreme Court case commenting on the validity of an interpretive approach finding significance in silence is *Tafflin v. Levitt*, 110 S. Ct. 792 (1990). There, the issue was whether state courts had concurrent jurisdiction over claims under the Racketeer Influenced and Corrupt Organizations Act (RICO), Pub. L. No. 91-452, tit. 9, 84 Stat. 922 (1970), *as amended* 18 U.S.C. §§ 1961-1968 (1982 & Supp. 1990). Without dissent, the Court held that concurrent jurisdiction existed. One interpretive issue Justice O'Connor confronted was the significance of congressional silence on the issue of state court jurisdiction when it enacted RICO. She commented on the meaningfulness of that silence as follows:

Our review of the legislative history, however, reveals no evidence that Congress even considered the question of concurrent state court jurisdiction over RICO claims, much less any suggestion that Congress affirmatively intended to confer exclusive jurisdiction over such claims on the federal courts. As the Courts of Appeals that have considered the question have concluded, "[t]he legislative history contains no indication that Congress ever expressly considered the question of concurrent jurisdiction; indeed, as the principal draftsman of RICO has remarked, 'no one even thought of the issue . . .'" Petitioners nonetheless insist that if Congress had considered the issue, it would have granted federal courts exclusive jurisdiction over civil RICO claims. This argument, however, is misplaced, for even if we could reliably discern what Congress' intent might have been had it considered the question, we are not at liberty to so speculate; the fact that Congress did not even *consider* the issue readily disposes of any argument that Congress unmistakably intended to divest state courts of concurrent jurisdiction.

Tafflin, 110 S. Ct. at 796 (citations omitted). Likewise, as to stock alienability. By failing to address the subject, Congress left it alone. It was left where it had always been—in state hands.

stock, by the 1930's corporate suffrage practices had undergone at least two significant changes. The first transformation concerned the question of whether voting power belonged to the *shareholder* or the *shares*. Until the mid-nineteenth century, corporate suffrage was thought to attach to the shareholder, rather than to the stock itself.⁴⁷ Thus, at common law each shareholder had one vote regardless of the amount of stock owned.⁴⁸ This predominate principle of "one person, one vote" derived from partnership law and was grounded on the belief that voice in corporate governance should be unrelated to one's financial stake in a venture.⁴⁹ In providing for weighted voting, early corporate statutes began moving away from the concept of "one person, one vote." By the turn of the twentieth century, the transition was completed and the modern custom of "one share, one vote" had become firmly established.⁵⁰

To understand historical (and cross-cultural) practices on the voting rights subject is thus to appreciate that there is more than one way to allocate voting power within a corporation.⁵¹ Isomorphism is not a part of corporate stock's ancestry. Moreover, notwithstanding the widespread modern convention of ascribing one vote to each share of common stock, corporation statutes have long permitted the authorization and issuance of shares lacking voting rights altogether as well as shares carrying either limited voting rights or multiple voting rights.⁵² This statutory authorization for classes of equity securities with disparate voting rights was the second watershed

47. See *Taylor v. Griswold*, 14 N.J.L. 222 (N.J. Sup. Ct. 1834). See generally Kerbel, *An Examination of Nonvoting and Limited Voting Common Shares—Their History, Legality, and Validity*, 15 SEC. REG. L.J. 37, 47-67 (1987) (reviewing restricted shares under statutory, legal, and regulatory framework in the United States).

48. *Taylor*, 14 N.J.L. at 223, 237-42.

49. L. GOWER, *GOWER'S PRINCIPLES OF MODERN COMPANY LAW* 403 (4th ed. 1979).

50. Seligman, *Stock Exchange Rules Affecting Takeovers and Control Transactions*, in *KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER* 465, 468-69 n.45 (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988).

51. In West Germany, for example, many large companies restrict a shareholder's voting rights to five percent of the total voting power, even if the shareholder owns more than five percent of the outstanding shares. Fisher, *Continental Suffers From Shareholder Power*, *Fin. Times* (London), June 28, 1990, at 33. This practice lies somewhere between the American common law practice of one person, one vote and the dominant modern American practice of one share, one vote. See D. RATNER & T. HAZEN, *SECURITIES REGULATION* 830-31 (4th ed. 1991) (describing various techniques for allocating voting power on other than a one-share, one-vote basis).

52. Kerbel, *supra* note 47, at 51-57.

development. Indeed, in the 1920s nonvoting shares were issued to nonmanagement shareholders with considerable frequency.⁵³ The effect was to greatly concentrate voting power in corporate management. A public outcry over this growing practice⁵⁴ led the Governors of the New York Stock Exchange (NYSE) to issue the following statement in 1926: "Without at this time attempting to formulate a definite policy, attention should be drawn to the fact that in future [sic] the Committee, in considering applications for the listing of securities, will give careful thought to the matter of voting control."⁵⁵ From this terse statement, perhaps published to head-off federal legislation on the subject,⁵⁶ and probably less significant than the later collapse of the stock market in actually halting dual class capitalizations,⁵⁷ grew the decades-long policy that the NYSE would not list non-voting common stock for trading on its facilities.⁵⁸

However significant the policies of the New York Stock Exchange may be to a company seeking to have its shares listed for trading on that exchange, it is important to remember that such policies are not positive law and do not prohibit the authorization and issuance of non-voting stock. Rather, those policies are declarations of institutional practice, i.e., club rules, designed to induce corporations to forgo exercise of a power made available to them under state corporation law. They are effective because they police behavior by threatening to withhold a substantial economic benefit: access to the near-monopoly on stock trading facilities held by the New York Stock Exchange in the early and mid-twentieth century.⁵⁹

Bearing this in mind, we see that when Congress adopted the Securities Act of 1933 and the Securities Exchange Act of 1934, the convention of attributing one vote to each share of common stock was, thanks to the NYSE, an indubitable part of the prevailing corporate culture. Like state law's grant of free share alienability, equality of voting power formed one of the critical background

53. Seligman, *supra* note 50, at 469 n.46.

54. *Id.* at 469-70.

55. *Exchange Grapples Non-Voting Stocks*, N.Y. Times, Jan. 28, 1926, at 25, col. 1.

56. Seligman, *supra* note 50, at 471.

57. See A. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 163 (5th ed. 1953); Kerbel, *supra* note 47, at 57 n.60.

58. NEW YORK STOCK EXCHANGE, *LISTED COMPANY MANUAL* ¶ 313.00(A) (1990).

59. Professor Eisenberg believes the NYSE stronghold on trading activity makes it a "de facto legislator." Eisenberg, *supra* note 28, at 1485.

assumptions for the entire edifice of federal law. Of course, there was concern as to whether adequate information was being transmitted to shareholders when they were asked to exercise their voting power. This concern lay behind section 14, the proxy solicitation provision, of the Exchange Act and its information disclosure requirement.⁶⁰ Nevertheless, inasmuch as the fashioning of corporate stock's core voting attributes had been a function of state law for many decades before 1933, the newly-minted custom of one share, one vote was just that—a custom; a custom not mandated by, or anchored in, state law. Moreover, in 1933, the trait of equal voting rights, like the attribute of free alienability, was unobjectionable, and had contributed nothing to the disturbing financial shenanigans that prompted passage of federal securities law in the first place. That unprecedented legislation was directed at practices which were broadly denounced. It was certainly not aimed at characteristics of corporate stock that were, at that time, widely acclaimed and seemingly well-controlled by the NYSE.

Careful attention to the history of legal regulation—here, corporate stock—is not only a safeguard against the conceit of modern practice, it sheds light on the meaning of old texts. As lawyers and judges struggle to grasp the relevance of federal statutes to contemporary social problems—here, the pertinence of New Deal federal securities legislation to transformative developments in state corporation law—they must, of course, construe those statutes. In doing so, they must, in the parlance of the day, engage in legal hermeneutics, the methodology of interpretation.⁶¹ The interpretive process is not a simple recipe to be uncritically followed but is a task of multi-dimensional complexity.⁶² Examination of the bare linguistic text (statute) is an essential and, for some, a sufficient starting point.⁶³

60. See S. REP. NO. 1455, 73d Cong., 2d Sess. (1934). "In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings." *Id.* at 74. See Bernstein & Fischer, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy*, 7 U. CHI. L. REV. 226, 227-28 (1940).

61. See Eskridge, *Gadamer/Statutory Interpretation*, 90 COLUM. L. REV. 609, 612 n.19 (1990) (providing a useful collection of materials on legal hermeneutics).

62. *Id.* at 633.

63. Professor Sunstein has criticized this interpretive approach: "In its purest form, however, the textualist approach is inadequate. The central problem is that the meaning of words (whether 'plain' or not) depends on both *culture* and *context*."

But to fully understand the textwriter's (Congress') legal "horizon,"⁶⁴ and the scope of its forward reach into the present, one must move beyond the words themselves. One must also appreciate the written "archeological"⁶⁵ accounts of the deliberations we call legislative history. That, too, however, is not enough, for often the archives are distressingly empty or wildly ambiguous. Critical interpretation must then take account of precisely what in the pre-existing legal order troubled Congress, and to what extent (often very little⁶⁶) Congress meant to rearrange that order.

As revealing as any of these and other diverse approaches to statutory interpretation,⁶⁷ however, is an understanding of the very categories of thought that shaped the intellectual climate in which the statute-text was written. These mental categories for federal securities law were the fully-formed precepts of state corporation law and the institutional practices of the NYSE. These precepts and practices were the unreflected-upon underpinnings, the heavy building blocks of the federal project, and they were pretty much borrowed wholesale. To understand what Congress did (and did not do) to corporate stock when it enacted federal securities legislation, one must see this utter dependence on outside sources and how, taken together, they molded the paradigm within which thinking about corporate stock took place.⁶⁸

When Congress adopted the federal securities laws, it had no reason to modify what were then thought to be desirable features of state law. It simply took for granted that each share of stock had one vote, just as it took for granted that each share of stock was freely alienable. It did so, sensibly enough, because those features

Statutory terms are not self-defining, and words have no meaning before or without interpretation." Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 416 (1989).

64. Eskridge, *supra* note 61, at 633.

65. Professor Eskridge uses this word, but attributes its coinage to Professor Aleinikoff. Eskridge, *supra* note 61, at 611 n.13.

66. See LaRue, *Statutory Interpretation: Lord Coke Revisited*, 48 U. PITT. L. REV. 733 (1987) (discussing need to read statutes in relation to the problem legislators sought to address).

67. See Sunstein, *supra* note 63, at 414-51 (describing what Professor Sunstein calls "standard approaches" to statutory interpretation).

68. Sunstein, *supra* note 63, at 417 ("The significance of congressional enactments necessarily depends on the context and on background understandings about how words should be understood."). To Sunstein's point about words, I would add a point about modes of thought and the larger theme of how federal and state regulation of a common subject matter are accommodated.

were deeply and imperceptibly rooted in the corporate culture, even the mindset, of the early 1930s. But federal law itself neither conferred, nor mandated the eternal preservation of, free alienability and equal voting rights, and took no position on these matters. Instead, it regarded those characteristics, crucial as they may be to the infrastructure of federal securities law, in the same way a carpenter views a foundation laid by a mason: a firm base upon which to build, but none of his business.

III. DISPUTED GROUND

The presuppositions of free alienability and equal voting rights which underlie federal securities law stood unquestioned and unchanged by state law for many decades. The fact that these supposedly baseline hallmarks of common stock remained intact did not, however, mean that other facets (indeed the larger thrusts) of state corporation law were unchanging or free from criticism. Nor did dissatisfaction with the overall condition of state law prevent a massive and protracted forgetting of the simple, complementary relationship between federal and state regulation of corporate stock just described.

A. Degenerate State Law: Two Solutions to the Dilemma of Vulnerable Shareholders

Throughout the mid-twentieth century the shareholder in a public corporation was widely regarded as occupying a precarious position.⁶⁹ It was generally thought that shareholders lacked truly effective mechanisms for insuring management's competence in deploying investor capital toward the diligent pursuit of corporate goals. Genuine accountability of management to shareholders was doubted.⁷⁰ Corporate suffrage, even as bolstered by the demanding disclosure requirements of federal securities laws, was seen as little more than empty ritualism and ultimately feeble as a device for disciplining slipshod management.⁷¹ Only the right to sell stock and leave the corporation—a course of action entirely dependent upon free alienability—seemed to offer a way out for the disenchanted investor.⁷²

69. This belief stemmed from Berle and Means' famous observation that management and ownership had become separated in the public corporation. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

70. See Johnson, *supra* note 7, at 875 & n.43, 881-84.

71. A. BERLE, *ECONOMIC POWER AND THE FREE SOCIETY* 7 (1957).

72. B. GRAHAM & D. DODD, *SECURITY ANALYSIS* 616 (3d ed. 1951).

This innate structural susceptibility to management misbehavior and indolence⁷³ was accompanied by two other trends in state corporation law during the 1950s, 1960s, and 1970s. First, modern corporation statutes continually evolved so as to confer ever greater discretion and flexibility on management.⁷⁴ Some of these changes were applauded as enabling management to operate public companies in a less rigid, more streamlined fashion.⁷⁵ At the same time, many changes further cemented management's vise-like grip on corporate affairs to the clear disadvantage of shareholders.⁷⁶ A conspicuous example is the rise of statutory authorization for cash-out mergers. These statutes were unknown before 1936 and remained rare until the late 1960s.⁷⁷ Initially, they were designed to enhance management's power to alter a corporation's capital structure in ways beneficial to the business enterprise.⁷⁸ Later, the oppressive capabilities of these statutes were fully realized, and they soon gained popularity as the preferred technique for expelling ("freezing out") noncontrolling shareholders from further participation in corporate affairs.⁷⁹

Corporation statutes of this kind did more than strengthen management's hand. By their very nature as enabling or empowering legislation, these laws lulled many observers into believing that the field of corporate law was incapable of exciting intellectual interest;⁸⁰ corporate law had corroded to the point of triviality. The statutes became little more than legal warrants to act, issued in blank. Moreover, statutes designed to liberate and assist management in the pursuit of corporate objectives seemed inherently unsuitable for preventing the attendant abuse of new-found authority. Only law of another sort, i.e., judicial vigilance in overseeing the actual exercise of statutory authority, seemed capable of checking the distressing

73. See CLARK, *supra* note 27, at 390-94 (discussing the systemic collective action problems faced by shareholders seeking to exercise corporate suffrage effectively).

74. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 665-66 (1974).

75. *Id.* at 666.

76. *Id.* at 666, 669-70 (citing illustrations).

77. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 641, 654 (1981).

78. *Id.* at 642-43.

79. *Id.* at 654 & n.184.

80. This was then-Professor Bayless Manning's point in his well-known essay mourning the passing of corporate law as an intellectually exciting endeavor. Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 245 n.37 (1962).

downward drift of managerial behavior under ever more lenient statutes.

This growing, almost ineluctable, dependence on judicial surveillance of corporate affairs points to a second major trend in mid-twentieth century corporate law. Judicial zeal in the oversight of managerial behavior was distinctly lacking. It became increasingly obvious that when shareholders challenged management's statutorily proper behavior as constituting a breach of fiduciary duty, judges—most notably, Delaware judges—consistently afforded management the substantial deference (some would say laxness) of business judgment review.⁸¹ The result was that the odds of a disgruntled shareholder persuading a judge to overturn statutorily authorized corporate actions, much less to impose personal liability on corporate management responsible for those actions, ranged from slim to nonexistent.⁸²

These corporation law developments, particularly in Delaware, generated a great deal of doleful commentary⁸³ and led to Professor William Cary's famous fulmination against the whole affair as a deplorable "race to the bottom."⁸⁴ It also rekindled calls for explicit federal intervention, either along the lines of a wholesale federal incorporation act⁸⁵ or the imposition of federal "minimum standards" on corporations of a certain size.⁸⁶ Short of enacting new federal

81. Under traditional business judgment doctrine, the reviewing court asks only whether the action of corporate directors can be attributed to any rational business purpose. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). There is no inquiry into the merits of the decision. *Id.*

82. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1358-62 (1989). This is not to say the Delaware courts did not occasionally strike down statutorily proper actions. The case of *Schnell v. Chris-Craft Indus.*, 285 A.2d 437 (Del. 1971) (use of corporate machinery and Delaware law for the purpose of management perpetuating itself in office was impermissible) is a good example. Professor Branson recently made this last point, but he also noted that before the 1980s, *Schnell* was generally given a very confined reading. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 96-99 (1990).

