

PROPERTY WITHOUT SOVEREIGNTY:
THE MYTH OF SHAREHOLDER DEMOCRACY

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Dalia Tsuk Mitchell*

All the stockholders act like a flock of sheep.¹

We put a man on the moon, but we can't manage the consequences of shareholder democracy.²

INTRODUCTION

Corporations are run by their managers. Under most states corporation laws, shareholders elect directors who select officers. The officers run the corporation and the directors monitor their performance. Shareholders also have statutory rights to vote on charter amendments and certain fundamental transactions such as mergers. In addition, management (by which I mean directors and officers) sometimes asks shareholders to vote to ratify corporate transactions, especially when, as in executive stock option plans, they are tainted with conflicts of interest. Voting in large public corporations is conducted by proxy. Proxies typically are solicited by the board. If the solicitation is successful, the board exercises the proxies to elect its own candidates, to make its proposed charter amendments, to engage in particular fundamental transactions, and to ratify its past decisions.

A shareholder seeking to challenge the actions of her corporation's management may engage in a proxy contest. That requires the shareholder to solicit proxies from other shareholders in competition with management. If the shareholder succeeds, she upsets management's plans, and may even oust the board. But this is rare. The board almost always dominates the proxy process. First, the only votes that count are those cast in favor of the names on the proxy, which usually are proposed by management. Furthermore, management often proposes only one candidate for each seat. Finally, 60% of American firms have a staggered board, which means that only one-third of board seats are up for election each year. A shareholder could still submit her own proxy carrying a rival slate of candidates, and if she gets more votes she wins. But unlike management, which has the right to use corporate funds to promote its slate, the

* Copyright © 2006. Associate Professor of Law, The George Washington University Law School. Thanks, appreciation, and love go to Larry for commenting on drafts, for editorial suggestions, and for innumerable conversations about corporate legal history. While he does not necessarily agree with all of my historical interpretations, his contributions are to be found in every paragraph of this article. All errors remain mine.

¹ Robert F. Herrick (cited in WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET 96 (1926)).

² Gretchen Morgenson, *Who's Afraid of Shareholder Democracy?* NYT, October 2, 2005.

shareholder has to incur her own cost of the proxy contest. This can amount to several millions of dollars. Not surprisingly, proxy contests rarely happen.³

Alternatively, and less aggressively, an individual shareholder might demand that management include a shareholder proposal along with its proxy solicitation under rule 14a-8 of the Securities and Exchange Act of 1934. But the Securities and Exchange Commission [SEC] and the courts have limited the permissible scope of shareholder proposals. Most important, a board can refuse to include a proposal dealing with “ordinary business” activity. Furthermore, a shareholder proposal that is included and voted on has no binding force. It is legally nothing more than an advice to the board, and the board can ignore it.

In short, as a recent article in *The Economist* pointedly concluded, “America is the world’s most prominent democracy, and its most successful exponent of shareholder capitalism. But when it comes to shareholder democracy, America has barely moved beyond the corporate equivalent of the rotten borough.”⁴

A similar statement could have been made in the early twentieth century. Despite milestones such as the securities acts of 1933 and 1934, which regulate the information that corporate managers provide to shareholders when soliciting their proxies before annual meetings, or the 1942 shareholder proposal rule, little has changed for shareholder democracy. Several boards of directors did recently adopt charter provisions allowing shareholders to force the resignation of any board member by withholding their votes. And, as I write this paper, the Securities and Exchange Commission, prompted by a request from the Second Circuit Court of Appeals, is considering whether companies can be required to include in their proxy solicitations shareholder proposals to demand shareholder access proposals in their bylaws. Shareholder access proposals permit shareholders to nominate their own candidates for the board in certain circumstances.⁵ Still, a thriving culture of shareholder democracy has yet to emerge.

Why does the world’s most prominent democracy allow its most prominent organizations to be run as “rotten boroughs” at the beginning of the twenty-first century? The question seems to beg an answer but, more important, it begs additional questions: What is shareholder (or corporate) democracy? What is or should be its goal? What have proponents of shareholder democracy expected of it at different points in the history of the modern corporation? What can their different ideals and ends teach us about our vision of the subject? What can they teach us about our political democracy?

As I argue in this paper, the history of conversations about the shareholder’s role in the modern public corporation reveals two competing conceptions of shareholder democracy: one focuses on the role of shareholders as investors, the other emphasizes the

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⁴ *No Democracy Please, We’re Shareholders*, THE ECONOMIST, May 1, 2004

⁵ John M. Walker, Jr., Chief Justice, United States Court of Appeals for the Second Circuit, to Giovanni P. Prezioso, General Counsel, Securities and Exchange Commission, January 9, 2006 (on file with the author).

role of shareholders as potential participants in corporate management.⁶ At certain moments in the twentieth century scholars viewed shareholders as investors and described the role of law as to guarantee that they have adequate information intelligently to participate in the market for securities. At other times, scholars stressed the need to empower or protect shareholders by making changes in the internal structure of the corporation. As should be apparent, these two conceptions of the shareholder's role correspond to two basic models of regulating corporations: regulation of the market for securities, and regulation of the corporation's internal structure.

While these broad conceptions have competed for policymakers' attention throughout the twentieth century, they have meant different things at different times. As I argue in this paper, one can trace three different interpretive frames in the course of the twentieth century. During the Progressive era, the scholars' frame of reference was the large public corporation. Their goal was to constrain potential abuses of corporate power. Their vision of shareholder democracy emphasized the role that shareholders as a group could play, either as investors or as participants, in taming corporate power.

Beginning with the New Deal and continuing roughly through the 1970s, reformers' attention shifted to the role that corporations could play in sustaining the ideal of American (political) democracy. Amidst fears of creeping totalitarianism (and later communism), they wanted to guarantee that both political and economic markets were committed to protecting individual rights (and eliminating economic and political hierarchies). The resulting vision of shareholder democracy focused not on shareholders as a group, but on protecting the rights of the individual shareholder, as a participant or as an investor, against potential abuses of power by management. Concerns about corporate power in society were replaced by concerns about managerial abuse of power. Individual shareholders were assigned the role of constraining management.

The focal point for analysis in the last decades of the twentieth century was the market. Mainstream legal scholars and economists came to believe that the market was the most effective institution to constrain corporate activities. If policymakers and legal scholars in the early twentieth century viewed shareholders as a group, and reformers in mid-century wanted to protect the individual shareholder from management's abuse of power, scholars in the late twentieth century emphasized the ability of individual shareholders, as investors or participants, freely to shape their own economic (and political) destinies. Concerns about corporate social, economic, and political power or about managerial abuse of power have dissipated; the corporation and with it corporate hierarchies have disappeared. All that was left of the shareholder's role in the corporation was her ability to vote or exit and the assumption that when fully informed investors rationally exercised their rights, the market would thrive.

While the interpretive frames have shifted from corporate power in society to internal corporate hierarchies to the market, certain assumptions have remained constant. Scholars who view shareholders as investors have focused on mandatory disclosure rules as the means of achieving shareholder democracy. At times they argued that disclosure would

⁶ *But see* Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97 (1988-89).

provide government agencies with information, which they could use to constrain corporate power. At others, they viewed shareholders as regulators and claimed that disclosure would provide shareholders information, which they could use in determining where to invest. At still others, they proclaimed that shareholders could receive the information from others on the market. Still, throughout the century, these scholars' basic premise remained the same: the shareholder's role in the large public corporation was limited to her decision to invest, or divest.

Scholars and reformers who envision shareholders as active participants in corporate management wanted to empower shareholders not necessarily by guaranteeing their active participation in corporate management, but by protecting them. In part, they feared that shareholders could not be trusted to make the correct decisions. In part, they feared that shareholders were too passive to make such decisions. Seeking to mediate their goals with their fears, they urged the protection of shareholders. Initially, they wanted to protect (and empower) shareholders as a group. Their vision was predicated upon the assumption that the law had to protect individual liberty by creating organizations where individuals could pursue their goals. By the 1940s, reflecting a changed understanding of the ideal of American democracy, scholars and reformers focused on protecting the small individual shareholders. By the 1980s, however, the assumption that the law (and the state) had to help individuals develop their goals or even protect their economic rights fell into desuetude. Instead, scholars and reformers focused on the ability of individuals to self-protect. In this intellectual milieu, the vision of the shareholder as participant has converged with the vision of the shareholder as investor. In either role, the shareholder's only goal is to maximize her profits.

The paper is divided into three parts. The first part [Disclosure, Organization, and Trust] begins by examining debates about the modern corporation in the first two decades of the twentieth century. I argue that while scholars expressed concerns about the disappearance of the individual investor in the large public corporation, they were more worried about the growth of trusts. Seeking either to eliminate monopolies or to subject them to national regulation, the early-twentieth-century Progressives converged on disclosure, either to local or national authorities, as a means of guaranteeing the prosperity of the modern economic markets.

In the 1920s, as growing numbers of investors flooded the market, scholars grew more concerned about the role of minority shareholders. In this atmosphere, prominent legal scholars and economists like Adolf A. Berle, Jr. and William Z. Ripley sought to empower the individual shareholders by organizing them. More precisely, they wanted to create institutions to protect shareholders. Presumably, they took their cue from the contemporaneous efforts to empower workers through collective bargaining and from the collective economic power represented by the corporation itself. But, as will become apparent, their interest focused not on giving shareholders meaningful voice in corporate management, but on imposing checks and balances on corporate power. When forced to choose between trusting shareholders as active agents to tame corporate power and using the goal of protecting shareholders to constrain corporate power, these scholars chose the latter.

