A NON-BUREAUCRATIC ALTERNATIVE TO MINORITY STOCKHOLDERS' SUITS

A Proposal

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Minority stockholders' suits have a bad name not only because they disturb the tranquility of those in control of corporations and confuse credit raters but because they are often an instrument of more or less genteel blackmail. The existing alternatives to this procedure, however, are full of menace to any society of free private enterprise. These alternatives are "bureaucratic" in the sense that they are continually extending the power of government officials over economic life.

If the system of free private enterprise in the modern world is a delicate and shrinking plant, why bother with ways and means of saving it? Certainly the familiar arguments about its economic advantages carry weight even though the stupendous expansion of bureaucratically directed economies in Russia and Germany and Japan has diminished the impressiveness of these arguments to the layman. Apart from economic calculations, however, certain moral and political aims may be invoked to legitimize our concern for the discovery of non-bureaucratic methods of corporate control.

The moral and political issue is freedom. The accredited spokesmen of our society proclaim the dignity of the individual. Whatever discrepancies there are between profession and practice—and more than our treatment of the Negro is at stake—we can still affirm without hypocrisy that Americans believe in a commonwealth of equal opportunity.[1] Our institutions deserve respect when they have moral consequences, that is to say when they contribute to a free society. A system of free private enterprise can provide an economic basis of freedom. In a competitive market the economic position of the individual depends upon the comparatively impersonal play of the bargaining process. Where monopoly prevails, either private or governmental, economics depends on "politics", on clarifying and "pressuring" the officials of an agency whose decisions are backed by potential coercion. Under these

1. For more details see Harold D. Lasswell and Myres S. McDougal, *"Legal Education and Public Policy: Professional Training in the Public Interest"* (1943) 52 YALE L. J. 203.

conditions men grow "diplomatic" in dealing with their superiors; they cultivate compliance, not outspokenness.[2]

In developing suitable methods of corporate control we have the following principles in mind:

1. Strengthen the self-regulating tendencies of the market.
2. Adapt existing procedures to the problem as far as possible in preference to the introduction of novelties.
3. Apply scientific and prudential rules of organization.

The great self-regulator of the market is rationally calculated self-interest. The practical failure of free competition is often connected with the failure of those who participate in the market to discern and pursue their short- and long-term interest. If we can find non-bureaucratic ways of improving the rationality of judgment of more parties to the bargaining process, we will be taking steps toward the solution of our problem.

As an adaptation of existing procedures to the problem of control, the minority stockholders' suit has something to be said in its favor. It does proceed within the accepted framework of the market: business is supposed to be done for the benefit of the investors.

In a sense, too, the minority stockholders' suit can be justified in terms of certain scientific and prudential principles. The stockholders' suit demands information about what is going on in the name of the stockholders and this is fully in accord with the principle that if rational judgments are to be made about self-interest there must be access to relevant facts.

The suit, however, is limited by the circumstance that it is an *extraordinary* measure. By invoking the machinery of litigation it brings in the government as an ally not only in the quest for facts but under circumstances that point toward liability, with all the threats implied. Such proceedings should not be set in motion lightly or without preliminary access to, and evaluation of, facts on the part of the parties internal to the corporation. Up to the present our methods of internal corporate control have not developed to the point of providing parties to the enterprise with easy access to needed facts pertinent to the discovery of self-interest and the criticism of policy. In connection with this problem, the general principle of democratic government is in point, namely,

2. Freedom is best served by a balanced, not a regimented, social structure; not "one big boss" but many bargainers maintain liberty. For a well grounded exposition of these social relationships see GAETANO MOSCA, THE RULING CLASS (1939), notably Chapter 5 on Juridical Defense.

the need of an "opposition."[3] By this is meant a group sufficiently well informed to criticize the officeholders of the corporation, hence compelling a balanced discussion of corporate policy. Existing limitations apply not only to the stockholders at large but to many members of boards who are often too dependent for facts upon information supplied by the executives and managers of the corporation, or upon the dubious rumors of the "grapevine."