83. See, e.g., Comment, *Law For Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969).

84. Cary, *supra* note 74, at 705.

85. See R. NADER, M. GREEN & J. SELIGMAN, *CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS* (1976).

86. Professor Cary rejected the idea of a federal incorporation act. Cary, *supra* note 74, at 700. He favored a Federal Corporate Uniformity Act applicable to corporations having more than \$1 million in assets and 300 shareholders. *Id.* at 701-03.

legislation, however, two other ingenious "remedies" for policing management misbehavior were conceived during this period. Their great appeal lay in the fact that neither proposal demanded the politically arduous task of seeking further legislation; only a thoroughly new and imaginative "understanding" of existing law was needed.

1. The Corporatization of Federal Securities Law

One antidote, initially for the gaps and later for the shortcomings in state corporation law, was to draw on existing federal securities law. To revert to the earlier metaphor of neighboring landowners, it was suggested that if state law was not properly tending its portion of the corporate stock parcel then federal securities law should edge over a bit and introduce more enlightened husbandry.

Borrowing from federal securities laws to bolster dissolute state corporation law—described as early as 1961 as the creation of a "wholly new and far-reaching body of Federal corporation law"⁸⁷—had spawned a great controversy by the mid-1960s.⁸⁸ Some observers at the time believed that federal law was overstepping its bounds and encroaching far into state terrain.⁸⁹ In retrospect, the developments on this front as of 1965, however significant they may have seemed at the time, were, in fact, relatively tame.

Besides extending coverage of the 1934 Exchange Act to companies with stock traded over-the-counter,⁹⁰ federal incursion into state law largely consisted of implying private causes of action from various provisions of the federal securities statutes⁹¹ and then applying those provisions to transactions in which shareholders were allegedly

87. *In re Cady, Roberts & Co.*, 40 S.E.C. at 910. See also *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir.), cert. denied, 368 U.S. 939 (1961).

88. Compare Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965) (federal law developments are sound) with Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. REV. 185 (1964) (critique of federal developments).

89. See Ruder, *supra* note 88. Cf. Kaplan, *Corporation Law and Securities Regulation*, 18 BUS. LAW. 868 (1963).

90. Pub. L. No. 88-467, 78 Stat. 565 (1964) (codified at 15 U.S.C. § 78l(g)(1)(B) (1964)).

91. See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (private cause of action under SEC proxy Rule 14a-9); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, modified, 83 F. Supp. 613 (E.D. Pa. 1947) (private cause of action under Rule 10b-5). See generally Fleischer, *supra* note 88 (discussing other judicial developments as of 1965).

defrauded. Since disclosure in connection with stock trading and proxy solicitation was the traditional stuff of federal securities law, this latter development may have considerably fortified federal weaponry against fraud, but it did not really expand the ambit or purpose of regulation.⁹² Moreover, given the unsatisfactory, almost bizarre patchwork of state law precepts governing securities fraud at the time federal law was enacted,⁹³ it seems fairly clear that Congress meant to augment the claims of investors aggrieved by fraudulent stock trading events taking place on national securities markets. Empowering defrauded investors to seek redress directly and privately is at least arguably consistent with congressional intentions, as well as being quite sensible. In hindsight, it also appears to be a rather modest breakthrough.

Even exponents of an expansive reading of federal securities laws did not, at least during the first stage of this effort (up to the mid-1960s), advocate use of these laws to remedy every claim that management had breached a fiduciary duty or otherwise mistreated shareholders.⁹⁴ Thus, although a broad construction of federal securities law was gaining favor at the very time the state law developments decried by Professor Cary were taking place,⁹⁵ such an interpretation was not thereby advanced as a general corrective for the ills of corporation law. A confluence of events, however, soon replaced relatively circumspect claims for federal securities law with much bolder assertions.

First, as Professor Sunstein recently noted, the 1960s and 1970s "marked a revolution in the category of legally protected rights"⁹⁶ While Professor Sunstein emphasized that "the rights revolution of the 1960s and 1970s was mostly the work of Congress and the President,"⁹⁷ it also clearly involved the Supreme Court and administrative agencies, including the SEC. Moreover, although the 1960s and 1970s are best remembered for landmark legislation protecting civil rights, consumers, and the environment, renewed at-

92. See Fleisher, *supra* note 88, at 1160-67.

93. 3 L. LOSS, *SECURITIES REGULATION* 1435 (2d ed. 1961).

94. Fleisher, *supra* note 88, at 1166 ("It is clear that federal law should not cover every breach of duty associated with a securities transaction.").

95. See *supra* text accompanying note 84 (leniency towards management is effectuating a "race to the bottom").

96. C. SUNSTEIN, *AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE* 24 (1990).

97. *Id.* at 25.

tention to shareholders grew out of the larger emphasis on boosting individual rights via governmental action at the federal level. Second, case law construing section 10(b) of the Exchange Act, and SEC Rule 10b-5 thereunder, swelled explosively in the late 1960s and early 1970s.⁹⁸ The volume of decisions delineating the reach of Rule 10b-5 expanded so rapidly during this period that the rule almost developed into a distinct area of jurisprudence.⁹⁹ Third, with little resistance from state law, the use of cash-out mergers to expel shareholders from corporations grew into the *denier cri* of oppressive practices in the late 1960s and early 1970s.¹⁰⁰ Perhaps, many thought, federal securities law, could be read to check this development, too. Fourth, throughout the same period, the SEC stepped up its enforcement activity significantly.¹⁰¹

Armed with a belief that federal securities law intruded more deeply into corporate affairs than previously thought,¹⁰² the SEC vigorously and tenaciously proceeded on a number of enforcement fronts. These included not only what we think of as conventional securities law subjects, e.g., the irksome problem of defining "securities,"¹⁰³ but also more controversial campaigns, such as that against the widespread practice of public companies making questionable payments (bribes) to domestic and foreign business and government officials¹⁰⁴ and the even larger and more intractable problem of director accountability to shareholders.¹⁰⁵ This activism was, no doubt, partially fueled by the "rights revolution" described by Professor Sunstein.¹⁰⁶ It was also undoubtedly influenced by the

98. Chief Justice Rehnquist described the growth of Rule 10b-5 case law as a "judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737, *reh'g denied*, 423 U.S. 885 (1975). See generally L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 726-29 (2d ed. 1988).

99. Two multi-volume treatises deal with Rule 10b-5 developments. A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD* (1979); A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10B-5* (2d ed. 1981).

100. See Weiss, *supra* note 77-79.

101. Pitt & Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 191-97 (1990).

102. Even Professor Cary, a tireless critic of corporation law, had grave doubts about relying on Rule 10b-5 to raise the standards of state law. Cary, *supra* note 74, at 699-700.

103. Pitt & Shapiro, *supra* note 101, at 192-94.

104. *Id.* at 194-95.

105. *Id.* at 195-96.

106. See *supra* text and accompanying notes 96-97.

idealism of the Vietnam War era, the post-Watergate desire to restore a sense of integrity to commercial as well as governmental affairs, and the rising concern over the whole subject of corporate responsibility in post-industrial society.¹⁰⁷

However laudable these larger political and social currents might be, and however naive it is to divorce legal developments from the larger cultural milieu in which they arise, reliance on federal securities law as the potion for remedying corporate ailments eventually encountered a stubborn jurisdictional reality: dominion over corporate governance and the shaping of corporate stock remained where it had been left in 1933 and 1934—i.e., with state governments.¹⁰⁸ However powerful multi-national corporations had grown in the intervening decades, however lamentable their behavior toward shareholders and other persons had become, however poorly state law responded to these developments, and however broadly Rule 10b-5 might be construed, Congress had done nothing to haul corporate governance under the cloak of national regulation.

This is not to say that those who applauded utilization of federal securities law to “upgrade” corporate practice—whether in the traditionally modest area of securities trading or in the field of corporate governance and social responsibility more generally—failed to enjoy success. They enjoyed seemingly unstoppable success until the mid-1970s. In the years 1975, 1976 and 1977, however, the United States Supreme Court issued three decisions which abruptly derailed the “corporatization” of federal law strategy.

In *Blue Chip Stamps v. Manor Drug Stores*,¹⁰⁹ the Court held that persons who do not purchase or sell a security in an allegedly fraudulent transaction have no claim for relief under Rule 10b-5. This means, of course, that someone who fails to buy a security because unduly pessimistic information is disseminated, or who fails to sell a security because unduly rosy information is disclosed, lacks a federal remedy. But, beyond ruling that *failing* to buy or sell in

107. See COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE: THE ALI-ABA SYMPOSIUMS (D. Schwartz ed. 1977-78) (providing a broad sampling of opinions on corporate governance and social responsibility issues in the mid-1970s).

108. See *supra* Part II. Congress has, from time to time, considered intervening into corporate governance but has always refused. See Boyer, *Federalism and Corporation Law: Drawing the Line in State Takeover Regulation*, 47 OHIO ST. L.J. 1037, 1041-56 (1986). Creeping federalization was essentially an effort to read the securities laws in a sufficiently broad fashion as to amount, in effect, to federal law on corporate governance in spite of Congress' refusal to act in the latter area.

109. 421 U.S. 723 (1975).

the trading markets gives rise to no federal claim, the decision means, more generally, that existing stockholders *qua* stockholders, that is, as *holders* (rather than sellers or buyers) of stock, never satisfy the purchaser or seller requirement and, consequently, have no federal claim for wrongdoing to them in that capacity. With this decision the range of corporate activity actionable under federal securities law shrank considerably.

In *Ernst & Ernst v. Hochfelder*,¹¹⁰ the Supreme Court held that an allegation of scienter, i.e., an "intent to deceive, manipulate or defraud,"¹¹¹ was a necessary element of a claim under Rule 10b-5. Negligent behavior would not support a claim. Inasmuch as the bulk of corporate mismanagement grievances (other than breach of loyalty self-dealing cases) suffered by shareholders amount to claims of simple incompetence, this ruling meant that, even if the formidable *Blue Chip Stamps* hurdle could be cleared, most of the financial damages inflicted on shareholders would go unredressed by federal law. However vast the losses it may cause, managerial ineptitude is not the target of Rule 10b-5.

If *Blue Chip Stamps* and *Ernst & Ernst* halted the intrusion of federal securities law onto state law turf, *Santa Fe Industries v. Green*¹¹² chased it back over the fence. In *Santa Fe Industries*, plaintiff shareholders alleged that Delaware's "short-form merger" statute, which enabled a parent company owning at least ninety percent of the stock of a subsidiary to merge with the subsidiary, thereby squeezing out the subsidiary's minority shareholders by making a cash payment, violated Rule 10b-5.¹¹³ The Supreme Court rejected that claim by holding that Rule 10b-5 outlawed only conduct involving manipulation or deception, not unfairness or director breaches of fiduciary duty.¹¹⁴ Thus, even if a shareholder buys or sells stock and alleges management scienter, the preconditions required by *Blue Chip Stamps* and *Ernst & Ernst*, federal law offers relief only for fraud, not unfairness or other wrongdoing.

Acting as a kind of judicial surveyor, the Court in *Santa Fe* went beyond construing the language of section 10(b) and Rule 10b-5 to signal its thoughts as to the appropriate boundary line between federal

110. 425 U.S. 185, *reh'g denied*, 425 U.S. 986 (1976).

111. *Id.* at 193.

112. 430 U.S. 462 (1977).

113. *Id.* at 466-67.

114. *Id.* at 471-74.

securities law and state corporation law. The Court did so by offering, as additional support for its ruling, the rationale that the Securities Exchange Act of 1934 had as its "fundamental purpose"¹¹⁵ that of implementing a "philosophy of full disclosure"¹¹⁶ and that the alleged squeeze-out conduct did not implicate that underlying purpose.¹¹⁷ Moreover, the Court reasoned that using Rule 10b-5 to regulate corporate conduct not involving manipulation or deception would serve "to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."¹¹⁸ The Court went on to explain why such policies must be honored: "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."¹¹⁹

A clearer statement as to the interface between federal and state hegemony over corporate stock would be hard to find. Because federal securities law bolstered only one facet of the shareholding function, i.e., access to enterprise information, and was superimposed on an already existing system of state laws, the latter holds sway unless Congress explicitly provided otherwise. Since much of what state corporation law does is constitutive of the very thing we call corporate stock, it is not surprising that Congress assumed, and so did not explicitly address, both the structural make-up of that property and state sovereignty in its design. Those prescriptive functions, the Court seemed to be saying, plainly fell on the state law side.

The immediate effect of *Santa Fe* was to squelch efforts to reform the allegedly dismal condition of state corporation law via the elixir of federal securities law.¹²⁰ There remained, nonetheless, a nagging ambiguity about the proper relationship between federal and state

115. *Id.* at 478.

116. *Id.*

117. *Id.*

118. *Id.* at 479.

119. *Id.* (quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975)).

120. In the same year it decided *Santa Fe*, the Supreme Court also stemmed the growth of implied causes of action under the federal securities laws. *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, *reh'g denied*, 430 U.S. 976 (1977) (bidder lacks standing to enforce antifraud provisions of Williams Act). Taken together, the *Santa Fe* and *Piper* opinions delivered two punches that decked creeping federal corporatization.

dominion over corporate stock. This ambiguity stemmed from the Court's apparent line-drawing statement in the *Santa Fe* holding.¹²¹ The supposedly decisive phrase, "internal affairs of the corporation," is fuzzy and lacks real shape.¹²² In fact, this language seemed to simply reformulate the federal-state clash over corporate stock by inviting the bedrock question of whether the task of configuring various qualities (including alienability and voting rights) into the species of property we call corporate stock—the very thing traded (alienated) on federal securities markets—is itself an "internal affair of the corporation"? If so, then in theory state law could redefine corporate stock so as to subdue, or outright negate, the central feature of alienability which federal securities law presupposed and built upon. But this extraordinary reading of *Santa Fe*, faithful as it may be, was ripe for neither action nor thought in the mid and late 1970s. At that time, just as in the early 1930s, certain core incidents of corporate stock were so commonplace as to appear indigenous rather than assigned. Any suggestion otherwise might well have been dismissed, even by the most free-thinking corporate lawyers and scholars, as fanciful or seditious. Rewriting corporate law to squeeze minority shareholders out of corporations was one thing; curbing the alienability or voting rights of a majority of shareholders might have seemed unacceptably heretical. Yet, another decade of experience with the second proposed "remedy" for the plight of corporation law would force this seemingly cataclysmic, but historically sound, interpretive possibility to resurface under more propitious circumstances. When it did reappear, the Supreme Court was compelled to mark out more clearly the precise contours of its key expression, and with it, the divide between state and federal law.

2. The Corporation as Marketplace

An altogether different response to, even radical reconception of, the purported disgrace of state corporation law came from another quarter. Believing that corporate activity¹²³ and corporate law¹²⁴ are

121. See *supra* text accompanying note 119.

122. *Santa Fe*, 430 U.S. at 479. However, its meaning was clear enough in *Santa Fe* itself where state law prescribed elaborate procedures for the accomplishment of mergers while federal law was utterly silent.

123. See, e.g., Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976) (corporation a nexus of contractual relations which are, in effect, the firm).

124. See, e.g., Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395, 401 (1983) (corporation statutes are standard form contracts).

best understood as part of the larger market forces which drive economic affairs in a capitalist society, proponents of this vision advanced several novel propositions about corporate law. First, the alleged "flaws" in state corporate governance identified by Professor Cary and others, e.g., management's wide range of discretion and lax judicial review, either may not be flaws at all (and actually may be virtues) or, if they are flaws, may be self-correcting.¹²⁵ In other words, before we prescribe medicine, we must be sure the patient is ill or, at a minimum, that he will not get better on his own. The conventional diagnosis of state corporation law as being in ill health, traceable all the way back to Berle and Means,¹²⁶ is thus turned on its head.

Second, the chief aim of law should not be to achieve desirable behavior by regulatory fiat, but to emphasize the status of various claimants on corporate activity as market participants fully able to order their own affairs.¹²⁷ The upshot is both a specific rejection of Cary's call for remedial federal legislation and a more general plea for removal of all legal barriers that stand in the way of, or distort, old-fashioned bargaining (whether real or imagined). Vindication of shareholder rights by private ordering, not public regulation, is the key insight. Less law, not more law, is the asserted outcome.¹²⁸

Third, while many markets impinge on corporate affairs, e.g., product and service markets,¹²⁹ the market for managers,¹³⁰ capital markets,¹³¹ and the market for corporate charters,¹³² the market for corporate control,¹³³ evidenced by hostile tender offers, plays an especially pivotal role in this market-oriented recasting of corporate

125. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 252, 258, 261 (1977).

126. See *supra* notes 69-72 and accompanying text.

127. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). See Winter, *supra* note 125.

128. Winter, *supra* note 125, at 262-64. This view neglects the way in which law underlies even so-called "free market" activities. See *infra* notes 153-54 and accompanying text.

129. Winter, *supra* note 125, at 264.

130. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

131. Winter, *supra* note 125, at 275-76.

132. *Id.* See also Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980).