The second part of this paper [Consumerism, Democracy, and Its Limits] demonstrates how the crash of 1929 and the following Depression shifted scholars' and reformers'

attention from the corporation back to the market. Amidst investigations of fraud and manipulation that contributed to the 1929 crash, revelations of corruption that permeated the securities market eclipsed earlier concerns about corporate power. The Securities Acts of 1933 and 1934 did not try to empower or protect shareholders. Their goal was to reinforce the ideal of a healthy free market. Accordingly, the government's role was limited to ensuring the free flow of honest information. Seeking to restore investors' trust, the securities acts (unlike other early-New Deal legislation) were not predicated upon the need for government planning, but on the ideal of consumerism. As long as individual shareholders, like individual consumers in general, were fully informed about their product, they would be able to make intelligent decisions about their securities purchases. As long as individual shareholders had access to management information, they would help free the market from fraud and manipulation.

The vision of the shareholder as participant did not disappear. In the mid-1930s, William O. Douglas reiterated Berle's and Ripley's ideas (and E. Merrick Dodd endorsed them), and in the early 1940s, the SEC adopted Rule 14a-8 to give shareholders the participatory role state law effectively denied them in managing the affairs of their corporations. By requiring management to include shareholder proposals in its proxy solicitation, reformers wanted to protect the rights of individual shareholders to share with others their ideas about the corporation's goals. As fears that totalitarianism would reach America rapidly displaced Progressive ideals about collectivism, reformers turned to the ideal of individual rights as the cornerstone of American and corporate democracy. They wanted to guarantee that the individual shareholder was protected from management's potential abuse of power.

Gradually, however, the idea that the state and its agencies should protect individual shareholders lost its power, together with the ideal of a social welfare state that sustained it. The SEC, which undertook the role of monitoring shareholder proposals, used its power to promote its changing vision of the role of corporations in society. As we will see, with the support of the SEC and the courts, rule 14a-8 has helped legitimate a rather limited vision of shareholder democracy. It was predicated upon the ability of the individual shareholder to protect herself.

As the third part [Markets, Voters, and Convergence] explores, this assumption underlay the economic theory of the firm, which has dominated corporate law in the last decades of the twentieth century. Endorsing a strong separation between the roles of shareholders and managers, proponents of this vision argued that dissatisfied shareholders should simply sell their stock. The hostile takeovers of the 1980s might have undermined the strength of their convictions, but it did not alter the basic premise: shareholder democracy thrived in the market. The shareholder's role was to maximize her profit and, with the market's (invisible-hand) assistance, she could do so herself. Law had nothing to do with it.

On this contemporary background, recent calls to give shareholders more meaningful voice in the selection of directors have distinct progressive overtones. In an intellectual milieu committed to the vision that investors are able to protect themselves, some recent board decisions that allow shareholders to force the resignation of board members by withholding their vote and the proposed shareholder proxy access proposal can only be described as empowering investors.

But these recent efforts are also rather timid. Gone is the Progressives' concern with corporate power in society and with it the assumption that shareholders could help channel corporate actions to achieve socially beneficial goals. Gone is the New Dealers' concern about hierarchy within corporations and with it the assumption that shareholders could constrain management. All that remains of the ideal of shareholder democracy is the power of shareholders to elect their directors, and to exit if they can't. In a world presumably free of corporate power and hierarchies, also gone is the concern about the shareholder's willingness or ability to tame corporations and their managements. The participating shareholder is the investor shareholder. If her share price does not soar, she can try to oust the board or sell her stock. Corporations are run as "rotten boroughs" because over the course of the past century we have eliminated all other alternatives.

1900s-1930s: DISCLOSURE, ORGANIZATION, AND TRUST

Disclosure Part I: Regulating Monopolies

The turn of the twentieth century witnessed a dramatic growth in the scale of private business organizations. Increasing consumer demand, rising numbers of skilled and unskilled workers, and an expanding pool of capital made the creation of large enterprises possible, while corporate lawyers created a variety of legal devices to help their clients to increase the scope of their operations through cooperation and combinations. Trusts, holding companies, and mergers became common, even if often contested in state courts.⁷ The nineteenth-century corporation, which was subject to strict constraints on its powers as well as limitations on its capital structure, was replaced by larger and larger units. Between 1888 and 1893, New Jersey revised its general incorporation statute to eliminate restrictions on "capitalization and assets, mergers and consolidations, the issuance of voting stock, the purpose(s) of incorporation, and the duration and locale of business." Other states followed suit, enacting more enabling incorporation statutes (including Delaware, which by the second decade of the twentieth century, would become the revolution's leader).⁸ And corporations were quick to use the power that these enabling statutes granted them. Between 1898 and 1901, "2,274 firms disappeared as a result of merger, and merger capitalization totaled \$5.4 billion."⁹

The concentration of power in the trusts and large business corporations undermined nineteenth century democratic ideals. Progressives feared that corporations were wearing away the function of the individual producer and, with it, the nineteenth-century democratic and economic ideals. These ideals were the power of markets equally to distribute the rewards of individual industry and to help conform individual liberty to socially beneficial ends. For some, individual ownership of property and participation in

⁷ ROLAND MARCHAND, *CREATING THE CORPORATE SOUL: THE RISE OF PUBLIC RELATIONS AND CORPORATE IMAGERY IN AMERICAN BIG BUSINESS* 7 (1998); William W. Fisher, III, Morton J. Horwitz, and Thomas A. Reed eds., *AMERICAN LEGAL REALISM* 130-31 (1993).

⁸ SCOTT R. BOWMAN, *THE MODERN CORPORATION AND AMERICAN POLITICAL THOUGHT* 60 (1996).

⁹ Melvin I. Urofsky, *Proposed Federal Incorporation in the Progressive Era*, 26 *AM. J. OF L. HIST.* 160, 161 (1982).

the market economy were a means of cultivating social and political citizenship. They saw in the corporation's collective ownership a threat to the idea of "ordinary producers," who "shape[d] their world on equal footing." For others, private property was a means of constraining the exercise of public power. They saw in the concentration of power in a few corporations a threat to individual autonomy. Giant corporations obfuscated "the traditional relationships between individual liberty, competition and social utility," and made impossible assessment of the national wealth based on aggregations of individual valuations.¹⁰

Seeking to sustain the nineteenth century ideals of civic engagement in the twentieth-century organizational society—to reconstitute the American democratic ideal—and to add organization, stability, and reason to what seemed to be the chaotic nature of industrial capitalism,¹¹ Progressives focused their attention on the "problem of the trusts." Some reformers emphasized the need to control business units locally so as to encourage civic participation and tame corporate power. Others wanted to subject large corporations to national regulation.¹² Interestingly, while endorsing two presumably opposing positions—decentralization and centralization of power, respectively—Progressive scholars seemed to converge on mandatory disclosure as the ultimate means of regulating corporate power.

Proponents of centralization viewed large business units (and an economy of scale) as inevitable and sought to subject them to national control. While the Sherman Act attempted to regulate trusts, the main attempt to involve the federal government in corporate regulation was the federal incorporation movement of the first decade of the twentieth century. It called for federal licensing of state-chartered corporations that engaged in interstate commerce, or alternatively federal chartering of all corporations engaged in interstate commerce. As President Theodore Roosevelt put it in his message to Congress on December 3, 1901, "In the interest of the whole people ... the Nation should, without interfering with the power of the States in the matter itself, also assume power of supervision and regulation over all corporations doing an interstate business." Roosevelt did not want to do away with big business, but rather to find ways, through national supervision and regulation, to encourage the growth of good trusts while constraining the power (or eliminating) bad trusts.¹³

While none of the numerous bills introduced in Congress between 1910 and 1914 to enact some form of federal incorporation or licensing law matured into law, the idea of federal incorporation received the support of business leaders. "George W. Perkins of the House of Morgan, railroad magnate James J. Hill, and Elbert H. Gary of U.S. Steel

¹⁰ L.S. Zacharias, *Repaving the Brandeis Way: The Decline of Developmental Property*, 82 NW. U. L. REV. 618-19 (1988). See also LAWRENCE E. MITCHELL, *SQUEEZING TRUTH FROM POWER: THE DEVELOPMENT OF AMERICAN CORPORATE CAPITALISM* (forthcoming 2007).

¹¹ RICHARD H. PELLIS, *RADICAL VISIONS AND AMERICAN DREAMS: CULTURE AND SOCIAL THOUGHT IN THE DEPRESSION YEARS* 3 (1998).

¹² MICHAEL J. SANDEL, *DEMOCRACY'S DISCONTENT: AMERICA IN SEARCH OF A PUBLIC PHILOSOPHY* 211-17 (1996).