In the absence of a well informed opposition to counterbalance the officeholders, the control of a corporation tends to gravitate into fewer and fewer hands. The ruling faction may represent one specific interest or combination, perhaps of ownership, bondholding, commercial financing, perhaps of executives or managers.[4] The oligarchical tendencies exhibited in the inner processes of corporate control conform to the general tendencies of large-scale organizations; only a general opposition can counteract them.[5]

Ever since the study by A. A. Berle, Jr. and Gardner Means, it has been conventional to consider concentration tendencies within corporations as an instance of a supposed separation between ownership and control.[6] Yet the facts now available suggest a different interpretation, at least at the present stage of development. The immediate change is a divorce between *total* ownership and *minority* ownership control. The ruling faction continues to be an ownership faction, often a family group, that hires and fires executives and managers, some of whom are gradually absorbed, often by marriage, into the ruling group.[7]

General awareness of the concentration of policy-making inside corporations had led to a dangerous state of affairs for the future of private enterprise. More and more ownership interests grow inactive, tacitly resigning their potential power to the active ownership-management minority. But this is not the end of the matter. Our economic system is subject to recurring crises in which it is put on the defensive, and many of the passive ownership interests, despairing of any effective part in shaping internal corporate policy, acquiesce in measures that expand the role of government. The passivity of the stockholders at large, con-

3. See "The Function of the Opposition," in W. Ivor Jennings, Cabinet Government (1936) 384-388. "In fact, opposition and government are carried on alike by agreement. The minority agrees that the majority must govern, and the majority agrees that the minority should criticize" (p. 385).

4. By the nature of the facts it is difficult to arrive at a true picture of the ruling factions at any given time. For indications see certain monographs of the Temporary National Economic Committee, notably Nos. 11, 21, 29, 30, 39, 43.

5. For a classical exposition refer to Roberto Michels, Political Parties (1915).

6. The Modern Corporation and Private Property (1932).

7. See especially Monograph No. 29 of the TNEC, "The Distribution of Ownership in the 200 Largest Non-financial Corporations."

venient as it may be to the ruling minority, devitalizes the free enterprise system as a whole and prepares the way for passive resignation to the bureaucratic state.

If more ownership interests are to be transformed from the passive to the active mood, a stream of reliable facts must be at hand. For this purpose the following suggestion is advanced: Establish a stockholders' reporting service. Organize it on a non-profit professional fee basis. Put it in charge of a board of men of nationally recognized integrity. Develop a staff whose level of competence is that of such top-flight research institutions as the National Bureau of Economic Research. Finance the staff not only from fees from professional reports, but from funds publicly granted by private foundations and public-spirited individuals. One share of stock may be assigned to the institution by all corporations with enough confidence in themselves and concern for the future security of the system of free enterprise to endorse the basic idea.[8]

In evaluating this proposal it is necessary to weigh it on the scale of relevant past experience and analysis. As usual, though, it is not easy to find comparable situations, or situations, if comparable, that have been adequately investigated. One question is whether the existence of the agency might defeat its counter-monopoly purpose by increasing the cost of capital to new and small enterprises. The reply is difficult in view of our limited knowledge of the financing of such enterprises.[9] There is some indication that most of the risk financing is done by a small group of relatives and friends who would not be directly affected by the existence of the new reporting service. They should benefit indirectly in the degree to which the effect on large corporations of the new procedure is to distribute funds more widely to stockholders, in this way diminishing the practice of syphoning funds to the minority faction and its friends.

Who can be expected to use a stockholders' reporting service, once set up? May not the passivity of general ownership interests already be so great that no one will avail himself of the proffered facilities? On this point there is one encouraging sign. Interested groups are learning to use the mechanism of the modern corporation as a means of policy information. I refer to the direct or indirect purchase of stock chiefly for information purposes by customers, suppliers, competitors, labor unions,

8. When corporations do not cooperate, individual assignments of the share may be received. In possession of the stock, the potential threat of a stockholders' suit is present. Before that extremity, of course, it may be wise to denounce managements that undertake to bar access to significant information.

9. New facts will be available as the financial research program of the National Bureau of Economic Research is executed.

and other organized groups directly implicated in the far-flung network of interest that links a vast corporation with its social environment. These procedures are so new that they continue to operate somewhat beyond the spotlight of publicity. But the pressure for information is genuine and unceasing, even though round-about and little-avowed. What is proposed here is nothing more than a step toward regularizing the semi-regular methods by which the fact-getting function is now performed. One possible advantage of bringing these relations out into the open is that the emerging control mechanisms of our corporate life will be instrumented by men of conspicuous integrity and specialized professional skill in the analysis of basic information. This is a special case of the application of the policy of disclosure to the technical task of control.