133. See Manne, *supra* note 127 (seminal article on the market for corporate control). See also Eisenberg, *supra* note 28, at 1497-99 (providing a summary of later explications).

law. If management is using corporate resources suboptimally, then share prices, being informationally efficient,¹³⁴ should reflect this fact and be appropriately discounted. Spotting an opportunity to make money, an enterprising bidder, by launching a tender offer through the medium of national securities markets, could purchase a controlling block of common stock in the underperforming business, oust incumbent management, operate the target company more profitably, and capture significant value.¹³⁵

This insightful and laudatory view of hostile takeovers has generated and still generates,¹³⁶ enormous excitement. For one thing, takeovers (as a means for wresting corporate control from existing management), are much more effective than old-fangled and rarely successful proxy fights. Takeovers provide shareholders with money on the table, not vague election promises of better management. Moreover, takeovers address the knotty problem of managerial incompetence (as opposed to outright disloyalty) which neither state fiduciary principles nor federal securities law after *Ernst & Ernst*¹³⁷ tackled with any vigor. Quite simply, if managers are inept, share prices should fall; bidders, believing they can perform better, suddenly appear and pay handsome premiums to shareholders for the opportunity. The mere threat of being sacked induces better behavior from corporate management.¹³⁸ Furthermore, this potent market for corporate control not only restores shareholder clout in corporate governance and augments investor wealth by virtue of the generous premiums paid by bidders to dislodge stock,¹³⁹ its champions also claimed that it reallocates corporate resources to more highly valued uses in a way that benefits the entire national economy.¹⁴⁰ Especially appealing was the fact that the simple and elegant workings of the

134. See Johnson & Millon, *The Case Beyond Time*, *supra* note 13, at 2107 & n.6 (describing the efficient capital market hypothesis).

135. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1173-82 (1981); Manne, *supra* note 127, at 113.

136. See, e.g., *Symposium on Contractual Freedom In Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

137. See *supra* text and accompanying note 110.

138. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 41 (1986).

139. Professor Michael Jensen reports takeover premiums as ranging from 30%-50% over market price. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21, 22 (1988).

140. See Johnson & Millon, *Misreading the Williams Act*, *supra* note 13, at 1866-67 & n.19, 1892-93 & n.125.

capital market did not depend on legislatures conferring, or the SEC and judges straining to divine, exotic (implied) legal claims for shareholder relief. Rather, the success of a hostile takeover attempt hinges on the simple willingness of existing shareholders to exercise their right to alienate stock.

It is no wonder that such a coherent intellectual framework for understanding corporate activity held such great appeal. The framework was first outlined by Dean Henry Manne,¹⁴¹ boosted by Professor (now Judge) Ralph Winter,¹⁴² and subsequently filled out by their intellectual descendants.¹⁴³ This framework offered a perspective on the nettlesome subject of corporate governance that was at once fresh, powerful and disarmingly simple. What was only faintly seen in the euphoria over this engaging case for hostile takeovers, however, was the crucial way in which the linchpins of the whole takeover phenomenon were two things so fundamental that, as with all such matters, they were taken for granted: (i) individual shareholder autonomy over *alienation* of corporate stock and (ii) shareholder *voting power* to replace incumbent management.¹⁴⁴ Without these twin attributes of stock ownership, the whole endeavor collapses. In fact, advocates of a market model of corporate governance overlooked the connection between hostile takeovers and the property incidents of corporate stock because they misread an even more basic relationship, viz, that of law and markets.

In touting the idea that various markets constrain human behavior more efficiently than stringent legal rules, takeover enthusiasts reversed the causal relationship between law and markets. Rather than swallowing the conventional post-Berle and Means view that law should intervene to correct market imperfections and failures,¹⁴⁵ takeover enthusiasts updated the insights of neoclassical economics

141. Manne, *supra* note 127.

142. Winter, *supra* note 125.

143. See, e.g., Easterbrook & Fischel, *supra* note 135; Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989).

144. Winter himself saw the importance of shareholder voting for the market for corporate control: "The operation of the market for management control, however, depends upon voting shares which have the power to replace an inefficient management and offer the opportunity for capital gains." Winter, *supra* note 125, at 277. Nowhere, however, is there any hint that the incident of voting power was then in jeopardy because of antitakeover legislation. Such legislation as existed at that time simply did not operate in that way.

145. See Fellows & Wu, *The Scope of Legal Interventions in Corporate Affairs*, 15 J. CORP. L. 465, 466, 469 (1990).

to fit an economy dominated by large corporations. They argued both that the separation of ownership and management is an "efficient functional division of the factors of production"¹⁴⁶ and that unfettered market forces will, over time, beget law favorable to investors.¹⁴⁷ Grounding this latter argument on the cardinal economic tenet that, to survive in a competitive environment, suppliers of goods must satisfy consumers, theorists likened states to producers of corporation law that must appeal to shareholder-consumers lest the latter withdraw their capital and re-invest in enterprises formed under more investor-friendly state law regimes.¹⁴⁸ Judge Easterbrook recently developed this Winteresque line of reasoning of consumer as king in consoling market enthusiasts for Easterbrook's unwillingness to void Wisconsin's formidable anti-investor antitakeover statute:

To say that states have the power to enact laws whose costs exceed their benefits is not to say that investors should kiss their wallets goodbye. States compete to offer corporate codes attractive to firms. Managers who want to raise money incorporate their firms in the states that offer the combination of rules investors prefer. . . . Laws that in the short run injure investors and protect managers will in the longer run make the state less attractive to firms that need to raise new capital States regulating the affairs of domestic corporations cannot in the long run injure anyone but themselves.¹⁴⁹

This account of how market forces supposedly optimize state corporation law is open to several lines of attack.¹⁵⁰ My objection

146. *Id.* at 471.

147. Winter, *supra* note 125, at 274. Favorable law for investors in this model is law that reduces the transaction costs of contracting with managers in a way that reduces agency costs. In short, the role of law is facilitative, not corrective. Fellows & Wu, *supra* note 145, at 471-72.

148. Winter, *supra* note 125, at 275-76.

149. *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 507 (7th Cir.), *cert. denied*, 110 S. Ct. 367 (1989) (citing Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977)). See Fischel, *From MITE to CTS: State Anti-Takeover Statutes, the Williams Act, the Commerce Clause, and Insider Trading*, 1987 SUP. CT. REV. 47, 74-84.

150. See Eisenberg, *supra* note 28, at 1507-14. See also Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987). Professor Eisenberg cites a number of flaws in Winter's analysis as he attempts to stake out a position somewhere between Cary and Winter. Although he criticizes Winter and ends up closer to Cary's side of the issue, Eisenberg does commend Winter for

works at a more fundamental level. What market advocates did not see, or care to acknowledge, is that law may subvert the very market forces that engender law. This is so because the relationship between markets and the law is not uni-directional, but is reciprocal and interactive.¹⁵¹ Thus, to focus on corporate law, the very existence of the market for corporate control depends on features of corporate stock which owe their existence to state law. By taking away the features of free alienability of stock and voting rights through the passage of new state law, the market for corporate control shuts down and with it goes two claims. First, the claim that market forces beget law, rather than vice versa, is undercut. Second, the belief that markets alone, unaided by stringent federal or state regulation, can restore shareholders to their rightful position as the pillars of corporate governance is severely shaken. As for Judge Easterbrook's view that investors will eventually abandon states with inhospitable corporate law in favor of those with more congenial legislation, state lawmaking on this subject more closely resembles the conscious parallelism of confident market power than the accommodative bent of competitive suppliers genuinely threatened by product substitutes. Unless one resorts to the *ipse dixit* that state corporation codes *must* be agreeable because investors are not leaving in droves, one is hard pressed to see much evidence of large-scale capital flight from cor-

highlighting optimality as one motivating factor in state corporation law. Thus, with Winter, he chides Cary's position as not recognizing that a "state . . . will not depart from optimality *too far*, because, if it does, the value-decreasing effect of incorporating in the state could become so large as to invite takeovers or federal intervention." Eisenberg, *supra* note 28, at 1513. Eisenberg is too generous to Winter on this point. The fact of the matter is that, today, states are falling all over themselves to turn off the takeover market without a whit of concern about the consequences for shareholder wealth. *See infra* notes 259-71 and accompanying text. States do so today, unlike the case in the 1970s, by striking at the heart of takeovers—free alienability of stock and, to a lesser extent, equality of voting power. Takeovers being thus de-fanged, they can hardly serve as the cure for this state of affairs. Professor Cary was correct on the point that only federal intervention (or action by self-regulatory organizations, *infra* notes 270-80 and accompanying text) will overturn this trend. *See also* Garfield, *State Competence to Regulate Corporate Takeovers: Lessons From State Takeover Statutes*, 17 HOFSTRA L. REV. 535, 593-95 (1989); Sidak & Woodward, *Corporate Takeovers, the Commerce Clause, and the Efficient Anonymity of Shareholders*, 84 NW. U.L. REV. 1092, 1116-17 (1990). Neither the federal government nor self-regulatory organizations, however, should intervene. *See infra* notes 276-309 and accompanying text.

151. *See* J. BURK, VALUES IN THE MARKETPLACE 7-8, 144-45 (1988); Tribe, *The Curvature of Constitutional Space: What Lawyers Can Learn from Modern Physics*, 103 HARV. L. REV. 1, 7-8 (1989).

porations organized under statutes with a distinctly pro-management, anti-shareholder slant. Either investors are not all that upset or, more likely, there is no place to go.¹⁵²

This objection that law may *undermine* market forces is the corollary of the legal realist insight that governmental action *fashions* the market in which private ordering takes place in the first instance.¹⁵³ Governments (whether the legislative, judicial, or executive branches) do this through laws imbuing property with manifold attributes and enforcing various bargains. For many legal realists, the establishment of property rights and of parameters to bargaining of the kind that make supposedly "private" market activity possible was just one more form of "public" regulation.¹⁵⁴ More pointedly, the possibility that state corporation laws may undo market forces without investor reprisal in the form of redeploying capital in states with "better" laws is not trivial or simply theoretical. Indeed, in 1977, when Ralph Winter passionately presented the outlines of the market model, he also saw that state antitakeover legislation¹⁵⁵ threatened to gum up the market for corporate control. Somewhat paradoxically, Winter sheepishly added a key caveat to his case against Cary's call for federal intervention in corporate governance. In light of state antitakeover statutes, Winter believed that federal regulation protecting competition in the market for corporate control was justified.¹⁵⁶ In effect, Winter confessed that markets alone do not always yield pro-shareholder legislation. Sometimes law clogs markets. Therefore, federal law must (slightly and just once) intervene to

152. Sidak & Woodward, *supra* note 150, at 1115.

Competition among states to provide regulations for governing corporations does not seem to have produced efficient rules with respect to antitakeover statutes The large number of states that passed second generation antitakeover statutes . . . runs contrary to empirical evidence showing that interjurisdictional competition in corporate law has produced a "race to the top" rather than a "race to the bottom."

Id. (footnote omitted).

153. See Singer, *Legal Realism Now (Essay Review)*, 76 CALIF. L. REV. 465, 491 (1988).

154. *Id.*; Sunstein, *supra* note 63, at 444 n.136. See Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697 (1990).

155. See Langevoort, *State Tender-Offer Legislation: Interests, Effects and Political Competency*, 62 CORNELL L. REV. 213 (1977) (describing early antitakeover statutes); Wilner & Landy, *The Tender Trap: State Takeover Statutes and Their Constitutionality*, 45 FORDHAM L. REV. 1 (1976) (same).

156. Winter, *supra* note 125, at 289.

displace antitakeover laws. This embarrassing one-shot reliance on federal law to restore competition resembled a kind of intellectual cul-de-sac in which the road of unregulated markets is left briefly to invoke federal corrective power, only to return once more to the main road. The evil of federal *regulation*, however, was summoned for the limited and ironic purpose of rehabilitating *unregulated* market competition, a condition which Winter seemed naively to believe stood logically and temporally prior to regulation like an unspoiled pre-law Eden.

Significantly, Winter's call for federal intervention to chasten states passing antitakeover laws would work only so long as state law also continued to imbue corporate stock with the alienability and voting attributes undergirding the market model. Alter those bedrock traits, which are not pristine but depend on state law for their very existence and shape, and there is either no market or there is a substantially different, less robust market. In the late 1970s, the absolute beholdenness of all stock market activity to the property law attributes supplied by state law went unnoticed because limiting those attributes would be so radically counter to commonplace understandings about corporate stock as to be unthinkable. This is not because personal property, here, corporate stock, inherently possesses certain incidents that foster market exchange, any more than real property intrinsically possesses one rather than another set of defining and limiting features.¹⁵⁷ It is only because the conventional attributes associated with corporate stock were, at that particular time in our culture, as in the early 1930s, taken for granted. No more than the air we breathe, the fabrication of corporate stock as conscious endeavor just was not thought about by those, like Winter, who hailed corporate takeovers, or those who most dreaded them, i.e., target management and state legislators.

157. See Honoré, *Ownership*, in OXFORD ESSAYS IN JURISPRUDENCE 107 (A. Guest ed. 1961) (providing an account of the standard incidents of property ownership in mature legal systems). As Honoré notes, legal systems confer or withhold various of these incidents:

[I]n nearly all systems there will be some things to which not all the standard incidents apply, some things which cannot be sold or left by will, some interests which cannot endure beyond a lifetime, some things (flick knives, Colorado beetles) which it is forbidden to use or to use in certain ways.

Id. at 109-10. See also Cohen, *supra* note 1, at 21-22; Radin, *Market-Inalienability*, 100 HARV. L. REV. 1849, 1917-21 (1987) (describing restraints upon alienation as "incomplete commodification").

As a result, antitakeover statutes neatly clipping off or snipping back those predicates of the market model which enabled shareholders to withdraw *en masse* from a corporation through the avenue of a hostile tender offer were not passed at that time. Instead, those who opposed takeovers because of the supposed social and economic dislocation caused by such abrupt transactions drafted laws that were clumsy and overbroad.¹⁵⁸ By doing so, the ability of state lawmakers to regulate hostile takeovers was sidetracked and stalled, for many years. Here again, although fueled by an entirely different ideological vision of law's function, the legal stumbling block was precisely the same as lay in the path of earlier failed efforts to federalize corporation law via securities law, i.e., a fundamental misapprehension of federal law's deep reliance on state law precepts which, however historically stable, are not intrinsic and fixed, but contingent and fluid. Forgetting the historic relationship of federal and state law¹⁵⁹ and the malleability of state law notions led to a serious underestimation of state power over corporate stock. The result was that while the first wave of federalization of corporate law had been beaten back in *Santa Fe*,¹⁶⁰ for several years the challenge to state law by activity on unregulated federal capital markets appeared far more formidable than it really was.

B. Initial Success for the Marketplace Solution: The Failure of First-Generation Antitakeover Statutes

The first antitakeover statute reviewed by the Supreme Court was struck down in 1982 as violative of the commerce clause.¹⁶¹ The Illinois law voided in *Edgar v. MITE Corp.* made two serious errors. First, it applied to corporations having an economic connection to Illinois but organized under the laws of other states¹⁶² and, second, it pointedly conflicted with the clear procedural steps by which tender offers are to be conducted under the 1934 Exchange Act.¹⁶³ Opponents

158. See Langevoort, *supra* note 155 (describing antitakeover statutes as they existed in the late 1970s); Wilner & Landy, *supra* note 155 (same).

159. See Part II.

160. See *supra* text and accompanying notes 112-19.

161. *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

162. ILL. REV. STAT. ch. 121 1/2, para. 137.52-10 (repealed 1983). See *Edgar*, 457 U.S. at 627.

163. Under the Illinois law, a bidder was required to register the offer with the Illinois Secretary of State prior to commencing the actual bid for shares. ILL. REV. STAT. ch. 121 1/2, para. 137.54A (repealed 1979). See *Edgar*, 457 U.S. at 627. Moreover, the Secretary was authorized to hold a hearing on the fairness of the offer, during which time the bid was held in abeyance. See *id.*

of hostile takeovers made these constitutional mistakes because of their failure to appreciate the interplay between state and federal law (here the Williams Act and the commerce clause) in regulating corporate stock in the novel takeover setting. This lack of understanding led not only to constitutional blunders but to serious misjudging of the enormous potential for state law supremacy on the subject of takeovers specifically and activity on capital markets more generally.