¹³ Urofsky, *supra* note 9, at 160-170.

endorsed the measure” as discussed in a 1904 report of the Bureau of Corporations. So did the *Wall Street Journal* and *Manufacturers’ News*. And their support revealed the limits of the proposal. While all corporations engaged in interstate commerce would have to secure a federal license (or charter), to do so they had to meet minimal criteria regarding organization, capitalization, and disclosure. Seeking to fight monopolies (or bad trusts), proponents of federal incorporation put their trust in mandatory disclosure. While the Bureau of Corporations would not have power to mandate certain behavior, proponents of federal incorporation believed that by requiring corporations to publicize their finances and activities, the Bureau could ensure “that corporations represented themselves honestly and ... [abided] by federal rules.”¹⁴

Despite their concerns about the disappearance of the individual producers, proponents of centralization accepted the dominant view of their time, that is, that shareholders were investors, not proprietors.¹⁵ Moreover, they treated shareholders—the investors—as a group, and did not pay much attention to potential conflicts of interest among shareholders (for example among controlling and minority shareholders). Perhaps because they were mostly concerned about the growth of trusts, the centralizers did not focus on intra-corporate relations, but rather on ways to prevent or regulate monopolies. They assumed that by imposing mandatory disclosure rules on corporations (through local or national agencies), they would protect not only the market but also shareholders as a group from the threat of monopoly.

Disclosure as a means of regulating monopoly was also the solution proposed by proponents of decentralization, as reflected in the writing of Louis Brandeis. According to Brandeis, large business units undermined democratic institutions and eroded “the moral and civic capacities that equip workers to think and act as citizens.” As he was concerned about political as well as economic concentration of power, Brandeis did not want “to confront big business with big government.” Rather, he wanted to encourage competition by protecting small businesses from “the predatory practices of monopolies and national chains.”¹⁶ In this vein, Brandeis urged not only more effective enforcement of the Sherman Act, but also proposed banning such practices as interlocking directorates and investment bankers acting as middlemen in corporate transactions (in direct conflict with their role as trustees for investors).¹⁷

But the most important element of Brandeis’s position was disclosure. He believed that the acquisition of information “concerning the great monopolistic trusts” would allow lawmakers and policymakers to create intelligent solutions to the problem of

¹⁴ Urofsky, *supra* note 9, at 170-182.

¹⁵ MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY* 93 (1992) (suggesting that “[b]y the time of the First World War, it was common for legal writers to observe that ... the stockholders today are primarily investors and not proprietors.”).

¹⁶ SANDEL, *supra* note 12, at 211-12.

¹⁷ LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY* 61-62, 81, 109, 199-200 (1914).

trusts.¹⁸ But he also recognized the importance of publicity as a tool to regulate manipulative practices. “Compel bankers when issuing securities to make public the commissions or profits they are receiving,” and require, also, “a disclosure of all participants in an underwriting,” he wrote.¹⁹

Brandeis hoped that those involved in predatory practices would stop them once required to report them. But his disclosure solution was also meant to solve a different problem—the problem of control. As we will see in the next section, by the second decade of the twentieth century, Progressives became concerned not only about the growth of trusts, but also about the growing separation of ownership from control in large business units. The realization that the power of giant corporations was controlled by a relatively small number of prominent investors exacerbated Progressive fears about monopoly. “The goose that lays golden eggs has been considered a most valuable possession,” Brandeis wrote. “But even more profitable is the privilege of taking the golden eggs laid by somebody else’s goose.” According to Brandeis, by controlling other people’s money, investment bankers and their associates “control[ed] the people through the people’s own money.” As he saw it, control of aggregate wealth threatened political and individual liberty.²⁰

If disclosure was a means of regulating predatory practices that led to the creation of trusts, Brandeis wanted investors to act as regulators. He believed that in their investment decisions and in their selection of directors, investors could regulate corporate actions.²¹ To be able to fulfill their tasks as regulators, investors had to be informed of the corporation’s business. Disclosure, according to Brandeis, had to be “disclosure to the investor.” As if scolding advocates of centralization, Brandeis noted that filing statements with state or federal agencies or with the exchanges was inadequate disclosure. “To be effective, knowledge of the facts must be actually brought home to the investor, and this can best be done by requiring the facts to be stated in good, large type in every notice, circular, letter and advertisement inviting the investor to purchase.”²² As I argue in the following sections, the idea that the individual investor (or shareholder) could help regulate corporate activities gained much support from Progressive scholars concerned not only about monopoly but also, and, more important, about the power of those in control of corporations.

¹⁸ Osmond K. Fraenkel ed., *THE CURSE OF BUSINESS: MISCELLANEOUS PAPERS OF LOUIS D. BRANDEIS* 129-137 (1934).

¹⁹ *BRANDEIS*, *supra* note 17, at 92-108.

²⁰ *BRANDEIS*, *supra* note 17, at 18.

²¹ For one thing, he wanted directors in large businesses to be elected by regional delegates who, in turn, would be elected by members of local units (each member having one vote regardless of her capital contribution). Brandeis’s model for this organization was the English Cooperative Wholesale Society in which directors were selected by votes of delegates of retail societies, who were selected by members of the local societies—that is, consumers. *BRANDEIS*, *supra* note 17, at 208-23.

²² *BRANDEIS*, *supra* note 17, at 104.

The Problem of Control

The practices that concerned decentralizers and centralizers were, for the most part, grounded in greed. Seeking to maximize their pursuit of profits, entrepreneurs developed a variety of tools to gain them. They found ways to convince the American public to invest in their enterprises, first in bonds and preferred stock, and then, by the second decade of the twentieth century, in common stock. And they found ways to manipulate stock price as well as drain the corporation of assets purportedly intended to guarantee the payment of debt.²³

The absence of federal laws requiring and regulating corporate disclosure and inadequate self-regulation by the exchanges helped those individual entrepreneurs and businessmen seeking to benefit at the expense of the public. But, more important, was their control. While businesses grew in size, their control became concentrated in the hands of the few. By virtue of their capital and social networks, investment bankers became, as Brandeis put it in 1914, “[t]he dominant element in our financial oligarchy....”²⁴ They became promoters and directors of corporations, and were able, through their economic power, to control even those boards on which they did not sit.²⁵ In 1932, using extensive statistical data, Berle, in collaboration with Gardiner Means documented how some two hundred corporations, controlled by less than eighteen hundred men, administered over one-third of the national wealth.²⁶

By the second decade of the twentieth century, the growth of business combinations and the resulting quest for capital led to the issuance of more common stock to draw in the public investor. The 1920s witnessed the widest participation rate in the securities market, up to that point, of the small, individual purchaser. Stock ownership in large publicly-held corporations became widely dispersed; ownership became collective or aggregated, and separated from control.²⁷

The separation of ownership from control allowed corporations and, more seriously, the control group, to amass tremendous power over individuals, groups, and even the state.²⁸ “Power without responsibility is, philosophically, a perilous matter,” Berle wrote

²³ MITCHELL, *supra* note 10.

²⁴ BRANDEIS, *supra* note 17, at 3.

²⁵ BRANDEIS, *supra* note 17, at 1-27.

²⁶ ADOLF A. BERLE AND GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (2nd ed., 1968) (1932).

²⁷ MITCHELL, *supra* note 10, at Chapter 4. *See also* RALPH F. DE BEDTS, *THE NEW DEAL’S SEC: THE FORMATIVE YEARS* 6 (1964).

²⁸ Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th Century American Legal Thought*, 30 L. & SOC. INQUIRY 179 (2005).

in 1925. “[T]he history of minority-controlled corporations during the last thirty years amply demonstrates that the hazard is not imaginary.”²⁹

The erosion of the traditional *ultra vires* doctrine, which limited corporate activities to its prescribed charter powers, and the reintroduction of the idea that the power of the board of directors was “original and undelegated” rather than delegated from the shareholders, helped minimize shareholder authority. So did changing voting rules. Proxy voting—which was banned in the early nineteenth century—became at the turn of the twentieth century the norm, authorized either in a specific charter provision or a statutory provision; gradually it became a means by which voting power was taken away from the shareholder. Shareholders’ ability to remove directors at will was eliminated. In addition, while in the nineteenth century a unanimous vote was required to effect fundamental corporate changes, at the turn of the twentieth century states gradually adopted statutes allowing a majority of the shareholders to sell corporate assets. By 1926, the common law rule of unanimous vote was abrogated by statute or the judiciary in almost every state.³⁰

The individual shareholder, who in the early decades of the twentieth century gradually became a speculator,³¹ was not necessarily troubled by these transformations, at least as long as she “held [a] soaring stock.”³² But economists and lawyers raised concerns. The more dispersed stock ownership became, the easier it was for the more prominent investors—life insurance companies, trust companies, banks—to control the activities of the corporation. In 1912, Ripley pointed out that “the larger the number of shareholders, the more easily may a small concentrated block of minority shares exercise sway over all of the rest.”³³ And, in 1932, when Berle and Means called attention to the growing separation of ownership from control in large business corporations, they pointedly explained that individual investors lost control not only to management, but also, and perhaps more important, to larger investors who elected the board of directors.

Generally, allowing less than unanimous consent to determine the outcome of shareholder voting was not viewed as a serious concern. (Ripley, however, called for regulation of situations when one company purchases not the entire capital stock of another company but only 51% of it.³⁴) It was expected that, for the most part, “the interests of a minority owner run parallel to those of the controlling majority and are in

²⁹ Adolf A. Berle, Jr., *Non-Voting stock and “Bankers Control”* 39 HARV. L. REV. 673, 674 (1925-26), reprinted in ADOLF A. BERLE, JR., *STUDIES IN THE LAW OF CORPORATION FINANCE* 41 (1928).