A Reply

ARTHUR H. DEAN

As a proposed substitute for minority stockholders' suits, Professor Lasswell suggests a non-bureaucratic alternative to minority stockholders' suits. In brief, the suggestion is that a stockholder reporting service be established on a non-profit professional fee basis. The service will be put in charge of a board of men of nationally known integrity who would develop a staff with a high level of competence, financed not only from fees from private reports but from funds granted by private foundations and public spirited individuals.

Professor Lasswell asks, "If the system of free private enterprise in the modern world is a delicate and shrinking plant, why bother with ways and means of saving it?", the implication being, it is assumed, that if directors are not strong enough to withstand the harassment of minority stockholders' suits, the system of private enterprise itself should be changed, because "the stupendous expansion of bureaucratically directed economies in Russia and Germany and Japan has diminished the impressiveness of these arguments to the layman."

It is not the purpose of this short comment to indulge in a defense of the system of private enterprise as developed in this country, inasmuch as Germany is daily receiving the answer, it is hoped that Japan will receive it soon in greater measure and Stalin himself is reported as toasting the productive efforts of American enterprise, without which the war could not be won.

While minority stockholders' suits have been known to the law for some time, in their present virulent form they are a by-product of the depression and of the high fees awarded by courts to the successful practitioners in this field. The formula is simple: after the lapse of a certain length of time, so that a number of the participants in the transaction are dead or unavailable as witnesses, and the memories of men are dimmed by subsequent events, a stockholder who has just bought a few shares of stock seeks out a lawyer (in many instances the lawyer seeks out the stockholder) and proceeds to bring suit against one or more directors or executives of the corporation. The allegation may be that the directors or executives have taken unto themselves an enterprise, feeble and uncertain at first, but grown lusty with the years, which should more properly have been undertaken by the corporation itself. Or it is alleged that mistakes of judgment have been made or errors of computation have occurred in connection with salaries, bonuses or incentive plans. Sometimes, but not always, it is intimated by friends of the "Johnny come lately" stockholder that unpleasant publicity may be avoided and harassing litigation circumvented if a settlement is made with the plaintiff or his counsel. If settlement is made on this basis, generally speaking the money does not reach the coffers of the corporation. If a complaint should be filed, long and inconvenient examinations of the officers and directors before trial may result; the time and attention of executive officers who are defendants may be diverted from creative thought on the current affairs of the corporation, to the detriment of the stockholders, and the allegations of the complaint including unsupported allegations of fraud (inserted solely in an attempt to circumvent the running of the Statute of Limitations) must be mentioned in current proxy literature to the confusion of the stockholders.

Now directors and executives of corporations represent a cross-section of human nature. While it is believed that the vast majority of directors and executive officers are conscientious in the performance of their duties, it is always possible that they could have been mistaken in their judgment as to what was a "corporate opportunity". In some instances it is possible they were faithless to their trust or avaricious to the detriment of the stockholders. But in the case of actions attacking transactions which have taken place years ago, it is almost impossible to reconstruct the events and to view them in the light of the morality of the market place or business practices or knowledge of processes current at the time the transaction took place, or to provide the court today with a pair of spectacles which will restore the proper perspective.

Many remedies have been proposed for the harassing nature of the unwarranted minority stockholders' suit. Not because "free private enterprise in the modern world is a delicate and shrinking plant". Far from it. But because questions which are fundamentally matters of judgment, to be decided by independent directors and the majority of disinterested stockholders, are placed under the investigatory control of a relatively new and small stockholder to whom the welfare of the corporation is far less important than the possibility of a huge fee to be obtained by his lawyer. Even Secretary Ickes complains that he has found himself hampered in administering his Department by the running fire of Congressional investigatory committees, demands for the production of records and key employees and the consumption of time by investigations which might more profitably be devoted to constructive work. And Ickes is no "delicate and shrinking plant".