Evidence of this profound and widespread confusion can be seen in two distinct portions of Justice White's opinion. First, in concluding that the Illinois statute was preempted by the 1968 Williams Act Amendments to the 1934 Act,¹⁶⁴ White stated that federal tender offer law was based on a conviction that an investor "furnished with adequate information would be in a position to make his own informed choice [as to whether or not he should tender his stock]."¹⁶⁵ This statement is perfectly reasonable. It implicitly recognizes the distinction between the federal law mission of making available choices *informed* and the state law function of providing *choices* in the first instance.¹⁶⁶ But White puts a subtle and dangerous spin on that assertion with the following: "[T]he Williams Act and its legislative history . . . indicate that Congress intended for investors to be free to make their own decisions."¹⁶⁷ Here Justice White implies that Congress, rather than the states, provides the substantive attribute of free choice in stock disposition matters. Federal securities laws have never done that,¹⁶⁸ and they certainly do not do so in the takeover context.¹⁶⁹ To do so would be to overstep the boundary line between federal and state law which Congress took for granted in the early 1930s, and again in 1968.

Second, in his commerce clause analysis, White faced the claim that Illinois was simply regulating the "internal affairs of a corporation."¹⁷⁰ Under the rationale of the landmark *Santa Fe* decision,

164. Only three justices concluded that the Illinois law was preempted by the Williams Act. *Edgar*, 457 U.S. at 639 (White, J., joined by Burger, C.J., and Blackmun, J.). The Williams Act was enacted in 1968. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988)). See generally Johnson & Millon, *Misreading The Williams Act*, *supra* note 13.

165. *Edgar*, 457 U.S. at 633-34.

166. See *supra* note 36 and accompanying text.

167. *Edgar*, 457 U.S. at 639.

168. See *supra* Part II.

169. See Johnson & Millon, *Misreading The Williams Act*, *supra* note 13.

170. *Edgar*, 457 U.S. at 645. This decisive phrase was adopted from *Cort*, 422 U.S. at 84. See *Santa Fe*, 430 U.S. at 479.

portraying the Illinois law as a regulation of "internal affairs" would place the subject of takeover regulation firmly in state terrain. Justice White, however, brusquely dismissed that characterization of tender offers: "Tender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company."¹⁷¹

This cryptic construction of the phrase "internal affairs" did two things. First, it frustrated state regulation of hostile takeovers by asserting that such transactions were not "internal affairs." Rather, according to White, they were "transfers of stock by stockholders" on interstate capital markets and therefore beyond the regulatory reach of state government. To White, the case looked like the flip side of *Santa Fe*. In *Santa Fe*, the Supreme Court had forbidden federal trespassing on state turf, but in White's view, that decision did not thereby license state law to poach on federal ground. For White, takeovers took place in interstate commerce; therefore, they fell under federal dominion. Absent from this analysis was any sense of where the key trait of transferability originated. Federal law successfully gained control over the disputed patch of ground because nobody thought to tell White that *interstate* transfers took place only because *transfers* took place by the grace of state law. This time, however, the case was not, as in *Santa Fe*, about a lowly administrative agency rule (Rule 10b-5) encroaching into state terrain to protect investors; rather, it involved the awesome commerce clause of the United States Constitution.

The second aspect of White's conception of tender offers was that it thrilled two disparate schools of corporate governance. Not only did it elate those who had earlier championed shareholder rights via the creeping federalization of corporation law—a trend abruptly arrested by the Supreme Court in *Santa Fe*—it delighted the supporters of a non-interventionist market-centered vision of corporate law. Ralph Winter had very clearly seen that if states could clog the market for corporate control under the banner of "internal affairs," takeovers would be de-clawed. Less sanguine than Judge Easterbrook about the market for corporate charters as a back-up disciplinarian,¹⁷² Winter believed that the demise of takeovers would, in turn, drain

171. *Edgar*, 457 U.S. at 645. Justice White supported this assertion by citing *Great Western United Corp. v. Kidwell*, 577 F.2d 1256, 1280 n.53 (5th Cir. 1978), *rev'd*, 443 U.S. 173 (1979).

172. *See supra* text accompanying note 149.

vitality from the larger market-driven notion of corporate law. Thus, just as Winter had foreseen, this cogent vision of *state* corporate governance had an ironic defect: it vitally depended upon the preeminence of federal law's singular emphasis on free capital movement. Federal law, as it were, was needed to run legal interference for a view of state corporation law as market driven.¹⁷³ In *MITE*, Justice White obligingly declared federal preeminence and so constitutionally sanctioned and safeguarded this market-centered notion of corporate law. In one stroke, the legal cornerstone for market transactions in controlling blocks of corporate stock was laid. Maybe natural law did not support the corporation-as-marketplace theory, but the U.S. Constitution is not a bad second. A sense of triumph about such a heady victory for so young a theory was understandingly hard to suppress.¹⁷⁴

Amazingly though, neither market theorists nor old-fashioned federal interventionists, much less the Supreme Court, really asked *why* shareholders can transfer their stock to third parties on interstate markets. If they did, they would see that it does not matter whether or not White was willing to label the power to curtail the incident of alienability a matter of "internal affairs." What is incontestable is that the attribute originates neither in the Williams Act nor in the United States Constitution. It is given and nurtured by state law. Consequently, it can be taken or shrunk by state law,¹⁷⁵ and

173. The legal realists could not have been happier with such a dramatic concession on the public underpinnings of "private" ordering. See *supra* notes 153-54 and accompanying text.

174. Professor Bratton dates what he calls the "new economic theory" of the firm from about 1980. Bratton, *The New Economic Theory of the Firm: Critical Perspectives From History*, 41 STAN. L. REV. 1471, 1476 (1989). Because of Henry Manne's work, *supra* note 127, that of Jensen and Meckling, *supra* note 123, and that of Ralph Winter, *supra* note 125, this author believes economic thinking was afoot in corporate law somewhat earlier. In any event, many of the works cited by Professor Bratton first appeared at about the time of, or shortly after, the *MITE* decision. Bratton, *supra*, at 1476 n.22. This author believes that decision gave market enthusiasts a real boost, particularly since Justice White cited some of their work in his opinion. *Edgar*, 457 U.S. at 643-44.

175. No issues of constitutional "takings" or impairment of contractual obligations are raised by state efforts to redefine corporate stock because corporation statutes customarily contain a provision reserving power to amend, or repeal, those statutes. See, e.g., Revised Model Business Corp. Act § 1.02 (1984). The practice of inserting these provisions into corporate statutes grew out of Justice Story's concurring opinion in *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 701 (1819).

soon it was, after long-established state hegemony over the make-up of corporate stock had been rediscovered.

C. Countermoves: Curtailing Stock Alienability and Equal Voting Rights

After the *MITE* defeat, lawyers representing potential target companies developed a more straightforward and potent antitakeover strategy. This strategy sought to undermine hostile takeovers by carving back the two root attributes of common stock on which takeovers are founded, i.e., free alienability and equal voting rights. These incidents were not completely lopped off, just trimmed and gathered a bit.

1. Impairing Alienability

Alienability of stock was not directly abridged after *MITE*. By no means did shareholders lose formal legal power to transfer their stock. Rather, the consequences of its collective exercise were made so prohibitively expensive to a bidder that, in effect, investors lost the unfettered ability to resolve hostile contests by selling their stock *en masse*.¹⁷⁶

176. In 1983, Professor Louis Lowenstein pointed out what he called a "small" fact about modern corporation statutes: "[N]owhere is it expressed in terms that management has the right, for example, to prevent third parties from acquiring, without its approval, ownership of the corporation's properties As to the takeover bid, . . . management lacks a statutorily defined role." Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 263 (1983). In effect, the tender offer phenomenon caught state corporation codes unprepared. *Id.* at 264. Moreover, alienability had long been a trait of corporate stock which enabled *individual* shareholders to obtain liquidity in the trading market. Never before, however, had that feature of stock been used to enable shareholders either to depart from a corporation *en masse* or to transfer control over corporate *assets* as well as stock without management's assent. This author thinks Professor Lowenstein's analysis, by pinpointing the remarkable silences of the statutory scheme, may well have hastened the development of what we call "second-generation" takeover statutes. See *infra* notes 195-216 and accompanying text. This author thinks these silences also reveal the way in which pre-suppositions and social conventions, as much as positive law, shape legal practices. If there are no takeovers, which there were not before the 1960s, why should corporation statutes address them, and why should the historic practice of individual shareholders enjoying unfettered alienability of stock be problematic? Both corporation codes and the bundle of attributes comprising corporate stock were, prior to the 1980s, established against a cultural backdrop in which hostile takeovers were virtually non-existent. The wave of hostile transactions unleashed by the 1980s, however, buoyed by *MITE*, shattered that backdrop and prompted serious rethinking of fundamental state law precepts.

a. The Success of Poison Pill Rights Plans

In the years following *MITE*, public corporations fearing hostile overtures began implementing "poison pill" shareholder rights plans.¹⁷⁷ Under those plans, boards of directors amend company bylaws to create a new class of securities. They then distribute to existing shareholders "rights" to purchase one dollar's worth of those securities for fifty cents upon the occurrence of various triggering events often associated with a hostile takeover attempt.¹⁷⁸ Inasmuch as a hostile bidder is invariably excluded from exercising such rights, and would face drastic dilution if the rights were widely exercised by other shareholders,¹⁷⁹ no rational bidder will swallow the poison pill by unconditionally buying such quantity of shares, or taking such other action as would set it off. Instead, the bidder must first secure the incumbent board's consent to the acquisition of stock and request the board to exercise its retained power to redeem and deactivate the pill. The upshot is that purchases of large amounts of stock require the approval of a corporate board of directors as well as the decisions of individual shareholders.¹⁸⁰ In short, the aim is to make "hostile" takeovers impossible so that only "friendly," negotiated acquisitions would remain.

If this strategy could be carried off, it would be an unprecedented development in corporate law. For the first time, shareholders would be deprived of the sole power to transfer control over a corporation's assets simply by transferring ownership of stock. Directors would enjoy immense influence in large-scale stock dispositions, similar to their long enjoyed decisive say in corporate mergers. Suddenly, Justice White's glib dismissal in *MITE* of stock transfers from shareholders

177. See Yablon, *Poison Pills and Litigation Under Uncertainty*, 1989 DUKE L.J. 54, 58-59 (providing a succinct explanation of poison pills). Martin Lipton has stated that he conceived the idea of poison pills in December 1982. *Id.* at 55 n.5. This is shortly after the *MITE* decision, and its timing reveals the practicing bar's struggle to devise novel defensive measures in light of a decision striking down antitakeover statutes. In this respect development of the poison pill paralleled the rethinking of corporate statutes prompted by Professor Lowenstein. See *supra* note 176. The Investor Responsibility Research Center found that, as of August 1990, 51% of 1,487 large United States companies had "poison pill" plans, an increase of 8% over June 1989. *Majority of Large U.S. Corporations Have Adopted Poison Pills, IRRRC Finds*, 22 SEC. REG. L. REP. 1659 (Nov. 30, 1990).

178. Yablon, *supra* note 177, at 58-60 & nn.25-26.

179. *Id.* at 60-61.

180. Notice how tidily poison pill plans fill the statutory "crack" identified by Professor Lowenstein, *supra* note 176.

to third parties as being "internal affairs" was suspect. After all, *Santa Fe* itself involved a corporate merger; collective stock transfers in the takeover context would now require the same board approval as for mergers. If the very case giving rise to the rationale of "internal affairs" involved a merger, and if a takeover could take place only with the identical board consent as a merger, then perhaps stock transfers also implicated a corporation's "internal affairs."

The effort to retool the corporate machinery by which hostile takeovers take place, so as to mimic the mechanics of mergers, still faced a pair of daunting obstacles. First, unlike corporate mergers, poison pill plans are not expressly provided for in corporate statutes.¹⁸¹ A key challenge to the implementation of such plans under Delaware law failed in 1985, however, when the Delaware Supreme Court upheld a board's statutory authority to establish such plans in *Moran v. Household International, Inc.*¹⁸² Thus in Delaware only the tactical deployment and not the establishment of rights plans remained an issue.¹⁸³

Second, just as Rule 10b-5 of the 1934 Exchange Act had been used to challenge oppressive cash-out mergers prior to *Santa Fe*, so also section 14(e) of the 1934 Exchange Act was thought by some to bar target management's unfair use of defensive measures.¹⁸⁴ In the same year as *Moran*, however, the United States Supreme Court held that manipulation or nondisclosure is a necessary element of a claim under section 14(e) of the 1934 Act.¹⁸⁵ The result was that a target company's defensive conduct in hostile takeovers, e.g., the deployment of poison pills and lock-up options or the sale of crown jewels, does not by itself offend federal law. Based on the opinion of the Supreme Court, devising ingenious ways to shrink the say of shareholders in hostile takeovers, while expanding that of managers, gave rise to no federal law claims. Thus, just as *Santa Fe* had remanded

181. This has now changed. Indiana, for example, pioneered a provision authorizing implementation of poison pill plans and a provision stating that directors are not required to redeem pill rights solely because a premium has been offered to shareholders. IND. CODE ANN. §§ 23-1-26-5, 23-1-35-1 (Burns 1989).

182. 500 A.2d 1346, 1348 (Del. 1985).

183. This is no small issue, however. See Johnson, *supra* note 7 (discussing the Delaware judiciary's post-*Moran* struggle with this subject); Johnson & Millon, *Case Beyond Time*, *supra* note 13 (same).

184. See *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 377 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982). But see *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1, 4 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984).

185. *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 8 (1985).

disputes about the fairness of cash-out mergers to state law, so also *Schreiber v. Burlington Northern, Inc.* meant that controversies over the fairness of defensive tactics should likewise be settled under state principles.

In the same way as the corporate jurisprudence of Delaware had initially heightened shareholder protection in cash-out mergers after *Santa Fe* handed the issue back to the states,¹⁸⁶ so the Delaware judiciary started clamping down on defensive tactics after *Schreiber*.¹⁸⁷ Moreover, just as Delaware later changed course and fitfully relaxed shareholder protection in cash-out mergers,¹⁸⁸ so Delaware gamely struggled with,¹⁸⁹ but then substantially weakened,¹⁹⁰ judicial solicitude for shareholder interests in takeover frays. The rationale for this nimble turnaround is simple. As important and venerable as shareholder autonomy over stock disposition matters might be in corporate law (even if historically tangential to the heart of corporate law), and however seriously poison pill plans jeopardize that notion, the Delaware judiciary eventually subordinated it to an even deeper and more hallowed tenet. At all times, even in the midst of a hostile bid, management can and must act for the well-being of the corporate enterprise,¹⁹¹ not for the immediate financial interests of investors anxious for a premium.¹⁹² Thus, in the name of promoting the manifold

186. See, e.g., *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032 (Del. 1979) (corporate short form merger requires business purpose); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977) (corporate long form merger requires business purpose). See *infra* note 188 at 704 (overruling *Roland* and *Singer* holding that the business purpose requirement "is no longer the law of Delaware").

187. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). See generally, *Johnson, supra* note 7, at 913-22 (discussing shareholder primacy in Delaware cases).

188. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

189. See *Johnson, supra* note 7, at 922-25.

190. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989). See *Johnson & Millon, Case Beyond Time, supra* note 13.

191. This point was made by the Delaware Supreme Court in 1985 when it emphasized that corporate directors must assess whether a takeover attempt endangers "corporate policy and effectiveness." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985). Furthermore, directors must analyze the "nature of the takeover bid and its effect on the corporate enterprise." *Id.* (emphasis added). The court then went on to recite numerous factors, including noninvestor considerations, that had a bearing on the corporation enterprise. *Id.* Being germane to the interests of the corporate enterprise, such considerations can be said, to use the rubric of *Santa Fe*, to be "internal affairs" of the corporation.

192. This point was recently driven home by the Delaware Supreme Court in its *Time* decision. See *supra* note 190. The court stated that a board's responsibility

interests of the corporate entity, management may resist and rebuff the advances of hostile bidders, even if that means denying shareholders an opportunity to tender their stock. In short, the interests of the enterprise are distinct from and trump those of investors. This landmark outcome is of immense normative importance in corporate law.¹⁹³ And it was possible only because the most authoritative corporate tribunal in the country believed what the United States Supreme Court had blithely forsworn in *MITE*: takeovers and responses to them implicate the "internal affairs" of the corporate enterprise. The result is that, unless this judicial ruling is itself unconstitutional,¹⁹⁴ the strategic countermove of trimming the attribute of alienability has been successful.

b. The Success of Second and Third Generation Antitakeover Statutes

The Delaware judiciary was not the only lawmaking body coming to grips with the unsettling effects of corporate takeovers on corporation law. During the mid-1980s, state legislatures were busy passing unusual and robust antitakeover statutes.¹⁹⁵ Besides limiting their coverage to domestic corporations and making sure they did not run afoul of the procedural requirements of the Williams Act, two fatal but easily remedied flaws of the Illinois statute,¹⁹⁶ the so-called "second" and "third" generation statutes took a radically different tack than the law struck down in *MITE*.