³⁰ On these transformations, see HORWITZ, *supra* note 15, at 77-99; Adam Winkler, “*Other People’s Money*”: *Corporations, Agency Costs, and Campaign Finance Law*, 92 GEO. L.J. 871, 908-9 (2004).

³¹ MITCHELL, *supra* note 10.

³² DE BEDTS, *supra* note 27, at 7.

³³ RIPLEY, *supra* note 1, at 95.

³⁴ William Z. Ripley, *Minority Shareholders in Railroad Combinations*, 26 Q. J. OF ECON. 377, 380 (1912).

the main protected by the self-interest of the latter.” In situations where their interests diverge, the minority owner would suffer, but it seemed that such harm was an inevitable consequence of corporate, or group, enterprise.³⁵

But control by a minority of the owners—be it management, an investment banking house, or any other small controlling block—was alarming. In 1925, Berle called attention to the fact that because management stock would likely be controlled by the investment banking house that served as a promoter for the corporation, “it [was] possible, if not probable, that there [would] be attractive opportunities for manipulation of securities, for negotiating favorable contracts with allied interests, or even for giving value to stock which represents no real investment.” Given the “web of economic interests” which the investment banking house served, and from which it made its profits, it was likely that management stock would be voted for transactions that benefited the investment banking house, or even the controlling groups, but not the controlled corporation.³⁶ And William O. Douglas labeled the interests of investment banking houses “high finance,” charging that they were “interested solely in the immediate profit.” According to Douglas, the interests of high finance were different from those of small individual investors or even the corporation, but with the power of control, high finance was able to profit by siphoning money from other investors.³⁷

Theoretically, of course, even a small investor could overcome his or her “normal apathy” and launch a proxy contest to replace seated directors. But, as Berle and Means sarcastically pointed out, the only example of a shareholder who succeeded in a proxy contest in the early twentieth century was John D. Rockefeller in his fight with the management of the Standard Oil Company of Indiana. Rockefeller, who had owned 14.9% of Standard Oil for years, became displeased with the company’s management and waged a proxy fight to replace it. As Berle and Means explained, he won because of his relatively large ownership stake, his ability to fund the fight, and his own standing in the community.³⁸ He won his fight for control because he had control.

Moreover, a variety of legal tools developed to remove even the possibility that a minority shareholder would have a meaningful voice. Not only were rules banning corporations from owning stock in other corporations replaced with statutes allowing mergers and holding companies (as early as 1889 in New Jersey), but a pyramid-style structure of ownership (that is, holding stock of a corporation which owned a majority of the stock of a subsidiary) became common.³⁹ By investing in a corporation with a line of subsidiaries, “each controlled through ownership of a majority of its stock by the

³⁵ BERLE & MEANS, *supra* note 26, at 68.

³⁶ Berle, *supra* note 29, at 676. *See also* BERLE & MEANS, *supra* note 26, at 75.

³⁷ William O. Douglas, *The Forces of Disorder* (an address delivered at the University of Chicago on October 27, 1936 with additions from talks before the Economic Club of Chicago on February 1, 1938 and before the Bond Club of New York on March 24, 1937) in James Allen ed., *DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS* 9 (1940).

³⁸ BERLE & MEANS, *supra* note 26, at 76-78.

³⁹ Winkler, *supra* note 30, at 907-8.

company higher in the series,” an investor could exercise control while having a very small ownership interest in the property so controlled. Moreover, “[b]y issuing bonds and non-voting preferred stock” to public investors in the subsidiaries (rather than voting stock), an investor could exercise control by owning an even smaller percentage of the property.⁴⁰ As Ripley concluded in the mid-1920s, the holding company was yet another way to wrest control from the shareholders.⁴¹

Furthermore, while non-voting preferred stock was longstanding, in the early decades of the twentieth century certain states, including Delaware and New York, enacted statutory provisions allowing corporations to issue common stock with different voting powers (including non-voting stock). Similarly, corporations began issuing conditional or contingent voting stock, that is, stock that could vote only on the occurrence of a particular event. And while the New York Stock Exchange viewed privileging one class of common stock over others with disfavor and refused to list new issues of non-voting common stock, a different legal device—voting trusts—was allowed. It often gave the trustees almost complete control over corporate affairs without any ownership interest.⁴²

All these legal mechanisms transformed the relationship between shareholders and their corporations. Ripley cautioned that democracy was replaced with the autocracy of investment bankers,⁴³ and Berle and Means concluded in *The Modern Corporation and Private Property*, that

the usual stockholder has little power over the affairs of the enterprise and his vote, if he has one, is rarely capable of being used as an instrument of democratic control. The separation of ownership and control has become virtually complete. The bulk of the owners have in fact almost no control over the enterprise, while those in control hold only a negligible proportion of the total ownership.⁴⁴

Berle’s and Ripley’s analysis did not stop at critique. While in the early decades of the twentieth century mandatory disclosure seemed a sufficient means of regulating corporations, by the mid-1920s it was a necessary but certainly not a sufficient solution to the problems associated with the growth of the modern public corporations. As the following section elaborates, those concerned about the disappearance of the individual shareholder wanted to change the internal structure of the corporation to empower shareholders, as a group, to take a more active role in corporate management. Yet while some wanted to see mandatory voting rights, and others called for establishing permanent shareholder representative organizations, the solution that was most widely endorsed focused on the protection of shareholders as a means of taming corporate power.

⁴⁰ BERLE & MEANS, *supra* note 26, at 69-71; W.H.S. Stevens, *Stockholders’ Voting Rights and the Centralization of Voting Control*, 40 Q. J. OF ECON. 353, 355 (1926).

⁴¹ NYT Feb. 13, 1927 (discussing Ripley’s ideas).

⁴² BERLE & MEANS, *supra* note 26, at 72-75, 129-31. See also E. Parmalee Prentice, *Book Review* (Review of *Voting Trusts* by Harry A. Cushing), 29 HARV. L. REV. 237-38 (1915) (arguing that voting trusts are not democratic). On the different legal mechanisms of securing control, see also RIPLEY, *supra* note 1, at 98-105.

⁴³ NYT, Feb. 13, 1927, *supra* note 41.

⁴⁴ BERLE & MEANS, *supra* note 26, at 83. See also Berle, *supra* note 29.

Voting, Organization, and Trust

Given the changes that corporations introduced in their voting rights during the first decades of the twentieth century, it is perhaps not surprising that reformers wanted to impose mandatory voting regimes. Take, for example, Eustace Seligman of Sullivan & Cromwell. In the mid-1920s, after criticizing the growingly popular corporate allocation of different voting powers to different classes of common stock, Seligman suggested that all common stock should have equal voting power. Viewing the shareholders' right to vote as derived from their ownership interest, Seligman described non-voting stock as depriving owners of one of the essential attributes of property and allowing the concentration of power in the hands of the few "in a manner inconsistent with the democratic tendencies of our modern political, as well as business, life."⁴⁵ (As already noted, the New York Stock Exchange also opposed the practice of issuing non-voting stock.) Moreover, Seligman wanted to mandate that, at all elections of directors, the voting should be cumulative, or as he also put it, that there would be proportional representation on the board. Alternatively, Seligman argued that customers, employees, and the general public should be issued different classes of stock, each entitled to elect a number of directors proportionate to the number of shares of stock held by the class.⁴⁶ His was, perhaps, the first articulation of the stakeholder model of corporate governance.

To allow shareholders to have a meaningful vote, Seligman also insisted that corporate management be required to provide adequate financial information to shareholders (and that management be prevented from using corporate funds to defend itself in a proxy fight).⁴⁷ By eliminating informational or financial advantages, Seligman wanted to level off the battlefield between management and its shareholder opponents; he wanted to eliminate, or at least minimize, intra-corporate power inequalities.

Like Brandeis's disclosure ideal, Seligman's solution was predicated upon the twin assumptions that the shareholder's role in corporate management was limited to the selection of directors and that shareholders wanted to play that role. Like Brandeis, Seligman also seemed to assume that shareholders by the sheer power of their vote would be able to constrain management's power. Other reformers did not share his assumptions.

Take, for example, Ripley. Ripley viewed the disappearance of the individual producer as impairing the march of the American civilization. "Our civilization," he wrote, "is founded on the private possession of property. We hold that the enjoyment of the fruits of labor through private property contributes to higher living standards, progress, family life and happiness." To prevent the risk that large corporations might

⁴⁵ Reflecting his concerns about the attributes of ownership, Seligman also suggested, as solutions to the problem of control, putting limits on a corporation's accumulation of capital so as to force directors to distribute dividends, and giving employees rights to profit through tools other than stock ownership—so as to avoid restraints on alienation of employee stock.

⁴⁶ Eustace Seligman, *The Relation of Law to the Modern Developments in Property Ownership*, PROCEEDINGS OF THE ACADEMY OF POLITICAL SCIENCE IN THE CITY OF NEW YORK Vol. 11, No. 3 (Popular Ownership of Property: Its Newer Forms and Social Consequences) (Apr., 1925), pp. 88-102.