Yet few would deny to the Congress the power of investigation. And most students of the present phenomenon of minority stockholders' suits hesitate to deprive the stockholder of a weapon by which real breaches of trust or chicanery in corporate office may be discovered and punished. One jurist before whom many of such cases have been tried, while recognizing the harassing nature of such suits to executives currently engaged in attempting to make money for their stockholders, has likened them to the gulls in the harbor and believes that they have a certain therapeutic value in keeping corporate directors and executives on the straight and narrow path.

In the years gone by, directors were supposed to bring to the management of corporate affairs ripe and mature business judgment, broad business contacts, and a shrewd and penetrating power of analysis which would be helpful to executives whose perspective might be limited by a single corporate horizon. The increasing duties and liabilities placed upon directors and the flood of minority stockholders' suits have made it increasingly difficult to obtain the services of such directors, particularly of men of means. And after all, if directors have little or no means, or are corporate officers dependent on their salaries, then the most dire civil penalties will be of no avail to the body of stockholders who may have been mulcted.

Consequently, viewing the loss of such directors as detrimental to society, various persons have suggested curbing, limiting or "outlawing" the minority stockholders' suit without at the same time protecting fraud. Professor Lasswell suggests an additional semi-public fact finding agency.

Since the '20s the amount of information available to stockholders

in this country has been greatly increased until today there is probably no country in the world where as much information is available to the general stockholder. Contrary to the general impression, corporate accounting and corporate reporting is much more advanced in this country than in England.

The Transportation Act of 1920, Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Act of 1935, the Corporate Reorganization Act of 1938, the Trust Indenture Act of 1939, the Investment Companies Act of 1940, the Federal Communications Act, the Civil Aeronautics Act and the myriad rules and regulations issued by the various governmental departments and agencies administering these and other acts have greatly added to the information available to the government and to the stockholder. Professor Lasswell recognizes this when he states:

> "Interested groups are learning to use the mechanism of the modern corporation as a means of policy information. I refer to the direct or indirect purchase of stock *chiefly for information purposes* (italics supplied) by customers, suppliers, competitors, labor unions, and other organized groups directly implicated in the farflung network of interest that links a vast corporation with its social environment. These procedures are so new that they continue to operate somewhat beyond the spotlight of publicity. But the pressure for information is genuine and unceasing, even though round-about and little-avowed."

At the same time Professor Lasswell states:

> "Existing limitations apply not only to the stockholders at large but to many members of boards who are often too dependent for facts upon information supplied by the executives and managers of the corporation, or upon the dubious rumors of the 'grapevine'."

If we are to meet the great challenge of our postwar world, our corporate executives must not only be dynamic and creative, they must be free to devote the major portion of their time to planning and production. The time spent by executives in assembling information in examinations before trial, in actual testimony in open court and in the actual preparation for such appearances is negligible compared to the time subtracted from their creative moments by worry about the allegations in minority stockholders' suits.

Let us suppose a minority stockholders' suit were threatened, and the officers and directors involved were willing to let the proposed "stockholders' reporting service" have access to their correspondence, memoranda, books of account and testimony, further that the staff of the reporting service were of high competence and integrity and would not supply the information obtained to minority stockholders' lawyers (as

has occurred in certain investigations). The report would not necessarily be binding on the corporation, its stockholders or a court. Minority stockholders could still use material in the report detrimental to the management and disregard the constructive findings of fact. The report would not be *res adjudicata* with respect to such actions, it could not he used in defense of suits brought in other jurisdictions, and it might not be admissible in evidence. In one instance with which the writer is familiar, the independent directors attempted to have all of the relative facts submitted to a distinguished former Supreme Court Justice for their guidance, but such report did not protect the management from minority attack.[1]

Even where a majority of stockholders has full knowledge—indeed, a fairly large percentage of the stockholders may have full cognizance of the alleged dereliction of the management and be fully satisfied not to have an action brought—there is at present no means whereby the matter can be submitted to the stockholders with full and complete revelation of the facts and final, binding action taken. So far, suggestions made as to pre-trial procedure, pre-examination of the facts, etc., seem merely to substitute an additional procedure for that already in vogue. While Section 23(b) of the Federal Rules of Civil Procedure (which requires a stockholder bringing a minority action in the Federal courts to prove that he was a stockholder at the time the alleged dereliction occurred) may in theory work an injustice, as a practical matter in the majority of cases it does not. And this is true even though the origin of the rule may have been procedural rather than substantive. Other suggestions have been made for limiting the amount of stock which a stockholder must own before an action may be brought or requiring the approval of a governmental agency which would make a pre-trial examination of the facts as a condition precedent to the filing of the complaint.