Although experimentation was the byword of the day, and a welter of statutes sprang up,¹⁹⁷ these laws shared a critical thrust. The statutes struck at the very heart of shareholder autonomy over corporate stock disposition. Like poison pill plans, these statutes did

was to "chart a course for a corporation which is in its best interest . . ." *Paramount*, 571 A.2d at 1150. And, except for the "limited set of circumstances as defined under *Revlon*, [a target board is not] under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover." *Id.* See Johnson & Millon, *Case Beyond Time*, *supra* note 13 (footnote omitted) (discussing Delaware's new re-emphasis on duty to the *enterprise* rather than to the *investors*).

193. See Johnson, *supra* note 7; Millon, *Theories of the Corporation*, *supra* note 13.

194. See Johnson & Millon, *Does the Williams Act Preempt State Common Law in Hostile Takeovers?*, 16 SEC. REG. L.J. 339 (1989) (raising but rejecting argument).

195. See Johnson, *The Eventual Clash*, *supra* note 13, at 36-37 n.3 (describing the various types of antitakeover statutes enacted in the mid-1980s); *infra* notes 265-71 and accompanying text (describing the latest versions).

196. See *supra* note 162 and accompanying text.

197. See *supra* note 195.

not directly divest shares of the alienability attribute. Rather, they sought to impose a substantial levy on bidders who hostilely purchased significant blocks of stock. The levy ranged from potential loss of voting rights in the stock acquired (under control share acquisition statutes)¹⁹⁸ to the inability to cause the corporation to engage in certain financially desirable transactions for several years (under business combination statutes).¹⁹⁹ Again, as with poison pill plans, no sensible bidder will risk these deal-breaking outcomes by unconditionally buying a triggering block of stock in the target company. Instead, the offeror must launch a bid conditioned on procuring the consent of shareholders as a class (under a control share acquisition statute) or of the incumbent board (under a business combination statute). The upshot of these statutes, as with poison pill plans, is to supplant the individual shareholder's decision to alienate his or her stock as the sole determinant of a hostile bid's success. The agreement of individual shareholders to sell is still necessary but is no longer sufficient.

The control share acquisition statute was upheld by the Supreme Court in 1987.²⁰⁰ In *CTS Corp. v. Dynamics Corp. of America*, the Supreme Court held that Indiana's Control Share Acquisition Statute²⁰¹ was neither preempted by the Williams Act nor in violation of the commerce clause. In both the preemption and commerce clause portions of its opinion, the Court pointedly spoke to federal-state relations in regulating corporate stock.

Under a control share acquisition statute, the purchaser of "control shares" gains voting rights to those shares only if target company directors or a majority of disinterested shareholders vote to confer those rights.²⁰² One of the arguments made to the Supreme Court was that Indiana's statute was preempted by the Williams Act because the need for a shareholder plebiscite on the voting question and the possibility of a negative outcome might "limit or delay the free exercise of [voting] power after a successful tender offer."²⁰³ A key premise of this argument is that Congress had taken affirmative measures to guarantee such voting power. The Court responded to

198. *Id.*

199. *Id.*

200. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987).

201. IND. CODE ANN. § 23-1-42-1 (Burns Supp. 1990).

202. A summary of Indiana's statute and how it operates can be found in the Court's opinion. *CTS Corp.*, 481 U.S. at 72-75.

203. *Id.* at 85.

that claim by noting that such a reading of the Williams Act would result in preemption of "a variety of state corporate laws of hitherto unquestioned validity" ²⁰⁴ Among the laws mentioned by the Court were those permitting staggered terms for directors and cumulative voting.²⁰⁵ These too somewhat impair the franchise after a purchase of stock. To strike them as unconstitutional would be an extraordinary and far-reaching outcome. Such an effect would so seriously undermine the "longstanding prevalence of state regulation in this area . . . that, if Congress had intended to preempt all state laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly."²⁰⁶

Thus, Indiana's law passed preemption muster in *CTS Corp.* because, unlike Illinois' statute in *MITE*, it did not run afoul of the federal time periods and procedures by which tender offers are to be conducted. But, having left the *process* of tender offers untouched, a state is not required to accord a particular packet of voting rights to such stock as may be purchased in that offer. A state might alter the very contexture of the property bid for, going so far as to nullify such a rudimentary trait as voting rights. This, the Court reasoned, was the state's prerogative, and did not conflict with federal law. To hold otherwise would be to read fiction into the modest disclosure and procedural provisions of the Williams Act. It would amount to a conclusion that Congress eternally affixed to corporate stock such desirable substantive attributes as will ensure the making of hostile bids.

The Court returned to and elaborated on this cardinal theme of state-federal relations in its commerce clause analysis. Acknowledging the "variety of tests"²⁰⁷ created by its earlier commerce clause cases, and wishing to keep its analysis straightforward, the Court asserted that state legislation would violate the dormant commerce clause only if it either discriminated against interstate commerce or subjected interstate activities to inconsistent regulation.²⁰⁸ The Court concluded that Indiana's law did neither. The statute regulated only corporations organized under Indiana's laws, a power that was undisputed if not precisely located. "No principle of corporation law

204. *Id.*

205. *Id.* at 85-86.

206. *Id.* at 86.

207. *Id.* at 87.

208. *Id.* at 87-88.

and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."²⁰⁹

Having said that, however, the Court again met the argument that, left unchecked, the principle of state control over voting rights would hinder interstate tender offers. By jiggering voting rights, the argument went, states diminished the attractiveness of corporate stock. That, in turn, would effectively halt the market for corporate control, an interstate market. The Court was urged to denounce this cunning but transparent move to undermine corporate takeovers and the eminent principle of federal sovereignty over interstate commerce. Here, like rival landowners claiming a disputed patch of ground, state dominion over corporate stock squarely confronted the formidable challenge of federal autonomy over interstate commerce. The decades-long peaceful coexistence of these two regimes was in jeopardy on this question. One of the two claimants would gain and one would lose the coveted turf.

Once more the Court underscored that "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law."²¹⁰ In regulating corporate affairs, state laws "necessarily affect certain aspects of interstate commerce,"²¹¹ sometimes prohibiting or making transactions more difficult. In spite of that potentially dampening effect, it remains "an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."²¹² Applying that general guiding principle to tender offers, the fact that states may so markedly redefine corporate stock so as to sap it of appeal to hostile bidders, thereby reducing the number of such bids on interstate capital markets, "would not substantially affect our Commerce Clause analysis."²¹³ Inasmuch as Indiana's law did not purport to prohibit

209. *Id.* at 89. The Court is saying that because Indiana's statute regulates domestic corporations—a "firmly established" principle—the statute creates no risk of regulation inconsistent with that of another state. Thus, the statute is not unconstitutional by reason of offending the commerce clause. Not being unconstitutional, the statute stands. It stands because states may act unless prohibited by the Constitution.

210. *Id.*

211. *Id.* at 90.

212. *Id.* at 91. *See supra* note 209 (firmly established state regulation of domestic corporations is the constitutional basis for state activity in the "business landscape").

213. *CTS Corp.*, 481 U.S. at 93.

offers or sales of corporate stock in interstate markets as such, but only re-formulated the characteristics of the good to be sold in those markets, it was acting constitutionally:

The very commodity that is traded in the securities market is one whose characteristics are defined by state law. . . . Indiana need not define these commodities as other States do Accordingly, even if the Act should decrease the number of successful tender offers for Indiana corporations, this would not offend the Commerce Clause.²¹⁴

In holding that dominion over the task of adding and subtracting the substantive attributes of corporate stock lay with the states, the Court was doing what it had done ten years earlier in *Santa Fe* but had bypassed in *MITE*. It was spurning efforts to substitute corrupt state corporation law with federal law purportedly more enlightened and beneficial for investors. It mattered not that in *CTS Corp.* the Williams Act and the United States Constitution, rather than Rule 10b-5, were the legal battering rams for the assault on state law. Nor was it of any consequence that the driving ideological thrust was more a libertarian fondness for anti-regulatory, pro-capital securities markets than a hankering for creeping federalization of corporate law. However the attack on state power was philosophically fueled or legally framed, and whatever the virtuous economic or regulatory interests set against that power,²¹⁵ the Supreme Court was adamant. For good or bad, hegemony over the prescription of corporate stock's substantive attributes lay with the states.²¹⁶

214. *Id.* at 94.

215. The Court was unmoved by the alleged economic merits of hostile takeovers: "The Constitution does not require the States to subscribe to any particular economic theory." *Id.* at 92.

216. In 1989, the Seventh Circuit upheld Wisconsin's "business combination" statute. *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir.), *cert. denied*, 110 S. Ct. 367 (1989). The decision is notable in several respects. First, Wisconsin's legislation is virtually impregnable, unlike the Indiana law upheld in *CTS*. Second, the opinion reveals a remarkable grasp of the takeover subject and the vast literature on it. Third, the opinion's analysis is exquisitely faithful to the reasoning of *CTS*. Fourth, the author of the opinion is Judge Frank Easterbrook, former University of Chicago law professor and articulate advocate of the value of economic analysis in law. If so able a spokesman of a market-driven vision of corporate law concedes sovereignty to the states, the intellectual battle over the legality of state antitakeover laws as they now exist seems finished. In this respect, *Amanda* is almost as significant as *CTS* in causing opponents of these laws to decamp.

2. Constricting Voting Rights: The One-Share, One-Vote Decision

Burdening the sale and purchase of stock in the manner achieved by poison pills and antitakeover statutes greatly diminishes the risk of corporate insurrection by means of a hostile takeover. It does not, however, eliminate it by way of another path—the proxy fight. However historically improbable ouster of incumbent management by means of a proxy contest may have been,²¹⁷ it has always remained a theoretical, if slumbering, possibility.²¹⁸ Moreover, two contemporary facts of corporate life make a resurgence of proxy battles especially likely.

First, shareholders who witness management repelling a high premium bid may become upset and more receptive to an insurgent's request for a proxy. This might even be true of shareholders in companies other than the target. Watching high profile skirmishes elsewhere can sensitize a shareholder to uprisings closer to home. In short, the usual stumbling blocks of a successful proxy challenge, i.e., investor apathy and strong allegiance to management, might be overcome if the financial stakes are both high and plainly visible.

Second, due to the rise of institutional ownership of stock, share ownership in public corporations may not be as widely dispersed as is commonly believed.²¹⁹ With greater concentration of ownership

217. Professor Seligman describes the extreme unlikelihood of ousting management through a proxy battle:

During the period 1956-1977, the SEC published data on proxy contests for all firms subject to Commission jurisdiction under Section 12 of the Securities Exchange Act. During that period, management retained control at least 99.7% of the time each year. During the last 11 years for which data are available, management retained control at least 99.9% of the time each year.

Seligman, *supra* note 50, at 474 (footnotes omitted).

218. Recently, the threat of a proxy battle with Girard Partners L.P. led Pic 'N' Save Corporation to make various concessions to Girard, including the right to designate three of the eight board members. Rose, *Pic 'N' Save Puts Batchelder, Associates on its Board, Agrees to Other Measures*, Wall St. J., Aug. 13, 1990, at A2, col. 5. NCR Corporation also faces a proxy battle after spurning a takeover bid by American Telephone & Telegraph Company. Smith, *NCR Rebuffs AT&T, Faces Proxy Battle*, Wall St. J., Dec. 17, 1990, at A4, col. 4.

219. According to a study conducted by the Columbia University Law School Institutional Investor Project, ownership of corporate stock is increasingly concentrated in the hands of institutional owners. White, *Giant Pension Funds' Explosive Growth Concentrates Economic Assets and Power*, Wall St. J., June 28, 1990, at C1, col. 2. As one example, the twenty largest "retirement funds now account for more than 25% of all pension assets, including stocks, bonds and other investments, up from slightly more than 21% in 1985." *Id.*

comes greater facility in coordinating collective action and, accordingly, more clout.²²⁰ That clout might be used at an annual or special stockholders' meeting to install more obliging directors, persons who will either immediately dismantle the antitakeover armor²²¹ or, if and when another attractive hostile bid appears, will timely redeem the poison pill and provide necessary consents under business combination statutes. Through the power of the *voting* mechanism traditional shareholder autonomy over stock *alienability* can be shorn from the managerial meddling made possible by poison pill plans and *avant garde* takeover statutes.

Together, these considerations meant that corporate suffrage represented a viable avenue for shareholders to flex their muscle and reclaim the center of the corporate stage. It therefore posed a grave threat to management's tenure. To counteract that hazard, many managers of potential target companies in the mid-1980s sought to constrict the shareholder franchise through dual class recapitalizations.²²²

Here, unlike the case with alienability, history and state law were on management's side.²²³ State corporation statutes had long

220. See *supra* note 15 and accompanying text.

221. Pic 'N' Save Corporation recently agreed to redeem its poison pill rights and to urge shareholders to vote to opt out of coverage by Delaware's antitakeover statute. See Rose, *supra* note 218.

222. The mechanics of recapitalizations aimed at reducing the voting power of nonmanagement shareholders are described by Professor Gordon. Gordon, *Ties that Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 3, 40-42 (1988). The aim is to concentrate high-voting common stock in the hands of corporate management and low-voting, or nonvoting stock in the hands of public investors. Professor Gordon also describes the collective action and strategic choice problems associated with dual class recapitalizations. *Id.* at 42-60.

223. Almost all state corporation statutes authorize dual class common stock. It is true that state *securities* regulations in eighteen states prohibit or regulate the offering of nonvoting or limited voting shares. See Seligman, *supra* note 50, at 477 & n.113. However, companies with securities listed on the New York Stock Exchange or the American Stock Exchange are ordinarily exempt from those regulations. *Id.* at 477 & n.114. Moreover, even if the states withdrew that exemption, see *id.* at 477 & n. 115, the rules against issuing nonvoting and limited voting stock are often not absolute. For example, the most recent policy statement by the North America Securities Administrators Association (NASAA) considers offerings of such securities to be "unfair and inequitable" "[u]nless preferential treatment as to dividends and liquidation is provided . . . or the differentiation is otherwise justified . . ." NASAA Rep. (CCH) ¶ 2401, at 1501 (1990). As Professor Gordon points out, exchange offer recapitalizations *do* offer a dividend preference, thereby complying with NASAA policy. Gordon, *supra* note 222, at 48. Furthermore, several of the state regulations turn out, on close examination, to be quite mild. For example, Alabama's regulation

authorized disparate voting rights in classes of common stock and, for a brief period in the early twentieth century, numerous companies had issued classes of stock with unequal or no voting power.²²⁴ The only snag to a dual capitalization strategy (besides shareholder consent which, with an appropriate financial inducement, seemed assured) was the New York Stock Exchange's 1926 one-share, one-vote policy.²²⁵ Even this august practice presented no insurmountable hurdle because the Exchange's stature in the trading markets was considerably less in the mid-1980s than it had been in the 1920s.²²⁶ Whereas earlier the New York Stock Exchange's practices were a dominant factor in shaping many of the conventions of American corporate stock culture, the eager rivalry of the American Exchange (AMEX) and the over-the-counter market severely imperiled that pacesetter role.²²⁷

Thus drawn to the evident antitakeover advantages of dual classes of common stock like moths to a flame, several New York Stock Exchange-listed companies in 1984 proposed such recapitalizations to their shareholders.²²⁸ These plans presented a direct challenge to NYSE policy. Precipitated by General Motor's plan to issue a second class of common stock with one-half vote per share, the NYSE, reluctant to lose the substantial revenue from GM's listing

applies only to companies in the formative stages or those without operating profits, hardly candidates for takeover. Alabama Rule 830-X-4-13, Blue Sky L. Rep. (CCH) ¶ 7453, at 3433 (1990). Ohio requires only that the fact of voting power disparity be prominently disclosed on the front cover of the offering circular. Blue Sky L. Rep. (CCH) ¶ 45,707, at 40,601 (1986). Texas regulations authorize the securities commissioner to consider whether offsetting benefits (like a dividend preference) accompany the stock. TEXAS ADMIN. CODE § 113.3(b), Blue Sky L. Rep. (CCH) ¶ 55,583, at 49,522 (1990). Taken together, these factors substantially reduce the constraint on dual capitalizations seemingly supplied by state blue sky laws.

224. See *supra* text accompanying notes 52-53. As a practical matter, today it is far from clear that many of the beneficiaries of institutionally-held stock have effective say on how that stock is voted. Thus, to a possibly large degree, the vote may already be separated from the holder of the financial incidents of stock.

225. See *supra* text accompanying notes 55 & 58.

226. The weakening of the NYSE's competitive position is succinctly described by Professor Gordon. See Gordon, *supra* note 222, at 5-6.