⁴⁷ Seligman, *supra* note 46.

eliminate the individual producer, Ripley wanted to create “some permanent agency” to represent “the shareholder’s right, title, and interest” and to awake “sufficient interest among the electorate to induce at least an intelligent minority to take part.” According to Ripley, “the participation of such an intelligent minority” would make corporate democracy “tolerable.”⁴⁸

Ripley compared his proposed shareholder organization to the labor union. In a pointed statement he wrote:

The parallel between the post-war situation in the field of labor and that of ownership and management of corporations is striking. The following excerpt from President Wilson’s Mediation Commission, substitution being made of “shareholder” for “employees” is directly in point. “Broadly speaking, American industry lacks a healthy basis of relationship between management and men. At bottom this is due to the insistence by employers upon individual dealings with their men. Direct dealings with employees’ organizations is still the minority rule in the United States.... The leaders in industry must go further; they must help correct the state of mind on the part of labor; they must aim for the release of normal feelings by enabling labor to take its place as a cooperator in the industrial enterprise. In a word, a conscious attempt must be made to generate a new spirit in industry.”

If the result in the field of labor was “the introduction of employee investment, of the company union, and even of labor membership on the board of management,” then, according to Ripley, similar solutions should be extended also to the field of ownership.⁴⁹

One should be careful, however, not to read into Ripley’s calls for the establishment of shareholders organizations strong support for active shareholder participation in corporate decision-making. For one thing, Ripley derived the idea from the temporary protective committees formed to protect the property interests of security holders during corporate reorganizations. In this vein, Ripley thought that the chief goal of the permanent shareholder organization (which could take the form and role of the executive committee) was to act as a supervisory council, especially with respect to the independent auditing of accounts. It could elect the independent auditor who would be accountable to it and act under its supervision.⁵⁰

Ripley wanted to guarantee that shareholders’ interests were protected but, more important, the organization he imagined was meant to impose checks and balances on corporate power. Ripley stressed that the goal of the permanent shareholder organization was not to engage in wars with management. Rather, recognizing that “full responsibility and authority [were] ... vested in the directorate,” Ripley wanted to create a liaison between the shareholders and management—another check on management power.⁵¹ By

⁴⁸ RIPLEY, *supra* note 1, at 131-33.

⁴⁹ RIPLEY, *supra* note 1, at 137-138.

⁵⁰ As if anticipating the creation of the SEC, Ripley also noted that “the Federal Trade Commission or some other prominent governmental agency should have jurisdiction over all such matters...” RIPLEY, *supra* note 1.

⁵¹ RIPLEY, *supra* note 1, at 133-42.

bringing shareholders and management together, Ripley thought to make corporations self-regulating. He assumed that cooperation between shareholders and management would limit potential abuses of corporate power.

Ripley's concluding remarks made clear these underlying assumptions. Rather than giving voice to shareholders, the organization was meant to serve as a medium of communication between management and the passive owners. Such an organization, Ripley promised management, would be extremely beneficial to it. For example, management would find it easier to raise capital if the organization endorsed management's programs, and it would find it easier to receive sufficient proxies to constitute a quorum if the organization advised shareholders as to how to vote. Moreover, according to Ripley, by keeping shareholders informed about management plans and activities, a permanent shareholder organization would increase shareholders' loyalty even when the corporation endorsed a conservative dividend distribution plan.⁵²

More important, according to Ripley, "positively the largest single grain of comfort which directors of our great corporations might discover in this proposed participation of shareholders [had] to do with possible amelioration of their legal liability in dollars and cents." Predicting an increase in fiduciary duties litigation, Ripley suggested that "a representation or check-up committee of shareholders" would afford a welcome relief to management. As he put it:

It is not that such participation by the shareholders should hamper or really divide responsibility—that would be a blunder; but rather that the fact the board had taken counsel with such a continuing body, representative of shareholder opinion and interest, should serve as proof of good faith in case doubt should be raised or litigation pressed. Not even under delicate circumstances, need disclosure necessarily be made of all the facts to all the shareholders at the time. Not infrequently it might be impolitic in midstream of negotiation to indulge in such revelation. But if the case were squarely laid before the representative body, thereby affording an opportunity for a free interchange of opinion in advance of action, it might be an ever-present help to the directorate in time of trouble, especially as against the allegation of private or personal advantage as a leading motive.⁵³

While Ripley might have included these comments to gain the support of the business community, they also reflected his particular view of corporate power and the role of shareholders in taming it. Ripley believed that corporations could self-regulate and he envisioned shareholders collaborating with management to pursue corporate goals. Shareholder organization was required not only as a solution to the problem of concentrating power in a few hands, but also to make passive, widely dispersed owners interested in corporate affairs. According to Ripley, solutions predicated upon individual shareholder participation were bound to go wrong, but collective action had a chance of success. As Ripley put, such an organization would be able to educate individual

⁵² RIPLEY, *supra* note 1, at 144-51.

⁵³ RIPLEY, *supra* note 1, at 153.

shareholders to participate in the modern economy—to become the new individual producers and put the economy on a healthy track.⁵⁴

In the mid-1920s, Berle shared Ripley's belief in self-regulation and its corresponding understanding of the shareholder's role in the corporation. Like Seligman and Ripley, Berle described the development of large corporations as creating "ownership which was irresponsible, and an extension not of personality but of something infinitely stronger than that—a kind of non-political sovereignty, a thing which was symbolized in the public mind by the word 'monopoly.'"⁵⁵ His solution, however, in the mid-1920s was similar to Ripley's. He wanted to create an intermediary organization between shareholders and the management.

Specifically, Berle's early writings suggested the creation of an organization (similar to the Investment Bankers' Association⁵⁶) to scrutinize "the corporate organization of the enterprises whose securities they float." Given that management depended on the investment banker, Berle believed the association could help limit management power with respect to the rights of investors (while allowing management to exercise its power to conduct the enterprise). In a similar manner, Berle believed that the different depositary institutions (or trust companies) could serve as a liaison "between the corporate management and the stockholders." As he explained, these institutions were better situated than the shareholder to keep informed "as to the affairs of the corporation whose stock was deposited with them." Moreover, "as representing their clients, [they] could take the action necessary to prevent or rectify violations of property rights where they occurred."⁵⁷

In short, while Seligman wanted to give shareholders the voting rights derived from ownership, Berle and Ripley wanted to create permanent institutions that would protect shareholders. Fearing that shareholders might not be willing or able to protect themselves, they wanted to establish intermediary organizations to help make corporations self-regulating.

⁵⁴ RIPLEY, *supra* note 1, at 154-55. See also NYT 11/24/1926 (reporting on Ripley's article in *The World's Work*).

⁵⁵ Adolf A. Berle, Jr., *The New Deal and Economic Liberty*, 178 ANNALS OF THE AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE 37, 41 (1935).

⁵⁶ The Investment Bankers Association was formed in 1912, a year after Kansas passed the first blue-sky law to regulate sale of securities by out-of-state corporations. Its goal was "to secure greater uniformity in state and federal laws, governing the issuance, purchase, and sale of securities." More important, it wanted to improve the prestige of the investment banking profession by strengthening the means of self regulation. While in the 1910s, the Investment Bankers' Association also supported federal regulation to eliminate securities fraud, the prosperity of the 1920s restored the Association's "faith in its own ability to discipline the securities industry." It withdrew its support for federal regulation and insisted instead that, with the Association's administrative assistance, state legislation was adequate and sufficient. MICHAEL E. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 5-21 (1970).

⁵⁷ BERLE, *supra* note 29, at 37-9.

But, unlike Ripley, Berle complemented self-regulation by strengthening the fiduciary obligations of the control group. For one thing, he argued that the control group could not, without full disclosure, allow one class of stock to appropriate to its benefit any portion of the capital contribution of any other class stock. In addition, the control group would be subject to fiduciary duties even when it exercised the voting rights of its own stock. Finally, those in control were to be held "jointly liable with directors for mismanagement of corporate affairs," unless they could prove that they did not assent to the acts of the directors.⁵⁸

While he did not necessarily believe in the ability of shareholders to participate in corporate management, Berle strongly believed in the potential effectiveness of fiduciary duties. In *The Modern Corporation and Private Property*, Berle (influenced both by his co-author, Means, and the 1929 crash) abandoned the ideal of self-regulation and instead emphasized the importance of strict enforcement of the trust relationships between those in control (directors, officers and controlling shareholders) and the corporation and its shareholders.⁵⁹

Berle did not view shareholders as regulators. But he viewed imposing fiduciary duties toward them as a means of constraining corporate power. He believed that forcing the control group to take into account the needs of the individual shareholder would channel corporate power toward socially beneficial goals.⁶⁰ Berle who, according to his biographer, wanted to be known as the Marx of the shareholders, did not seek to empower shareholders to make their own decisions regarding corporate affairs, but to protect them. Moreover, he used shareholders' disempowerment to impose fiduciary duties on management and the control group for the benefit of the corporation and society.

Berle and Ripley were concerned about the disappearance of the individual investor. But they had a broader goal: they wanted to protect shareholders so that they could limit or tame corporate power. By guaranteeing shareholder protection, albeit not empowerment, they avoided addressing potential conflicts between the shareholders' perception of their interest and broader corporate goals. In any event, as the following part explores, by the time the New Deal administration came to power, concerns about corporate hierarchies substituted for concerns about corporate power. Rather than viewing shareholders as a means of taming corporate power, scholars and reformers focused on the shareholder's vulnerability in the corporate hierarchy. As we will also see, vulnerability was an individual condition. Those viewing the shareholder as investor wanted to guarantee that the individual shareholder was informed, while those describing the shareholder as participant wanted to ensure that her (individual) voice was protected. For the most part, the idea of shareholder empowerment through organization had disappeared.