It is not the purpose of this brief comment to examine such other suggested remedies, other than to say briefiy that many of the remedies so far proposed have been worse than the disease. The volume of such litigation on the whole seems to have subsided and the body of precedents which the courts are building up may serve both as a deterrent to additional stockholders wishing to try their luck at this bonanza and to corporate officers and directors who may be tempted to forget their duties. Much remains to be done in connection with clarifying the exact relationship and duties of directors and executives in large organizations, in agreeing upon the proper relationship between directors and manage-

1. Piccard v. Sperry, 36 Fed. Supp. 1006 (S. D. N. Y. 1941).

ment, and management and stockholders, and upon intelligent methods of corporate reporting, in order that stockholders may have intelligent information in readily available form on which to base decisions, without at the same time penalizing the corporation in its relationships with its competitors.

If there is to be a remedy it must provide finality. Otherwise it will only involve additional work with no certainty of result. Professor Lasswell's proposal would not provide finality. If not exceedingly well executed it could do great harm. More and better questionnaires certainly will not provide the answer.

A Third Viewpoint

DAVID L. PODELL

"Bureaucracy" has not a friend in the democratic world. For that reason it lends itself ideally to the political arena as an epithet which may be hurled back and forth to the discomfiture of the party in control. "Free enterprise" is another one of those elusive, sugar-coated and deliciously flavored political battle phrases. It is universally acclaimed because it is usually interpreted as indicating freedom from anything that is irksome to the particular group or individual. The monopolist would be free from anti-trust laws. The industrialist would be free from taxes and other such nuisances. The corporate director would be free from stockholders' suits and government supervision. Dr. Lasswell's search for a "non-bureaucratic" alternative and Mr. Dean's reply remind one of the story of the two ardent Republicans who, after a lively discussion, emerged from the contest with the firm conviction that the Democrats are all villanous.

Not all government bureaus are evil, nor are all corporate managers, nor all stockholders' suits. Each in its turn has suffered an ample measure of abuse and misuse. Each in its turn has through the years made substantial contribution toward the development of a social consciousness and fiduciary responsibility in the management of "other peoples' money."

Almost a half century ago, an ultra-conservative economist—none other than Dr. Arthur T. Hadley, of Yale—declared in his book on economics:

"If the managers of an enterprise are allowed to use other peoples' money while they risk comparatively little of their own, a number of serious evils will inevitably follow. They will persuade the public to engage in enterprises which are doomed to failure in advance, in the hope that they may themselves make a temporary profit out of their management, either in the form of large salaries or of lucrative personal contracts, or they may so manipulate the finances of the companies which they control as to make a personal profit out of fluctuations in the value of their securities. These possibilities form a temptation to waste the investor's private capital and what is far worse, to misuse an appreciable part of the public capital. The former causes loss to the individual investors directly concerned, the latter affects the whole community, consumers as well as investors, by preventing the national resources from being properly utilized. This danger is most inadequately met in the United States. There are few localities where either law or public sentiment does much to check this. In this respect America is far behind other countries.

"In most parts of Europe these evils are avoided or mitigated by holding the promoters of new concerns responsible for the correctness of their manipulations and by making it a crime for them to divert the money of investors to their own uses by lucrative private contracts."[1]

As Mr. Dean demonstrates, private industry is anything but a delicate and shrinking plant. Within our own generation it has suffered and survived the severest punishment in its history, largely visited upon it by the Kreugers, the Insulls, the Musicas and the Hopsons. These were stars of the first magnitude, shining over vast financial and industrial empires. There were many lesser luminaries. Private industry endured the severest resultant depression. It survived a flood of stockholders' suits that swept the country and roused the investors from their passivity.