227. In the mid-1980s, the National Association of Securities Dealers (NASD) did not prohibit nonvoting or limited voting stock by companies whose securities were traded over-the-counter. The AMEX did not permit nonvoting stock but, within limits, did permit classes of stock with disparate voting rights. Am. Stock Ex. Guide (CCH) ¶ 10,003, at 3514 (1974). See Seligman, *supra* note 50, at 472-73.

228. See Kerbel, *supra* note 47 at 40-41 nn.6-9 (providing the names of several corporations that adopted dual capitalization plans); Gordon, *supra* note 222, at 4, 80-85 (same).

to the American Exchange or the National Association of Securities Dealers Automated Quotation System (NASDAQ), undertook a review of its longstanding policy. The 1985 report of the committee appointed to reconsider the rule cited various factors in support of relaxing the rule²²⁹ but the specter of trading competition seemed predominant. The outcome of the committee's deliberations was a recommendation, hedged in with several conditions, that dual capitalization with unequal voting rights among classes no longer be a bar to listing privileges on the Exchange.²³⁰ Sixty years of practice was to be set aside.

Responding to the saber, rattling of possible federal legislation dictating one share, one vote,²³¹ officials of the NYSE then huddled with those of AMEX and the National Association of Securities Dealers (NASD). The discussion centered on whether, rather than the NYSE dropping its historic ban, the other two bodies should impose their own. The NASD balked, and in 1986 the NYSE, bowing to competitive pressure, proposed to relax its rule even further than initially recommended. In accordance with section 19(b) of the 1934 Act,²³² the Exchange then sent its new rule on for SEC approval.

The SEC did not endorse the proposed rule. Claiming to act pursuant to section 19(c),²³³ the agency promulgated its own rule for comment. After receiving extensive comments on the proposed rule, the SEC adopted Rule 19c-4 in final form in July 1988.²³⁴ The rule did not mandate that public corporations adhere to a policy of one share, one vote. It proceeded more obliquely. The rule prohibited *all* national securities exchanges and national securities associations from listing the stock of such companies who had thereafter adopted dual capitalization structures that reduced the voting power of existing shareholders. The SEC reasoned that corporations could voluntarily,

229. See Kerbel, *supra* note 47, at 64.

230. NEW YORK STOCK EXCHANGE, INITIAL REPORT OF THE SUBCOMMITTEE ON SHAREHOLDER PARTICIPATION AND QUALITATIVE LISTING STANDARDS 3 (Jan. 3, 1985).

231. See Kerbel, *supra* note 47, at 65 n.81 (describing S. 1314, 99th Cong., 1st Sess. (1985) and H.R. 2783, 99th Cong., 1st Sess. (1985)). See also Tender Offer Reform Act, H.R. 2172, 100th Cong., 1st Sess., 133 CONG. REC. H2540 (Apr. 27, 1987) (proposal for establishing federal one-share, one-vote standard).

232. 15 U.S.C. § 78s(b) (1982).

233. *Id.* § 78s(c).

234. Voting Rights Listing Standard; Disenfranchisement Rule, 53 Fed. Reg. 26,376, 26,394 (1988) (codified at 17 C.F.R. § 240.19c-4 (1990)). See Comment, *Toward a Liability Rule Approach to the "One Share, One Vote" Controversy: An Epitaph for the SEC's Rule 19c-4?*, 138 U. PA. L. REV. 1761 (1990) (critiquing Rule 19c-4 from a contractarian viewpoint).

if begrudgingly, follow a policy of equal voting rights, because publicly held companies want their stock listed for national trading and all major outlets for stock trading are covered by the rule.

Plainly, the SEC doubted its ability to directly adjust the voting rights of corporate stock. The key legal question was whether the SEC could indirectly accomplish that result by its oversight of national securities exchanges and associations. But this strategy, however apparently new and canny, was in fact the same backdoor federalization strategy defeated twice before. It lay behind the effort to extend SEC Rule 10b-5 into corporate governance so as to check the unseemly practice of cash-out mergers. It was also the central game plan for curbing state antitakeover regulation through a historically unsound reading of the Williams Act and by conjuring the commerce clause into a guarantor of stock alienability. Indeed, the one-share, one-vote issue is simply the reverse side of the issue in the antitakeover statute cases lost in *CTS Corp.* and *Amanda Acquisition Corp. v. Universal Foods, Inc.* In the latter set of cases, the decisive legal question was whether the states had acted unconstitutionally. On the one-share, one-vote issue, the critical question was whether, as an administrative agency, the SEC had overstepped its statutory grant of authority. But both questions bottom on a more basic inquiry—wherein lies the sovereign power to define stock attributes? Whose turf is it?

Twice the flanking strategy had failed because twice federal law was being pushed beyond its proper bounds. Now, both in spite of those defeats and in order to surmount them, and in a final effort to salvage a role for federal law in stemming the dizzying erosion of shareholder rights under state law, regulatory hegemony over the *places* where stock is traded was used to impose a kind of dress code for admission, i.e., unless common stock looks a certain way, no trading.

However thoroughly one scours the legislative history of the 1934 Act, or however broadly one tries to read certain of its key provisions,²³⁵ all arguments in support of SEC authority to adopt

235. Professor Seligman makes the strongest case for SEC authority to adopt Rule 19c-4 that this author has seen. See Seligman, *supra* note 50, at 477-79. But even he has some doubt because he states only that the SEC has such power "in all probability." See also Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1259 & n.345 (1984); Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 714-19 (1986).

Rule 19c-4 boil down to one ultimate claim. In the early 1930s, Congress not only assumed that shareholders had equal voting rights because of NYSE policy,²³⁶ it also intended that if that pre-understanding ever changed then the SEC was empowered to restore equal voting rights. That viewpoint is conceptually incredible and historically unsupportable. Acting against a legal backdrop in which equal voting rights and alienability were taken for granted, Congress built upon them, but it did not enshrine them. Congress never drafted a contingency plan to kick in if and when circumstances changed. Altering the substantive attributes of stock might indeed jeopardize the regulatory edifice constructed by Congress as an overlay on state law. But that outcome is no warrant for inferring that Congress had prophesied and provided for precisely that possibility when, in fact, it never thought about the matter.²³⁷

When the basic complementary relationship between state corporation law and federal securities law is recalled,²³⁸ especially in light of the Supreme Court's line-drawing efforts in *Santa Fe* and *CTS*, the decision of the Court of Appeals in vacating Rule 19c-4 is no surprise. The SEC had lost the case long before it was decided. This can be seen in the court's treatment of SEC reliance on section 19(c) of the 1934 Act as the statutory keystone for its rule. Because that section authorizes the SEC to adopt rules "otherwise in furtherance of the purposes of this [title],"²³⁹ the court was quickly led to the bedrock question: "What then are the 'purposes' of the Exchange Act?"²⁴⁰

The SEC's principal claim was that section 14(a)'s blanket grant of power to regulate the solicitation of proxies revealed a congressional intention "to ensure fair shareholder suffrage."²⁴¹ Probing behind the vague reference to "fair corporate suffrage" in the legislative history, the court found that Congress' true aim for the 1934 Act's proxy provisions was to ensure that shareholders had "adequate knowledge" by shareholders of the major questions to be decided at

236. See *supra* text accompanying notes 59-68.

237. The author finds no basis whatsoever for making the following kind of statement about what was on Congress' mind in 1934: "In 1934, Congress presumably must have viewed nonvoting common stock or common stock with disproportionate voting rights as . . . an abuse." Seligman, *supra* note 50, at 479. See *supra* note 46.

238. See *supra* Part II.

239. 15 U.S.C. § 78s(c) (1982).

240. *Business Roundtable*, 905 F.2d at 410.

241. *Id.*

stockholder meetings.²⁴² In other words, as to the pointed question of *how* Congress intended the very general objective of “fair corporate suffrage” to be realized, the court’s answer was, unsurprisingly, “disclosure.” Moreover, the court highlighted language in the House and Senate Reports²⁴³—and could have emphasized the language of section 14(a) itself²⁴⁴—to declare that it was only the *solicitation* of proxies Congress regulated. Since the goal was to improve the flow of information when proxies are solicited, to read into section 14(a) a general concern with voting rights is to regulate not only the *solicitation of proxies* but also the *stock* of shareholders.

That the SEC actually abjured the Congressional philosophy of disclosure because the SEC did not believe even informed shareholders could be trusted to decide whether to relinquish voting rights by approving a dual capitalization plan was not lost on the court. The court could not resist tweaking the SEC by observing that Congress itself “acted on the premise that shareholder voting could work,”²⁴⁵ and hastening to add that Congress “did not seek to regulate the stockholders’ choices.”²⁴⁶ Shareholders were free to disenfranchise themselves.²⁴⁷ But the court could have gone even further. Not only did Congress not dictate *how* shareholders can choose, it did not even dictate (as opposed to assuming) that shareholders must have the right to choose at all. Why should it? In the early 1930s, it was not an issue. It only became an issue decades later, in the 1980s, when legal reactions to hostile takeovers quickened the anti-shareholder drift of state law earlier noted by Cary and others.

Recognizing that Rule 19c-4 had crossed beyond Congressional concern with information and into the state law domain of corporate powers, the court saw little to impede further incursions once that move was made. Were that to happen, the result would be the same as that to which an expansive reading of Rule 10b-5 was being put in the 1960s and 1970s: federal corporate law by administrative rather than legislative action. This time, however, the vehicle being used was access to national capital markets. Citing *Santa Fe*’s emphasis

242. *Id.* See *supra* note 60.

243. *Business Roundtable*, 905 F.2d at 410; H.R. REP. NO. 1383, 73d Cong., 2d Sess. 14 (1934). See S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934).

244. See 15 U.S.C. § 78n(a) (1982).

245. *Business Roundtable*, 905 F.2d at 411.

246. *Id.*

247. See Comment, *supra* note 234 (arguing, from a “contractarian” viewpoint, that shareholders *should be* free to contract away their voting power).

on the supremacy of state law in regulating internal affairs and in assembling the substantive attributes of corporate stock, the court refused to read section 19(c) as a blank check for the SEC to alter that "tradition."²⁴⁸

Finally, the court observed that although the attribute of equal voting rights may be "an important part of the background"²⁴⁹ against which Congress acted, nowhere is there evidence that one of the purposes of the federal securities laws is "preservation of the one share/one vote principle."²⁵⁰ In these few words, the court captured a simple but stubborn fact about federal securities law, i.e., its utter beholdenness to state law for sculpting the contours of the commodity it regulates. And that cogent recognition extinguished the last embers of a persistent but failed effort to make federal law do more than it was ever designed to do.

IV. SHOULD CORPORATE STOCK BE REJUVENATED?

In one sense it seems odd that there was ever any doubt as to whether a federal law almost sixty years old did or did not usurp control over a key corporate subject. But the question of which legal regime (state or federal) governs an area never arises, or is of any interest, in the abstract. Rather, that debate is fueled by disagreement over specific issues that may develop long after the legal machinery is in place. Eventually, social, political or economic change leads to the emergence of conflicting beliefs on concrete matters. In a political system founded on principles of federalism, over time the merits of the dispute evolve to crystallize around two positions, i.e., continuation of state practices or a federal override. The result is a turf battle.

The supposed points of conflict between federal and state law described in this article would have been meaningless sixty, fifty, forty, or even thirty years ago. Only chronic spoliation of state law, coupled with the acute emergence of the hostile takeover phenomenon and the increasingly sophisticated responses to it, produced this clash. One's beliefs about the relative value of those two transshaping

248. *Business Roundtable*, 905 F.2d at 412 (noting that "[a]t least one Commissioner shared this view, stating '[s]ection 19c does not provide the Commission *carte blanche* to adopt federal corporate governance standards through the back door by mandating uniform listing standards'" (quoting Final Rule, 53 Fed. Reg. at 26,395/1) (Grundfest, Comm'r, concurring)).

249. *Business Roundtable*, 905 F.2d at 413.

250. *Id.*

developments generally control whether one prefers state or federal law. Thus, if the drift of corporate law over the past several decades is disturbing, some would look to market forces such as hostile takeover activity as remedies. In this simplistic view, markets are decontextualized into extra-legal phenomena that benevolently constrain corporate law and eventually correct its ills. Yet, if nurturing *market* forces requires a *regulatory* presence in the form of a federal override (via claims that state law is preempted or violates the commerce clause) or federal intervention (via new legislation), some are unwilling to contravene state authority.²⁵¹ Others, however, might be willing to pay that political price to revitalize market activity, while still others are less enamored of hostile takeovers generally and would deal with undesirable developments in corporate law through other means. The underlying issues should be tackled openly and not dodged by various artful claims that existing federal law has very much to say about them, precisely because they generate such heated discussion and disparate responses.²⁵² What are those issues, and who should address them?²⁵³

A. *The Direction of State Corporation Law*

Disturbed as he was in 1974 at the weakened position of shareholders in public corporations, compared to their status in 1990, Professor Cary should have been elated. Especially over the past six years, state corporation law has severely shackled shareholder influence over corporate affairs. This dampening of shareholder say is a direct result of hostile takeovers. This trend is evidenced by both corporate statutes and, after a brief flirtation with shareholder pre-eminence, current judicial review of defensive measures as well. Whether one focuses on the proliferation of insuperable antitakeover

251. Professor Romano, for example, is disturbed by antitakeover statutes but reluctant to advocate federal intervention. *See Romano, supra* note 150.

252. *See Johnson, supra* note 7, at 868. *See also id.* at 868 nn.11, 12 & 869 n.17 (referring to works treating various facets of the takeover controversy).

253. In another context, Professor Stanley Fish has recognized the importance of addressing who gets to decide answers to legal questions:

After all, the crucial question, which returns the original problem to center stage, still has to be asked: Who gets to make the rules? And once that question is answered, another question (it is really the same) waits behind it: Who gets to say who gets to make the rules?

Fish, *Force*, 45 WASH. & LEE L. REV. 883, 884 (1988).

laws or the Delaware Supreme Court's recent *Paramount Communications, Inc. v. Time Inc.*²⁵⁴ decision, the emphasis on expanded managerial prerogative is unmistakable. Today, the scope of this prerogative is far greater than that critiqued by Professor Cary. It now extends to the market for corporate control thought by Ralph Winter and others to be both the missing ingredient in Cary's misguided call for federal action and the unsung vehicle by which shareholder power would be reclaimed. The two prongs of state corporate law have adroitly outflanked believers in this brand of market medicine for corporate ills. By empowering corporate management to short-circuit market mechanisms, state law has now effectively neutralized the capital market antidote for its earlier failings.

One can easily launch a searing indictment of this development.²⁵⁵ In addition to betraying shareholders, states are accused of sheltering parochial interests and of pandering to corporate management. Besides a massive erosion in shareholder influence, the results are said to be a substantial diminution of shareholder wealth, depressed share prices, externalization of costs, throttling of competitive market forces, reduction in the efficiency with which corporate resources are used, loss of international competitiveness, absence of genuine protection for local interests, retrograde corporate governance, and a serious lack of managerial accountability.²⁵⁶

The responses to these allegations are well-known.²⁵⁷ One claim still heard, although less frequently than in the past, is that shareholders are now better off because of state law. This claim has both a descriptive and a normative dimension. Descriptively, this refrain is a managerial apologist's ironic variation on a theme sung by market advocates: the current status of law must be beneficial to shareholders because, over the long run, corporate law itself is the

254. 571 A.2d 1140 (Del. 1989).

255. After Pennsylvania added several new wrinkles to its already formidable antitakeover law in 1990, Senator Vincent Fumo labeled it the "Fat Cat Protection and Shareholder Rip-off Act of 1989." Elias, "Turning Up the Heat on the Top," *Insight*, July 23, 1990, at 8, 9. See generally *id.* (providing other criticisms of Pennsylvania's new law).

256. See Cann, *Toward The Depoliticization of Takeover Theory: Creation Of An Innovation Factor*, 40 SYRACUSE L. REV. 1167, 1172-77 (1989) (summarizing many of these arguments). See also Prentice & Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They be Allowed To?*, 15 DEL. J. CORP. L. 377 (1990).

257. See, e.g., Cann, *supra* note 256, at 1177-81; Prentice & Langmore, *supra* note 256. See also *supra* note 13.

product of a bargain of sorts. Given institutional shareholder complaints about the status of state law, either the description is wrong or the parties have yet to "renegotiate" their bargain. The normative thrust is that if management's defensive power is so awesome, then it should be deployed to extract higher premiums from hostile bidders. However appealing that normative justification of positive law was when management could delay (but not flatly rebuff) hostile overtures, current law so heavily fortifies management that event-driven auctions, restructurings, and other investor wealth-enhancing measures²⁵³ seem increasingly unlikely. Today, the claim that these statutory and case law developments therefore are visibly advantageous for shareholders rings hollow.