⁵⁸ Berle, *supra* note 29, at 682-90.

⁵⁹ Tsuk, *supra* note 28.

⁶⁰ Dalia Tsuk, *Corporations without Labor: The Politics of Progressive Corporate Law*, 151 U. PENN. L. REV. 1861, 1892-93 (2003).

1930S-1970S: CONSUMERISM, DEMOCRACY, AND ITS LIMITS

Disclosure Part II: Regulating Markets

The market's collapse in October 1929 painfully brought home the "feverish activity of speculation" that characterized the 1920s. But the blame for the crash was laid not only on speculation, but also, and more important, on the fraudulent practices which helped fuel speculation. According to one report, "in the ten years before 1933, total investor losses through worthless securities were approximately \$25 billion, or half of all those issued." According to the same report, even before the depression, investors' losses "reached a staggering annual total of \$1.7 billion, of which \$500 million alone was accounted for within the state of New York." Not surprisingly, the New York Stock Exchange became the focal point for reform.⁶¹

The New York Stock Exchange proclaimed its attempts to self-regulate. It recorded "its opposition to the issuance of nonvoting common stocks, and urged its listed companies to publish their quarterly earnings." But self-regulation proved ineffective especially with respect to disclosure. Neither the stock exchanges, which refused to enforce strict disclosure standards upon listed companies for fear of losing securities to other exchanges, nor the Investment Bankers Association were able to provide full disclosure to investors. Moreover, none of these self-regulatory bodies was willing thoroughly to examine their members' conflicts of interest. For the most part, these were like private clubs "in which members could do no wrong, so long as their behavior toward each other was governed by club rules." Their self regulation was often meant to protect their members rather than the investing public.⁶²

The collapse of self-regulation as a means of regulating the securities markets eclipsed Progressive concerns about the power of corporations and the control group. Revelations of investment bankers' and management's conflicts of interests and the consequential fraud on the market helped shift policymakers' and scholars' attention from regulating the internal structure of corporations back to regulating the market for securities and investments. As Berle put it in *The Nature of the Difficulty* (a memorandum co-written with Louis Faulkner and discussed with Roosevelt, Moley, Jim Angell, Tugwell, and Sam Rosenman), the investment banking community had maintained "an attitude of irresponsibility," viewing investment bankers as merchants with no responsibility to assure the value of the sold merchandise. Berle recommended the establishment of a federal body to "perform the functions of a federal Blue Sky Commission."⁶³

Indeed, the New Deal focused on restoring investors' faith in the securities market. As industrial activity and progress became "dependent upon a bewildering array of financial and organizational tools: bonds, debentures, cumulative and non-cumulative preferred stock, and common stock....,"⁶⁴ the administration was keen to guarantee that these tools

⁶¹ DE BEDTS, *supra* note 27, at 11-12.

⁶² DE BEDTS, *supra* note 27, at 12-28; PARRISH, *supra* note 56, at 36-41.

⁶³ Beatrice Bishop Berle, ed., NAVIGATING THE RAPIDS, 1918-1971: FROM THE PAPERS OF ADOLF A. BERLE 46-47 (1973).

⁶⁴ PARRISH, *supra* note 56, at 3.

would survive the Depression. Roosevelt determined to bring an end to speculation—“The joy and moral stimulation of work no longer must be forgotten in the mad chase of evanescent profits”⁶⁵ he said in his inaugural address. And, informed by the positions of centralization and decentralization alike, he determined to let in “the light of day on issues of securities, foreign and domestic, which are offered for sale to the investing public.”⁶⁶

Regulating the market and regulating corporations are of course not mutually exclusive positions. Indeed, Seligman, Berle, and Ripley, while seeking to protect shareholders as a group, also emphasized the need for adequate disclosure. Seligman demanded that management provide adequate information to shareholders in order to make shareholder voting meaningful. Ripley believed that permanent shareholder organizations would help supervise independent audits of the company’s books.⁶⁷ In a New York Times article, written shortly after the publication of *Main Street and Wall Street*, he proclaimed that “the greatest single need for the protection of the public was adequate publicity by means of intelligible financial statements... coupled with a markedly higher standard of accountability to be anticipated at the hands of the courts.”⁶⁸ Finally, Berle viewed the fiduciary duties of management and the control group as encompassing a duty to disclose. Shortly after the crash, he and Means pointedly argued that corporate information was not simply a private matter, of interest only to shareholders. They wanted corporations to provide the market with periodic statements, statements pertaining to extraordinary activities, information provided to brokerage firms, as well as information provided to financial publications.⁶⁹

But in the 1930s, the obsession with disclosure obscured the need to regulate intra-corporate relations. Berle urged Roosevelt to have a federal body with powers to plan, stimulate, and stabilize economic activity; maybe even to consider a federal incorporation act. The other brain trusters, Raymond Moley, and economist Rexford Tugwell, did, too. But Roosevelt believed that when bankers’ activities were exposed to public scrutiny, self-interest would be curbed. The different drafts of the 1933 act thus reflected the idea that federal legislation should be limited to requiring “full and fair disclosure of the nature of the security being offered and that there should be no authority to pass upon the investment quality of the security.”⁷⁰

The different drafts of the securities act of 1933 aimed to guarantee that all new securities would be registered and that issues of new securities would be “accompanied by full publicity and information and that no essentially important element attending the

⁶⁵ Franklin Roosevelt, Inaugural Address, March 4, 1933, <http://www.sechistorical.org/>.

⁶⁶ Cited in JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 19 (1982).

⁶⁷ RIPLEY, *supra* note 1, at 133-34.

⁶⁸ NYT, Apr. 29, 1926.

⁶⁹ BERLE & MEANS, *supra* note 26, at 278.

⁷⁰ SELIGMAN, *supra* note 66, at 39-63.

issue shall be concealed from the buying public.”⁷¹ Reformers wanted corporations to disclose information about the corporation’s business, its capital structure (including equity, debt, and income), the corporation’s allocation of voting rights, preferences, and dividend rights, the private interests of the underwriting syndicate and the corporation in the new issue, as well as the purposes for which the new issue’s proceeds were to be used. And they wanted this information to be disclosed both in a registration statement filed with the Federal Trade Commission and in prospectuses issued to the public.⁷² But the 1933 act did not grant power to the FTC to assess the quality of the securities issued, and it exempted from its coverage securities already issued as well as securities issued intrastate, and several other categories. As Felix Frankfurter explained, the 1933 act was “a belated and conservative attempt to curb the recurrence of old abuses which, through failure of adequate legislation, had attained disastrous proportions.”⁷³

The 1933 act aimed to restore public confidence in the markets by giving “impetus to honest dealing in securities.”⁷⁴ Gone was the earlier decades’ concern with corporate power and the rapid separation of ownership from control. The drafters of the final bill embraced the view that modern business and finance could be regulated only through the combination of flexible national administration, existing state regulation, and “individual freedom to make investment decisions.”⁷⁵ Instead of curbing corporate power through national or local regulation as the early advocates of disclosure suggested, the New Dealers trusted the individual investors—the consumers—to tame it. Traced back to Walter Weyl’s *New Democracy* (1912), this approach was not predicated upon the creation of venues for Americans “to confront the impersonal world of big business and centralized markets ... as members of traditional communities or as bearers of a new nationalism.” Rather, it rested on the assumption that individuals would be better off facing the modern economy as “enlightened, empowered consumers.”⁷⁶ As Roosevelt described the Act, it was meant to add to the rule of *caveat emptor*, “the further doctrine, ‘let the seller also beware’.”⁷⁷

The Securities and Exchange Act of 1934 followed suit. While the New York Stock Exchange was trying to demonstrate, as late as 1933, that it could regulate its members, even businessmen rapidly emphasized the need for federal regulation to prohibit “costly manipulations” and guarantee the flow of information to investors. The 1934 act thus focused on the registration of the stock exchanges and the requirement that firms traded on these exchanges file annual and quarterly reports with a newly established agency, which the act created—the Securities and Exchange Commission. The act further

⁷¹ PARRISH, *supra* note 56, at 47 (citing from Roosevelt’s message in support of the first draft).

⁷² PARRISH, *supra* note 56, at 49; SELIGMAN, *supra* note 66, at 38-9.

⁷³ SELIGMAN, *supra* note 66, at 63-71.

⁷⁴ DE BEDTS, *supra* note 27, at 33.

⁷⁵ PARRISH, *supra* note 56, at 61-62; DE BEDTS, *supra* note 27, at 34.

⁷⁶ SANDEL, *supra* note 12, at 211-17.

⁷⁷ DE BEDTS, *supra* note 27, at 33.

prohibited certain manipulative devices such as short selling used by corporate insiders and exchange members to exploit the market, and it sought to regulate insider trading by both management and controlling shareholders. To prevent fraudulent reporting, the act required “certified periodical audits for any corporation listing its securities on a national exchange.”⁷⁸ As to the shareholders’ role in the corporation—the 1934 act put their fate in the hands of the SEC, which was authorized to adopt rules regarding proxy voting when appropriate “in the public interest or for the protection of investors.”⁷⁹ As we will see, in the 1940s the SEC would use its power to promulgate the shareholder proposal rule.