One of the major reasons for this survival, if we examine recent history in its true perspective, is to be found in government regulation which has often been dubbed "bureaucracy." The exposé commenced with the Pecora investigation before a Legislative Committee of the Congress. That was soon followed by the Securities Act of '33 and the Securities Exchange Act of '34. Prior to those enactments, the Governors of the Stock Exchange were not merely a private bureaucracy; they were a complete autocracy, and to all intents and purposes above and beyond the reach of the law.

Since the enactment of these regulatory statutes our security exchanges, after going through a severe cleansing, have settled down to a level where they have never been on a sounder basis, and we have witnessed a capacity for production by private industry which is nothing short of miraculous. This has been accompanied by an upsurge in the

1. HADLEY, ECONOMICS (1897).

security markets which has been strangely free from parasitic fly-by-nights.

As one who has served in a department of the Federal government and who has defended directors, and who has presented stockholders' grievances, the writer has not the slightest hesitation in declaring that by far the most difficult and burdensome path in the field of corporate law is that which must be followed by the stockholder who seeks to invoke the only civil remedy available, the derivative suit. Mr. Dean's design of the simple pattern for the stockholder's action is indeed illuminating. One can see the stockholders and their lawyers lying low and marking time to wait for the day when the directors will be dead and the records will be destroyed, then pouncing upon the helpless corporation and its directors with the full majesty of the law. Of course, Mr. Kreuger shouted his chicanery from the housetops, and no stockholder thought of suing until he had, in sheer desperation, committed suicide. And yet, how much suffering and misery would have been spared if some "Johnny-Come-Lately" stockholder, whether he owned ten or ten thousand shares, had been able to halt Kreuger in his tracks in the early twenties, when he began his thieveries, provided only that he did not connive with Kreuger or his management in making a stealthy private settlement, and had the intestinal fortitude to fight his case through—always against tremendous odds. The fees, no matter how liberal, would have sunk into insignificance compared to the billion dollars or more he might have saved American investors alone.

A disinterested private research bureau, fully alive to its opportunities for public service, functioning as suggested by Dr. Lasswell, might well have thrown some light on the manipulations of the financial heroes named above and their various counterparts before they had progressed so far as to bring the financial world to the brink of ruin, and before they brought disrepute to the vast body of capable and conscientious corporate managers. The probability is strong, however, that such a bureau, not implemented by any legal weapons, would have encountered insurmountable difficulty in any effort to break through to the inner sanctum of financial knowledge and power.

If private settlements of stockholders' suits are conducive to various abuses, they can and should be banned. On the other hand, the full burden of retrieving the corporate assets for the benefit of the corporation should not be thrown upon the individual stockholder who determines to litigate. He should be in a position to enlist the aid of some government agency with full power to gather and supply the essential facts of any given situation. The writer endorses as particularly applicable to

derivative suits, the statement of Judge Wyzanski in the case of *Crosby Steam Gauge & Valve Co. v. Manning*,[2] where he declared:

> "Recent investigations . . . have shown how often the private defendant is helpless adequately to present its case against a monopolistic use of a patent.
> ". . . it is none too early for the Courts to modify their procedures so that there may be a more realistic trial of the complex issues of economic fact and industrial policy. . . .
> ". . . judges must be willing to hear from more than the conventional parties in an adversary procedure, to receive expert suggestions from specialized governmental agencies, to accept economic testimony appropriate for laying down a broad rule of industrial government and to frame decrees suited to the character of the many dimensions of the problem revealed."

Dr. Lasswell's disinterested, non-profit making group to observe and report on management of corporate affairs should be welcomed, not as an alternative to anything, but rather as an added contribution to that eternal vigilance which is the price of true freedom in the conduct of private corporate enterprise.

As we approach the critical Post-War Reconstruction period it is well to keep in mind the words of Chief Justice Stone when in 1934 he declared:

> "I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and major faults will be ascribed to the failure to observe the fiduciary prineiple, the precept as old as holy writ that 'a man cannot serve two masters'. The separation of ownership from management, the development of the corporate structure so as to vest in small groups control of the resources of great numbers of small uninformed investors make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function."[3]

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2. 51 F. Supp. 972, 974 (D. Mass. 1943).
3. Stone, *The Public Influence of the Bar* (1934) 48 HARV. L. REV. 1, 8.