Moving away from a shareholder-centered standard of appraisal, state law developments are sometimes applauded for curbing an unhealthy and destabilizing use of debt to finance corporate acquisitions, freeing corporate management from an excessive focus on short-run stock price performance (thereby enabling it to manage enterprises for the longer term), increasing international competitiveness, slowing foreign purchases of American companies, protecting various noninvestor interests, and, in general, "throwing some sand" into the gears of the takeover mechanism.²⁵⁹

One obvious problem in seeking to settle these conflicting claims is disagreement over the proper criterion (or criteria) for evaluation. Using the orthodox metric of shareholder well-being, state corporation law regulating hostile takeovers fails the grade. Likewise, when strict management accountability is the calculus. When efficiency in resource use is the measure, however, the evidence is mixed.²⁶⁰ Some

258. Prentice & Langmore, *supra* note 256. See also *supra* note 13.

259. The phrase "throwing some sand" is Professor Tobin's. Plender, *Throw Sand in the Takeover Machine*, Fin. Times (London), July 24, 1990, at 18. Concern over foreign investment in America found expression in the Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act of 1988. Omnibus Trade & Competitiveness Act of 1988, Pub. L. No. 100-418, 102 Stat. 1107 (1988). As summarized by Joseph Reece, the amendment "gives the President the power to suspend, prohibit or dismantle mergers, acquisitions and takeovers of United States companies by foreign investment which threaten 'national security.'" Reece, *Buyer Beware: The United States No Longer Wants Foreign Capital to Fund Corporate Acquisitions*, 18 DEN. J. INT'L L. & POL'Y 279, 281 (1990). As of mid-1990, President Bush had followed the advice of the Committee on Foreign Investment in the United States, a high-level inter-agency panel, on each of the occasions when a formal inquiry over the "national security" aspects of a takeover has been held. Riddell & Kehoe, *Sale of U.S. Chip Group to Japanese Wins Backing*, Fin. Times (London), July 18, 1990, at 3.

260. See Johnson, *supra* note 7, at 869 n.20, & 884-88.

economists positively crow about takeovers (and thus against state law obstacles) while others are highly skeptical of efficiency claims. As to exorbitant levels of debt, conventional finance wisdom emphasizes caution in reliance on leverage, yet Professor Michael Jensen asserts that too little debt is the real culprit.²⁶¹ On the role of takeovers in enhancing long-run competitiveness, again both sides claim victory. With respect to protection for noninvestor interests as a justification for antitakeover laws, concededly such interests remain subject to incumbent management discretion and enjoy no fully-developed legislative program for their protection.²⁶² But, at the same time, those interests regularly join the clamor for protection from hostile bids²⁶³ and appreciate the fact that facing a rifle with one bullet (managerial latitude) is better than facing one with two (hostile bidders as well).

Thus, there is not only a difference of opinion over how the evidence stacks up in agreed categories, but a deeper sparring over standards for assessment. The former quarrel can be resolved empirically within the limits of social measurement. The latter dispute cannot for it represents a rejection of the conventional shareholder-welfare, management-accountability prism for viewing corporate issues in favor of a more heterodox, less easily quantifiable outlook. It is as if one of two neighbors, who have long tended a plot of ground together, suddenly decides to farm by organic principles while the other remains wedded to high doses of herbicides and pesticides. One claims to value sustainability of the soil while the other cherishes a higher yield. At this level of controversy, there is no palpably "right" answer because incommensurable standards are at work. However important it is that each side remain open to, respectful of, and instructed by the other's views, it is futile to try to shoehorn the arguments and data of one party into the normative scheme of the other.

Today, however tentatively and fumblingly, state law expresses serious reservations about the social utility of hostile takeover activity. In doing so, the law mirrors the doubts of society at large, a proper role of law, corporate or otherwise.²⁶⁴ Part of the regulatory fallout is adversity for shareholders. But that fact, however disturbing when

261. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986).

262. See Cox, *supra* note 13, at 203-14.

263. See Millon, *supra* note 16.

264. Johnson, *supra* note 7, at 934.

viewed in isolation, clinches nothing, either for social policy or corporate law, when set into a larger matrix of considerations. Thus, the claim that in 1991 state corporation law is not fully responsive to shareholder concerns is not denied, it is duly noted and met with a "yes, but"

B. Responses to State Corporation Law

Only by appreciating a couple of basic points can one answer the question of what, if anything, should be done about the current condition of state corporation law. First, empirically, much is still unknown about the overall effects of hostile takeover activity. Second, a significant number of responsible persons are saying "yes, but" Failure to acknowledge these facts will lead to calls for one or more of the misguided courses of action described in the three subparts below.

1. Continued Constitutional Challenges to State Antitakeover Legislation

Like the quest for nuclear fusion, state legislatures feverishly continue their search for a truly invincible form of antitakeover legislation. Control share acquisition and business combination statutes, now *de rigueur*, are joined by a remarkable panoply of other innovative laws. These baroque laws authorize,²⁶⁵ and sometimes require,²⁶⁶ directors to consider noninvestor interests in forming corporate responses to hostile bids; make explicit that shareholder interests are not the primary or controlling factor in managerial decision making;²⁶⁷ require bidders to honor trade union contracts and make substantial severance payments to discharged employees;²⁶⁸ authorize corporations to insulate directors from liability;²⁶⁹ make it clear that directors may refuse to redeem poison pill plans;²⁷⁰ and oblige shareholders, who have held twenty percent or more of a company's voting

265. See, e.g., MINN. STAT. ANN. § 302A.251, subd. 5 (West 1990); OHIO REV. CODE ANN. § 1701.59D (Anderson Supp. 1989).

266. See CONN. GEN. STAT. ANN. § 33-313(e) (West 1990).

267. IND. CODE ANN. § 23-1-35-1(f) (Burns Supp. 1990); 1990 PA. LAWS 36, §§ 2, 4 (amending 15 PA. CONS. STAT. §§ 511(e), 1721(f)(3) (Supp. 1990)).

268. 1990 PA. LAWS 36, § 6 (adding §§ 2581-2583, 2585-2588 to 15 PA. CONS. STAT.).

269. DEL. CODE ANN. tit. 8, § 102(b)(7) (1974 & Supp. 1988); 1990 PA. LAWS 36, § 2 (amending 15 PA. CONS. STAT. § 512).

270: 1990 PA. LAWS 36, § 4 (amending 15 PA. CONS. STAT. § 1721(F)(1)).

stock for less than two years, to disgorge to the corporation any profit on shares sold within eighteen months after the shareholder first became a twenty percent or more owner.²⁷¹ Only the limits of corporate lawyers' imaginations constrain yet additional legislation.

These latest enactments have caused considerable handwringing among, and have been harshly criticized by, academic commentators, shareholder advocacy groups, and the recently-resigned General Counsel of the SEC.²⁷² Moreover, the new chairman of the SEC, Richard Breeden, has lambasted these laws and asserting a compelling federal interest in a national market for stocks, menacingly indicating the SEC may challenge them on constitutional grounds.²⁷³ At least one corporate scholar believes that a challenge on constitutional grounds will be successful.²⁷⁴ Tough talk is the prerogative of a new administrative chief.²⁷⁵ But whatever the chairman's beliefs about the substantive flaws of this legislation, one can only hope his threat of legal action, issued before the SEC's drubbing in the one-share, one-vote case, will be reconsidered as a waste of time and a lost cause. Failure to do so can only signify an almost conscious blindness to the fact that, for good or bad, states possess the constitutional power to pluck attributes of stock to the point that the shareholder is virtually impotent. The real row should not be over whether they now have that power, but whether it should be taken from them.

2. Imposition of One Share, One Vote by Self-Regulatory Organizations

Invalidation of Rule 19c-4 may lead to voluntary adoption of a one-share, one-vote pre-condition to trading by the NYSE, AMEX and NASD. Although the NYSE ignited the voting rights furor in the first place by proposing to rescind its longstanding policy, it retained its own one-share, one-vote rule after promulgation of Rule

271. 1990 PA. LAWS 36, § 6 (adding §§ 2571-2575 to 15 PA. CONS. STAT.).

272. See Elias, *supra* note 255; *States Acting in Takeover Arena Says SEC General Counsel*, Fed. Sec. L. Rep. (CCH) No. 1389, at 4 (Apr. 18, 1990).

273. *Chairman Breeden Addresses Takeovers and Shareholders' Rights*, Fed. Sec. L. Rep. (CCH) No. 1392, at 4-6 (May 7, 1990).

274. Professor Ronald Gilson of Stanford University Law School has stated that "state regulation of publicly held domestic corporations conflicts with the commerce clause." Elias, *supra* note 255, at 15. See also Sidak & Woodward, *supra* note 150.

275. Day, *Tough Cop at the SEC; Chairman Richard Breeden, in Office a Year, Aggressively Seeks to Expand Agency's Authority*, Wash. Post, Oct. 14, 1990, at H1.

19c-4. Moreover, although the NYSE is understandably concerned about competitors refusing to adopt such a rule in an effort to capture listings, the NASD Board of Governors recently adopted a one-share, one-vote rule.²⁷⁶ If the AMEX goes along, it would appear that the whole voting rights upheaval could be expeditiously resolved and the 1926-1988 era of corporate suffrage be restored. For two reasons, this would be an unsatisfactory outcome.

First, in light of the one-share, one-vote decision it is far from clear that a one-share, one-vote rule adopted by self-regulatory organizations will have the force of federal law, as opposed to the status of a rule imposed by any voluntary association, be it a country club, fraternal organization or self-regulatory securities organization. The court rejected the SEC's claim that it had authority to promulgate the rule under the "otherwise in furtherance of the purposes of this title" language of section 19(c) of the 1934 Act.²⁷⁷ Section 19(b) of the Act provides that self-regulatory organizations must file their proposed rules with the SEC.²⁷⁸ It further provides that the SEC shall approve the rule, presumably thereby according it the same legal status as a rule promulgated under section 19(c), if it makes a finding that the proposal is "consistent with the requirements of [the Act]."²⁷⁹ If the SEC cannot make such a finding, it shall disapprove the proposed rule.²⁸⁰

While the language of section 19(b) differs somewhat from section 19(c), it seems likely that if an agency-initiated rule is not in "furtherance of the purposes of this title," then the same self-regulatory organization-initiated rule is not "consistent with the requirements of this title." Under this reading, the SEC must disapprove such an SRO-sponsored rule. If, on the other hand, such a rule is "consistent" with the "requirements" of the Exchange Act because "consistent" is more neutral and less demanding than "furtherance," then all kinds of rules are "consistent" with that Act. In that case, the SEC could "approve" the rule but the effect of its action on

276. On July 25, 1990, the NASD filed with the SEC a proposed rule change whereby Part III, Section 5 of Schedule D of the NASD Bylaws would be amended to adopt the same prohibitions as were contained in vacated SEC Rule 19c-4. 55 Fed. Reg. 31,465 (1990). The proposed change does not apply to all issuers on NASDAQ, but only those larger issuers whose stocks are in the NASDAQ National Market System. *Id.* at 31,465 n.5.

277. *Business Roundtable*, 905 F.2d at 407.

278. 15 U.S.C. § 78s(b)(1) (1982).

279. *Id.* § 78s(b)(2).

280. *Id.*

the status of the rule under federal law is unclear, and would seem to be different than approval under the "furtherance" standard of section 19(c).

By bringing rules of the SROs under SEC authority, as it did by enacting section 19(b), one might argue that Congress has forbidden SROs to impose and enforce rules that are not "consistent with the requirements of this title." Otherwise, it is not clear what SEC approval is supposed to add to the rules of voluntary associations. The inability of the SEC to approve an SRO-proposed one-share, one-vote rule may mean more than simply regarding SRO rules as mere policies or conventions that, while lacking the force of federal law, still must be complied with by issuers. It might mean that those rules which cannot be approved lack force of any kind. Even if approved, the status of such rules under federal law is murky.

Were section 19(b) construed otherwise than as argued, SROs could do voluntarily under that section far more than the SEC could mandate under section 19(c). For example, they could condition trading privileges on the agreement of issuers to opt out of antitakeover statutes or to rescind poison pill plans. Those conditions would invade state corporation law as deeply as the SEC's one-share, one-vote rule. Perhaps Congress meant either to "leave" such power in the hands of SROs (if not the SEC) or to "confer" such power on SROs notwithstanding the clear aim of drawing those bodies under the federal regulatory mantle.²⁸¹ But it is also a possibility that in leaving corporate governance with the states, Congress denied dominion over such fundamental matters to SROs as well as the SEC.²⁸²

Second, states have pruned the alienability and voting attributes of corporate stock because they believe that unfettered exercise of those powers causes deleterious effects on other important interests. The states may be dead wrong. But should their collective legislative decisions be overborne by the views of self-regulatory organizations? Officials of SROs, like the SEC, may conceive of the one-share, one-vote issue as simply a matter of restoring integrity to corporate

281. Moreover, the *collective* exercise of this power by the SROs might raise an antitrust issue. Compare *Silver v. New York Stock Exch.*, 373 U.S. 341 (1963) (no implied revocation of antitrust laws by Exchange Act) with *Gordon v. New York Stock Exch.*, 422 U.S. 659 (1975) (implied revocation of antitrust laws by Exchange Act); *Finnegan v. Campeau Corp.*, 915 F.2d 824 (2d Cir. 1990) (same).

282. In the one-share, one-vote decision, the court briefly digresses to take up the § 19(b)—§ 19(c) anomaly. *Business Roundtable*, 905 F.2d at 414-15. This author finds its treatment enlightening but not persuasive.

stock and, therefore, like apple pie, an unquestioned good. Lacking multiple constituencies or the democratic processes of legislatures, they may not view erosion of shareholder power as a necessary, albeit draconian, means to the end of quelling perceived abuses of takeover practices. Such officials may wonder "What abuses? Takeovers raise trading volume." Debate over problems underlying perceived abuses never gets started because the vast body of people adversely affected by corporate activities have no input into the deliberations of stock trading associations. Even if they did, the decision-making criteria of those organizations center solely upon facilitating capital exchanges and enhancing investor protection. Yet, exaggerated emphasis on those qualities, however laudable in proper portions and in context, may be the very instrument by which the alleged disruption wrought by takeovers is accomplished. In this respect, the range of stock exchange considerations is as narrow as many prescribe for corporate law.²⁸³ Finally, ordinary citizens cannot register disapproval of the potentially enterprise-shaking actions taken by these officials because these officials are not elected.

At bottom, corporate suffrage in the 1990s is not a dull, obscure subject to be gratefully consigned to those stock exchange officials who can stomach it. Voting power, and the control over corporate activity it entails, is inextricably tied to the need of society at large for a clearer assessment of hostile takeovers and their broader socioeconomic ramifications. It is tied, as well, to the need for extended discussion of the strength and reach of the claims of capital providers on corporate activity in a modern society. Consequently, decisions about voting rights should not be in the hands of those whose livelihood depends on high levels of trading activity in corporate stock. The issue should be in the spotlight. It belongs in a legislative forum.

3. Federal Intervention

There is little question that, by virtue of the commerce and supremacy clauses, Congress has the constitutional authority to override state corporation law. Proposals for federal intervention into corporate governance have been made from time to time throughout the twentieth century.²⁸⁴ Occasioned by the recurring belief that state

283. See *supra* text accompanying note 7.

284. See Boyer, *Federalism and Corporation Law: Drawing the Line in State Takeover Regulation*, 47 OHIO ST. L.J. 1037, 1041-56 (1986).

law has sunk to new depths, these calls have ranged from modest tinkering with state law to proposals for a wholesale federal incorporation act.²⁸⁵ They have always failed. Most recently, the 1987 decision of the Supreme Court upholding state antitakeover statutes²⁸⁶ set off a new clamor for federal action, this time in the form of recommendations for express preemption of state antitakeover laws.²⁸⁷ That effort fizzled as well. Now, unless SROs voluntarily act, the one-share, one-vote decision will rekindle pleas for federal law mandating equal voting rights.²⁸⁸

From the vantage point of corporate law orthodoxy, such appeals seem compelling and uncontroversial. Who in a political democracy can demur to equal voting rights, more vibrant corporate governance, stricter accountability and a reaffirmation of shareholders as the sheet anchor of corporate life? Framed that way, only a shameless apologist for despotic managers could dissent. But like other takeover-related legal issues, the two sides of this specific issue serve as rallying points for beliefs about the pros and cons of that larger phenomenon. Those with honest misgivings about the overall value of high levels of hostile takeover activity are not in principle opposed to equal suffrage, accountability, and shareholder welfare. They do not, however, assess those virtues in isolation or regard them as static abstractions. Consequently, they are unwilling to commit unreservedly to those concepts if doing so is not demonstrably, and by some widely acclaimed measure, the superior course of action in light of the exigencies of a specific social phenomenon. This reluctance is nothing more than a desire to keep matters open for discussion until wider consensus is reached or, short of that, until the source of disruption (here,

285. *Id.* See *supra* text and accompanying note 85.