William O. Douglas’s Crusade

The business community did not welcome the 1933 and 1934 acts. Of particular concern were the liability clauses of the 1933 act, which imposed civil liability on corporations and their officers not only for fraud but also for misstatements in the registration statement,⁸⁰ and the limitations on the powers of the exchanges that the 1934 act imposed. Those advocating broader corporate reform were not satisfied, either. In an article published several months after the 1933 act was passed, Berle cautioned that, while the act sought to eliminate financial fraud, it did not resolve the crucial “problem of power arising from financial control exercised by investment bankers.”⁸¹

Indeed, the vision of the shareholder as a member in need of protection did not disappear. It was powerfully reiterated in 1934 by William O. Douglas, soon to be the SEC chairman (and endorsed by E. Merrick Dodd of Harvard Law School).

Douglas emphasized that the newly enacted securities laws offered some protection to shareholders by requiring accurate disclosure in the proxy solicitation process, but he did not think disclosure was sufficient. First, like Brandeis, Douglas thought that disclosure was inadequate if it meant “registration in some dusty file in Washington or in some state capitol.” He wanted mandatory disclosure “in the sense of direct and unequivocal statement in the periodical reports to stockholders.” In this respect, Douglas would demand disclosure of directors’ compensation, the shares traded during any given period, as well as directors’ affiliations and conflicts of interest. But Douglas also believed that in certain situations, only direct prohibition (for example, demanding the separation of commercial from investment banking as under the Glass-Steagall Act of 1933) could be effective.⁸²

Concerned about the separation of ownership from control, Douglas also feared that “[p]ublicity and prohibition alone [were] too feeble for the task at hand even when they

⁷⁸ DE BEDTS, *supra* note 27, at 76-77.

⁷⁹ SELIGMAN, *supra* note 66, at 73-100, PARRISH, *supra* note 56, at 108-44.

⁸⁰ DE BEDTS, *supra* note 27, at 49-50.

⁸¹ Adolf A. Berle, *High Finance: Master or Servant*, YALE REVIEW *cited in* DE BEDTS, *supra* note 27, at 51.

⁸² William O. Douglas, *Directors who do not Direct*, 47 HARV. L. REV. 1305, 1323-25 (1934). Indeed, according to Douglas, the establishment of the SEC can be traced to ideas expressed in *Other People’s Money*. DOUGLAS, *supra* note 37, at vi.

carry adequate enforcement machinery.” Shareholders were simply too passive. As Douglas put it, given that shareholders in large public corporations “seldom [had] the desire or the initiative to act, or the ability to act intelligently,” even with full information flow, proxy voting was likely to sustain management’s control over the board.⁸³

To make disclosure more effective, Douglas wanted the SEC to buttress standards of trusteeship and responsible management through its power to regulate corporate information. As he put it before the meeting of the International Management Congress, misrepresentation in dealing with security holders “is a direct undermining of that free economic system which is necessary for the preservation and perpetuation of capitalism under a democratic form of government.” Management’s diligence and tireless devotion to the standard of fiduciary responsibility toward its shareholders was the cornerstone of Douglas’s democratic vision and he wanted the SEC to take a more active role to make corporations conform to it.⁸⁴

Moreover, Douglas viewed shareholders as participants in corporate affairs. Like Seligman, Douglas wanted to eliminate “non-voting, qualified voting, or contingent voting shares,” and to add mechanisms such as “cumulative voting, pluralistic voting, or division of stock into blocks, each block electing a specified number of directors and no more.” He hoped that such mechanisms would empower “scattered and disorganized” investors. But, like Berle and Ripley, he saw in organization the most important means of empowering shareholders or, at the very least, of protecting them.⁸⁵ Informed by the successes of the English Shareholders Protection Association and by the creation of shareholders protective committees during reorganization, Douglas wanted shareholders to form groups that could pressure corporate boards. As he explained:

The device needed is one which will give these scattered and disorganized investors group strength and power so that they can gain admittance to the councils of business and make their influence felt around the negotiation table or in the courts. Letting each investor look out for himself merely accentuates the conditions giving rise to the need for regulation and makes more likely the recurrence of abuses which have cost the investor so dearly in recent years.⁸⁶

While Douglas followed in Berle’s and Ripley’s tradition, it is important to notice the nuances between their approaches. While Berle and Ripley endorsed self-regulation, Douglas advocated a combination of self-regulation and government supervision (or

⁸³ Douglas, *supra* note 82, at 1307-1317.

⁸⁴ William O. Douglas, *Corporation Management* (an address given in Washington, DC, before the meeting of the International Management Congress on September 27, 1938), in DOUGLAS, *supra* note 37, at 56-59.

⁸⁵ For E. Merrick Dodd’s endorsement of Douglas’s position, see E. Merrick Dodd, Jr., *Statutory Developments in Business Corporations Law, 1886-1936*, 50 HARV. L. REV. 27, 51-52 n.99 (1936); E. Merrick Dodd, Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable*, 2 U. CHI. L. REV. 194, 197 n.10 (1935).

⁸⁶ Douglas, *supra* note 82, at 1307, 1330.

administration).⁸⁷ Accordingly, he urged that the organization be formed on a national basis with “some form of governmental approval or backing.” Douglas was also more explicit about the role that the organization would serve. While Ripley and Berle believed that the shareholders organization should aim to cooperate with management, Douglas viewed it as constraining management’s actions. As he pointedly put it, if such an organization were to develop, “as it easily can, into a respectable and vigilant organization, management would always gauge its policy by its vulnerability at the hands of such agency...” Moreover, while Ripley and Berle viewed shareholder organization as helping to self-regulate corporate power, Douglas envisioned a different role. He wanted the organization not only to protect stockholders “against the board or the officers,” but to serve “as effectively in any case where bondholder, debenture holder, note holder, creditor, or stockholder needed protection...” In short, while he remained concerned about corporate power, the more important issue for Douglas was corporate hierarchy. He wanted the shareholder protective organization to help any member of the corporate community who needed protection against management.⁸⁸

Notwithstanding such nuances, Douglas, like Berle and Ripley before him, was of two minds when assessing the role of the shareholder in the large public corporation. On the one hand, he wanted to empower the vulnerable, individual investor. On the other hand, he did not trust shareholders to make decisions for the greater social good. Interestingly, his solution resembled Berle’s. While Berle wanted to impose fiduciary duties on management and the control group as a means of protecting shareholders, Douglas wanted to impose such duties on the shareholder organization itself. He insisted that the shareholders’ organization had to be organized “as a quasi-public corporation on a service rather than on a profit-making basis.”⁸⁹ As such, it was required to act in the public interest.

When the stock market again collapsed in 1937, shortly after Douglas became chairman of the SEC, his plans for shareholder organizations were put on a backburner, and his attention turned to the regulation of the exchanges. On November 23, 1937, the SEC issued its demand for the New York Stock Exchange reorganization (specifically to democratize it and to adopt short-sale trading rules). “Fair play and simple honesty are a part of our inheritance. Individualism is our pole star,” Douglas told the Association of Stock Exchange Firms. As he saw it, the exchanges were “the greatest market places in the world,” and he wanted to guarantee that the consumers—buyers and sellers alike—were able to trust the market. The SEC, he stressed, was “first and last the investors’ advocate.”⁹⁰

⁸⁷ Louis Loss, *The Protection of Investors: The Role of Government*, 80 S. AFRICAN L. J. 53, 61 (1963).

⁸⁸ Douglas, *supra* note 82, at 1329-1334.

⁸⁹ Douglas, *supra* note 82, at 1329.

⁹⁰ William O. Douglas, *Reorganization Begins* (a speech delivered before the Economic Club of Chicago on February 1, 1938) and *Reorganization of the New York Stock Exchange* (an address given before the Association of Stock Exchange Firms on May 20, 1938), in DOUGLAS *supra* note 37, at 74-92. In 1938, after Congress passed the Maloney Act, empowering industry organizations to issue binding rules, the National Association of Security Dealers [NASD] was formed to

Douglas pushed the SEC toward a more statist, regulatory position. But he was never able to pass his proposed federal licensing or incorporation statute. Nor was he able to gain support for the idea of permanent shareholder organizations. Indeed when, in 1942, the SEC adopted rules to promote shareholder democracy, under the chairmanship of Ganson Purcell (Douglas resigned in 1939 to accept a seat on the Supreme Court), it was a different notion of democracy than the one Douglas, following Berle and Ripley, favored. Not only did it focus solely on corporate hierarchies rather than on corporate power, it also sought to empower individual shareholders by protecting their individual rights rather than through organization.

Democracy

The main actors in the history of the SEC believed that its role was to promote capitalism. Given the failure of self-regulation, they viewed government planning as required to guarantee the financial stability that could sustain capitalism. They presumed that the SEC would both “encourage rational organization within private groups and between private groups in order to achieve that stability,” and eliminate those market practices that threatened it. In short, the SEC “was both policeman and promoter; a vehicle for reform and a shield against more violent change.” It became a symbol of both economic and political tranquility.⁹¹

By the early 1940s, the business community came to believe that “the law, effectively enforced, assisted financial operations by policing marginal elements within the industry and by promoting minimum standards of disclosure.” As more businessmen joined the government war efforts, their influence grew. Gradually, it also became apparent, that the SEC was not “opposed to business institutions or the profit motive.” In fact, it seems that the commissioners and staff members “looked upon the SEC as an extension of business enterprise.” Between 1934 and 1940, the Commission, “utilizing full disclosure, investigations, stop orders, stock exchange surveillance, and participation in utility organization, only reduced opportunities for corporate theft and restricted the methods by which individuals, while inflicting pecuniary damage upon one another, could derange the entire economy.”⁹² It was in this atmosphere that the SEC recommended an overall change to the proxy rules.

Section 14 of the 1934 Act was meant to regulate proxy solicitation and eliminate the proxy abuse about which Berle, Ripley, Douglas and their contemporaries expressed deep concern. The section was not intended to empower shareholders, but only to “enhance management communication with stockholders within the framework of existing state corporation law.” From 1934 through 1942, the SEC promulgated rules to encourage

organize investment bankers, brokers, and traders in over-the counter markets. The NASD was to become both a trade group and an enforcement organization under the supervision of the SEC. Phillip A. Nicholas, Jr., *The Securities and Exchange Commission and the Shareholder Proposal Rule: Agency, Administration, Corporate Influence, and Shareholder Power, 1942-1988*, at 67-81 (PhD Dissertation, State University of New York at Albany, 2002).

⁹¹ PARRISH, *supra* note 56, at 179-80.

⁹² PARRISH, *supra* note 56, at 229-32.

management to communicate with shareholders, as well as communication among stockholders themselves.⁹³

The SEC might have been successful in encouraging management to provide information to shareholders. But many corporations refused to refer to shareholders' proposed actions in their proxy solicitations. In 1939, Bethlehem Steel Corporation refused to include in its proxy solicitation a request from Lewis Gilbert for a shareholder vote on "moving the annual meeting site from Wilmington, Delaware to New York City, and to change the bylaws to allow stockholders to elect the auditors." When Gilbert notified the SEC, it advised Bethlehem Steel to postpone the scheduled meeting in order to give stockholders the opportunity to revoke their proxies. Bethlehem Steel "adjourned the meeting, and sent out a second proxy statement that made reference to Gilbert's proposed actions."⁹⁴

Shortly thereafter the SEC's Office of General Counsel undertook a study of the proxy regulations and, in 1942, suggested a number of changes. These changes aimed to provide shareholders with the information necessary to enable them to exercise their voices, for example by requiring corporations to disclose executive compensation in excess of \$25,000. They also sought to give individual shareholders more meaningful voices in corporate management, for example, by allowing them to nominate director and auditor candidates and by eliminating the practice of treating unmarked proxies as affirmative positive votes. More important, the changes proposed adopting a rule requiring management to include proposals from security holders in its proxy solicitation, to allow shareholders to vote on these proposals, and, if management opposed the proposal, to allow the proponent to include 100-word supporting statement.⁹⁵

The business community overwhelmingly opposed the changes, especially the rule requiring disclosure of executive compensation and the rule eliminating "management discretion in voting unmarked proxies." Most corporations masked their objection as one of preventing the imposition of additional burdens on business during the war. But, with the war for democracy as important rhetoric, it is perhaps not surprising that there was less business opposition to the shareholder proposal rule (or to the rules allowing shareholders to nominate directors and auditors).⁹⁶

The SEC took business opposition into account and, on December 18, 1942, promptly after Congress recessed, released a watered-down version of the new proxy rules. Reacting to the general feeling that executives should not profit from the war effort, the SEC strengthened the rule requiring executive compensation disclosure (requiring disclosure of compensation in excess of \$20,000). At the same time, the SEC reacted to fears about burdening corporations, whose contributions were crucial to the war effort, by omitting the rule prohibiting management from using unmarked proxies, as well as the

⁹³ Nicholas, *supra* note 90, at 108-112.

⁹⁴ Nicholas, *supra* note 90, at 108-112. See also LEWIS D. GILBERT, *DIVIDENDS AND DEMOCRACY* (1956).

⁹⁵ Nicholas, *supra* note 90, at 108-112.

⁹⁶ Nicholas, *supra* note 90, at 116.

rule allowing shareholders to nominate directors or auditors. Opponents of the latter seemed to have convinced the SEC that it would only lead to “insincere or frivolous nominations.”⁹⁷

While they were not as vocal about it, business groups were also opposed to the shareholder proposal rule and any other form of “further legitimizing shareholder activism.” In various disparaging comments about the knowledge, intentions, and ability of small shareholders, business groups proclaimed that the rule would “allow ‘crack-pots’ to make virtually meaningless statements”; that it “would put ‘dangerous weapons in the hands of the professional troublemaker’”; and that it would increase the length of the proxy statement and burden corporations with increased cost (at a time of war). Some went as far as to suggest that “shareholder participation was not really necessary at all.”⁹⁸

Those businesses and business groups who were willing to support the rule wanted to limit the scope of shareholder democracy. They suggested imposing restrictions that would permit only shareholders who owned a certain amount of stock to include their proposals and limit the number of proposals that any shareholder could propose. They further suggested that shareholder proposals be limited to “proper subjects for shareholder action under state law, and not address the ordinary business activities under the purview of management.” The final rule endorsed the latter. It required management to include shareholder proposals in its proxy solicitation only when these proposals were “proper subjects for action by the security holders.”⁹⁹

While it was willing to change the rule’s requirement, the SEC was not willing to omit it. Proclaiming that it did not see how the shareholder proposal rule would burden corporations (even in times of war), the SEC included the shareholder proposal rule in its December 1942 release. Purcell and his team were simply keen on expanding the rights of shareholders, especially the small individual investor, or as they described her—the owner. For one thing, Purcell explained that:

... [t]he rules are based on the fact that stockholders are the owners of their corporations and the stockholders’ meetings are their meetings, and not the management’s meetings. Anybody who approaches a stockholder and asks him for his proxy, must recognize that he is asking the stockholder to appoint him as the stockholder’s agent. He should give the stockholder accurate information and must recognize his rights as the owner of the corporation.¹⁰⁰

There was little public pressure to enact the rule, but the SEC staff persisted. If early New Deal programs sought to empower organized groups such as labor unions, the shareholder proposal rule aimed at empowering small, disorganized shareholders in order

⁹⁷ Nicholas, *supra* note 90, at 118-26. It is also important to note that proponents of shareholder democracy feared that “if shareholders were only permitted to nominate one director for each available directorship,” management would include the weaker of stockholders nominees to guarantee election of management nominees. *Id.*

⁹⁸ Nicholas, *supra* note 90, at 128-30.

⁹⁹ Nicholas, *supra* note 90, at 128-30.

¹⁰⁰ Cited in David C. Bayne, S.J., *The Basic Rationale of Proper Subject*, 34 U. DET. L. J. 575, 589 (1956-57).

to allow them to fight concentrated managerial power.¹⁰¹ As Milton Freeman, the draftsman of the shareholder proposal rule, explained in 1954, they envisioned the small shareholder who treated her investment as a long-term investment as the principal beneficiary of the rule. Holders of larger blocks of shares either had control or were able to launch a proxy fight if they wanted to gain control.¹⁰² If the 1934 act was designed to protect all individual shareholders, the shareholder proposal rule focused on those most vulnerable among the shareholders. In a world growing rapidly concerned about totalitarianism, Purcell and his team wanted to protect the individual investor against management and the control group. Frank Emerson and Franklin Latcham, the avid 1950s advocates of shareholder democracy, beautifully captured these New Dealers' aspirations when they wrote:

Shareholder democracy holds promise of rekindling on a broader basis the spirit of individual inquiry and free discussion through use of the SEC provisions for security holder communication and proposals for corporate action. This, too, is salutary in that it affords a haven for human growth in an awesome atomic age.¹⁰³

Robert Healy (a former FTC counsel) was the only commissioner who voted against the adoption of the shareholder proposal rule; he believed that the rule reached beyond the remedy of disclosure and thus beyond the scope of the SEC's authority.¹⁰⁴ The shareholder proposal rule became effective January 15, 1943. In 1945, after recounting the mid-1920s attempts to empower shareholders, George Hornstein noted that with the enactment of the shareholder proposal rule, shareholder organization, while still theoretical, had become at least possible.¹⁰⁵

Democracy's Limits

The battle for shareholder democracy did not end with the adoption of the December 1942 rules. Business groups were able to interest Congress in the argument that the SEC had reached beyond its statutory power to regulate disclosure in adopting the shareholder proposal rule. Congressional hearings ensued, during which the House Interstate and Foreign Commerce Committee was able to express its displeasure over the rule, but not to eliminate it. Purcell was able to convince members of Congress that the shareholder proposal rule, by permitting communication between shareholders, was, for the most part,

¹⁰¹ Nicholas, *supra* note 90, at 153-54.

¹⁰² Milton V. Freeman, *An Estimate of the Practical Consequences of the Stockholder's Proposal Rule*, 34 U. DET. L. J. 549, 552 (1956-57).

¹⁰³ FRANK D. EMERSON AND FRANKLIN C. LATCHAM, *SHAREHOLDER DEMOCRACY: A BROADER OUTLOOK FOR CORPORATIONS* 10 (1954).

¹⁰⁴ Nicholas, *supra* note 90, at 132.

¹⁰⁵ George D. Hornstein, *A New Form For Shareholders*, 45 COLUM. L. REV. 35, 48 (1945). On the shareholder proposal rule, see also Daniel E. Lazaroff, *Promoting Corporate Democracy and Social Responsibility: The Need to Reform the Federal Proxy Rules on Shareholder Proposals*, 50 RUTGERS L. REV. 33 (1997-98).