286. See *supra* text and accompanying notes 200-16 (discussing the holding of *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987)).

287. "'There are lots of people who would like to pre-empt these state [takeover] statutes, but the majority of them are law professors and economists. . . . That's not a large enough constituency to encourage strong federal pressure to overturn what are about 40 state laws.'" Sontag, *After Ruling, Stricter Law on Mergers?*, Nat'l L.J., July 10, 1989, at 24, col. 4 (quoting Professor John Coffee of Columbia University School of Law). In 1988, Congress considered preemption, but intense lobbying by labor unions, the Business Roundtable, and other groups quashed the subject. See *id.*

288. See S. 1314, 99th Cong., 1st Sess. (1985) and H.R. 2783, 99th Cong., 1st Sess. (1985) (two recently proposed one-share, one-vote bills). Recently, Professor Seligman has renewed the argument for federal minimum corporate-law standards. Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 917 (1990).

takeover activity) calms down and can be assayed with less passion. In short, it is a strategy for resolving conflict by prolonging rather than stifling full-bored debate. Thus it celebrates a proliferation and diversity of voices and rejects calls for prematurely closing the book and imposing uniformity of practice.

This strategy, of course, is the strategy of federalism and it exists by design, not accident.²⁸⁹ Accepting that with liberty comes both a continual disruption of established practices and an understandable quarrelling over how to reorder affairs in light of that disruption, it resists forced adherence to enlightened orthodoxy (from whatever point on the political spectrum) and instead encourages experimentation while expecting (and tolerating) errors.²⁹⁰ Unless one believes that the machinery of state governments has simply broken down, one can view developments in state corporation law in this fashion. Certain of these laws do offend venerable precepts and engage in a bit of overkill, while others are just downright puzzling. Moreover, if, as appears to be the case, takeover activity does subside, a mechanism for withdrawing (or reconsidering) those provisions which were inspired by, and aimed specifically at, takeovers is sadly lacking. Now being law, they may remain so for quite some time, and with implications unrelated to the dislocations caused by hostile takeovers. Acknowledging these defects, state law should not be displaced, unless particular corporate governance notions, however seemingly crucial, are so fundamental as to be more important than preservation of state government as a forum for differentiated responses to contemporary problems (not to mention a viable counterforce to the awesome power of the federal government). Moreover, within corporate law there is strong evidence of a genuine, if episodic and incomplete, grappling with notions that once seemed settled. This struggling would truly be academic and futile were federal law first to brand state lawmaking as deviant and renegade, and then to quash it.

289. This subpart has been influenced by John Kincaid's recent article on federalism. See Kincaid, *Federalism and Community in the American Context*, 20 *PUBLIUS* 69 (1990).

290. Alexis de Tocqueville noted the frustration that attends deference to local governments: "A very civilized society finds it hard to tolerate attempts at freedom in a local community; it is disgusted by its numerous blunders and is apt to despair of success before the experiment is finished." 1 A. TOCQUEVILLE, *DEMOCRACY IN AMERICA* 62 (J. Mayer ed. 1969). A better statement of frustration over the devolution of political power in today's Soviet Union would be hard to find.

Rethinking of core corporate law ideas is taking place by academics, practicing lawyers, business persons, and government officials, all of whom deserve an initial presumption of acting in good faith. At the same time, as the legal pendulum swings toward expansive managerial prerogative, these persons must be prepared to say how shareholders and noninvestors can be assured that such prerogative will be exercised responsibly. Bearing in mind this latter challenge, I list but a small sampling of intriguing ideas now afoot in corporate law:

1. Perhaps product and service markets in an increasingly international economy constrain and discipline corporate management more reliably than the market for corporate control.

2. Perhaps takeovers do not invariably create more efficient enterprises.²⁹¹

3. Perhaps share prices do not represent intrinsic enterprise values or accurately predict acquisition outcomes.²⁹²

4. Perhaps greater managerial accountability to shareholders does not yield better corporate performance or international competitiveness.²⁹³

5. Perhaps managerial accountability to shareholders is not as important as sometimes thought.²⁹⁴

291. Extensive evidence in both the United States and the United Kingdom casts doubt on the efficiency outcomes of hostile acquisitions. *See* Prentice & Langmore, *supra* note 256, at 448-51 nn.362-71 (U.S. data); Fortier, *Hostile Takeovers and the Market for Corporate Control*, *Econ. Persp.*, Jan.-Feb. 1989, at 2, 12 ("Research does not provide clear support for the hypothesis that there are real efficiency gains from takeovers. . . . Only with additional research can the social and economic welfare implications and policy directives regarding hostile takeovers be more precisely drawn.") John Plender describes the United Kingdom experience: "A recent Department of Trade and Industry study also highlighted the consistency with which academic work found either that takeovers failed to generate efficiency gains or that the evidence was inconclusive." Plender, *supra* note 259, at 18.

292. *See, e.g.*, Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 *YALE L.J.* 1235 (1990).

293. SEC Commissioner Philip R. Lochner, Jr. recently stated that an assumption which needs to be examined is that "shareholder accountability equals good management." *Commissioner Lochner Raises Questions Concerning Proxy Reform*, Fed. Sec. L. Rep. (CCH) No. 1400, at 1 (June 21, 1990). Commissioner Lochner also questioned the factual basis for assertions that increased corporate democracy will enhance international competitiveness. *Id.* at 2.

294. *Id.* at 1-2; Coffee, *supra* note 7 (bilateral view of corporate governance ignores interests of stakeholders).

6. Perhaps electing corporate directors only every five years will lead to better financial performance.²⁹⁵

7. Perhaps hostile takeovers should be banned or subjected to merit review.²⁹⁶

8. Perhaps other criteria for evaluating the usefulness of hostile takeovers are needed.²⁹⁷

9. Perhaps shareholder primacy is a less commanding concept today than earlier.²⁹⁸

10. Perhaps other organizational, governance and ownership structures will evolve and flourish.²⁹⁹

295. Lipton, *An End to Hostile Takeovers and Short-Termism: Corporate Governance*, *Fin. Times* (London), June 27, 1990, at 21 (arguing that the present system forces corporate management to focus on short-term performance and results, and that a "five-yearly system would permit corporations to pursue long-term planning without fear that investment in research and development, plant and equipment, expanding markets and similar short-term depressants on earnings would result in a takeover"). *Id.*

296. Trevor, *Hostile Takeovers: A U.S. Falkland Islands Where the Argentines Always Win*, in *HOSTILE TAKEOVERS: ISSUES IN PUBLIC AND CORPORATE POLICY* 16 (D. McKee ed. 1989) (proposing Abolition of Tender Offers Act); Morrissey, *Safeguarding the Public Interest in Leveraged Buyouts*, 69 *OR. L. REV.* 47 (1990) (proposing merit review of leveraged buyouts by SEC). These two proposals are interesting but require federal intervention of a kind this author believes to be both unnecessary and fraught with the usual dangers of reliance on solutions from a central authority.

297. See Cann, *supra* note 256, at 1209 (advocating innovation as the key criterion).

298. See *supra* note 7.

299. Worker ownership of businesses, especially through Employee Stock Ownership Plans (ESOPs), is one such arrangement that has generated recent interest. See Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 *YALE L.J.* 1749 (1990). The question of share ownership is a key issue in the privatization of state-owned enterprises in Central and Eastern Europe. In August 1990, this author travelled to Hungary, Czechoslovakia, and Poland with a delegation of American securities lawyers to meet with government officials of those countries about this transformation of ownership. At this time, the plan is to convert state-owned enterprises into joint stock companies. This step is relatively uncontroversial. The next step is to sell or otherwise distribute the shares of stock in those companies. How this will be done is somewhat controversial. In Czechoslovakia, for example, officials at the Federal Ministry of Finance are considering a plan whereby every citizen of the federation will receive the opportunity (via voucher) to be given one share of stock. Conversation with Jan Tauber, adviser to the Czechoslovakia Federal Ministry of Finance, August 27, 1990. At the end of the process, the citizenry at large will own 20% of the capital stock of the formerly state-owned enterprises, and transfers of that stock will be prohibited for a period of time (perhaps one year). *Id.* In Poland, by way of contrast, current plans call for distributing up to 20% of the state-owned enterprises (as converted into joint stock companies) to the employees of those companies. Conversation with Dr. Gregory Domanski, Professor of Law, Warsaw University, August 29, 1990.

Calls for federal intervention to overturn (or preempt) one or more provisions of state law (whether allowance of unequal voting rights or other practices) are claims that certain matters are settled and that uniformity of practice is a must. The "opening" of corporate law to deal with the several ideas listed above suggests those claims are more wishes than descriptions of fact. Today, those claims also often contrast the patchwork of American corporation law (as well as securities, insurance, and banking law) with European movement toward greater coordination and economic, and possibly political, unification.³⁰⁰ From a comparative perspective, the suggestion seems to be that European nations will continue to relinquish "sovereignty" over vast areas of commercial activity, including sole control over currencies. The clear implication is that Western Europe is progressing while America is caught in a retrograde time warp. Alarmed by the specter of slippage in world stature, Americans are urged to heed the call for commercial and regulatory uniformity as an indispensable plank in the platform for economic well-being, even survival.³⁰¹

This comparison is beguiling but naive. Although the United States is a mere youth compared to older European nations, we are considerably more advanced in our experience with wide scale free enterprise and capitalism. There is no reason to think the answers to certain economic questions (here, precisely what attributes should attach to corporate stock) will be the same in mature capitalist societies as in those just getting under way.³⁰² Ironically, the Western capitalism that Europe strives to emulate may be softening at the edges, not because we do not still believe in it, but because we have had longer experience with it. This irony is born of experience, however, not ideology, and so it adds a distressing tincture for those who like their legal and political doctrine pure.

The workers will have the option to buy additional shares at a 50% discount for a period of one year. *Id.* The Polish Parliament may also issue vouchers to the citizenry at large, thereby entitling each citizen to acquire stock, whether or not an employee of the particular enterprise. *Id.* See also Bobinski, *Poles Will be Given Large Share of State Industries*, *Fin. Times* (London), Sept. 7, 1990, at 6.

300. SEC Chairman Richard Breeden recently compared what he called the "balkanization" of American regulatory law with European efforts to eliminate barriers to cross-border transactions. *Supra* note 273, at 5-6. See also *supra* notes 9-10.

301. See *supra* notes 9-10.

302. See *supra* note 299 (proposed share ownership plans in Central Europe).

That demands on corporations are increasing in this country, and thereby tempering shareholder claims, is a sign that mature market economies (and the institutions operating within them) are complex and must take seriously the social, environmental and moral boundaries (and failings) of markets.³⁰³ So doing is not to understate the enormous value of lively markets and capitalism in unleashing human potential but is to attend more consciously to checking their shortcomings and excesses. This may lead to a rethinking and whittling back of certain conventions, but it does not signify a deviation from the capitalist path. It represents a healthy examination of private ownership as an evolving, flexible notion with an irrepressible social and moral dimension.³⁰⁴ It sees competition itself as a banded or "encapsulated" phenomenon having free reign within a province the size and shape of which is demarcated by shifting laws, normative values and social bonds.³⁰⁵

To encourage rethinking of current practices is, of course, to run the risk of mistakes and to live with an untidy eclecticism. But the alternative is imposition of drab conformity by a central authority. Even when sweetened by the better-sounding names of consistency and harmony, and even when done to achieve unfettered markets, the imposition of standard behavior from on high, so as to override inferior governments, may weaken state bodies as suppliers of competing legal regimes and stifle them (and other civic associations) as mediators between a powerful central government and the individual.³⁰⁶ Paradoxically, by invoking the legal monopoly power of the

303. See Etzioni, *Encapsulated Competition*, 7 J. POST-KEYNESIAN ECON. 287 (1985) (describing how ethical precepts, social bonds, and government support work together to "encapsulate" competition within socially set limits). This article appears in somewhat modified and expanded form in A. ETZIONI, *THE MORAL DIMENSION: TOWARD A NEW ECONOMICS* (1988).

304. If centrally-planned command economies of the kind seen in the Soviet Union and Eastern Europe truly are relics of the past, new attention to the moral dimension of their polar opposite, capitalistic market-driven economies, can be expected and should be welcomed. See Johnson, *The Capitalism & Morality Debate*, 1 FIRST THINGS 18 (1990) (providing one view of this vital issue). Discussion of this issue is just getting under way in Great Britain as well. Longley, *The Business of Investing in Faith*, *The Times* (London), Mar. 17, 1990, at 12 (describing recent exchanges about the moral dimension of capitalism between business and Church of England leaders).

305. See Etzioni, *supra* note 303.

306. Professor Nisbet uses the term "intermediation" to describe the role of those groups intermediate to the individual and central governmental authority. Nisbet, *The Present Age And The State Of Community*, *Chronicles* (June 1988) at 11, 17.

highest governmental authority, the craving for uniform market solutions to *economic* problems rids the *political* arena of competition. This paradox haunts Ralph Winter's analysis and all models that hold market activity to be somehow truly independent of public action. Moreover, the disdain for messy, democratic, decentralized responses to the complexities of social transformation marks this craving as countermajoritarian in its impulses.

Furthermore, when the rhetoric is punctured, one sees that the nations of Europe are also debating some of the same issues.³⁰⁷ True, directives lowering trade barriers in the EC are spilling out of Brussels at a fast clip in the run-up to 1992. But progress on currency reform has stalled, and serious debate on what political unification really means, viz, a genuinely supra-national government is farfetched, has hardly begun. As to corporate law matters, the European Commission, after seventeen years, passed breakthrough merger legislation.³⁰⁸ But with less fanfare than some of the exciting border-dropping measures, the European Commission is also now working on several directives comprising the social charter of worker rights,³⁰⁹ including that well-known feature of the European corporate landscape workers' councils.³¹⁰ With strong social democratic traditions, not to mention markedly different institutional arrangements for share ownership,³¹¹ it can be expected that free movement of capital will not trump all other interests and that European nations will be as alert to the social

307. See, e.g., A. COSH, A. HUGHES, A. SINGH, J. CARTY & J. PLENDER, TAKEOVERS AND SHORT-TERMISM IN THE UK (Industrial Policy Paper 3, Institute for Public Policy Research 1990).

308. See *supra* note 10.

309. The first of these directives are now being released. See, e.g., *Commission Proposes Regulation of Working Hours*, Common Mkt. Rep. (CCH), Aug. 16, 1990 at 2. Soon, the EC Commission will issue a plethora of proposals. See, e.g., Buchan, *The European Market; EC Set to Renew the Battle Over Social Policy*, Fin. Times (London), Sept. 3, 1990, at 4. See generally Bercusson, *The European Community's Charter of Fundamental Social Rights of Workers*, 53 MOD. L. REV. 624 (1990); Hepple, *The Implementation of the Community Charter of Fundamental Social Rights*, 53 MOD. L. REV. 643 (1990).

310. Kellaway, *Brussels Directive Would Force EC Employers to Consult Workers*, Fin. Times (London), Dec. 5, 1990, at 3, cols. 1, 2.

311. In France and Italy, for example, the state still owns many business enterprises. In West Germany, banks own large blocks of stock in many companies. This structural pattern of ownership will, by itself, dampen the market for corporate control.

ramifications of cross-border acquisitions as any state in this country.³¹² In the mixed economy of West Germany (and Japan in Asia), now the envy of other countries, hostile takeovers are virtually unknown, so they can hardly be viewed as the *sine qua non* of prosperity. And if the European Community is broadened to include countries of yet different traditions, such as the massive liberal welfare states of Scandinavia (not to mention the countries of Central Europe) the resistance to pure capital market directives will further stiffen. The precise blending of free enterprise capitalism and social democratic practices is yet to unfold. But that it will be a blending there can be little doubt.

V. CONCLUSION

For both European nations and the United States, corporate law issues such as equal voting rights are inescapably bound up with larger social currents. Notions like investor confidence, efficiency, and liquidity, because they have been somewhat downgraded by states, must be assessed in a markedly broader and richer context, particularly as institutional investors reassert their voice in corporate affairs and talk turns to federal proxy reform. Historical, as well as cross-cultural, practice is one useful, but not dispositive, guide in this fledgling effort. As things now stand, however, one thing is clear: states occupy the position they have held all along in our country. They are sovereign over corporate stock. It is the furor caused by their exercise of that enduring sovereignty that, in the 1990s, has provoked renewed attention to fundamental matters. Now is the time to sustain that awareness, not shut it off.

312. Rice, *EC Mergers Policy: Importance of Social Policy Criteria Unclear*, Fin. Times (London), Sept. 21, 1990, at 4.

